LOBBY SEVEN

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"They write politics, we write government"

FISCAL POLICY, PART I: TAXES

Where does it come from?

"There's one for you, nineteen for me." – The Beatles

The U.S. Federal Government does almost everything on a massive scale.

The rest of the world shares eight aircraft carriers. The U.S. has ten. Eisenhower wanted some highways like the ones he saw in Germany? Let's build 47,856 miles of Interstates. The Federal Government spends close to $1.1 trillion per year just on health. That's more than the entire GDP of Mexico – and 180 other countries.

But the Federal Government is almost as good at collecting money as they are at spending it. To pay for all these goodies, they need to collect $3.6 trillion each year. That's $10 billion per day, seven days a week, 365 days a year. The collection of this money greatly affects everything citizens do: how people work, invest and spend.

- What is the difference between the deficit and the debt?
- What are some principles of a good tax policy?
- How does the Federal Government raise tax revenue?

What is the difference between the deficit and the debt?

Before we dive into the weeds, we're gonna get some of our terminology and concepts straight. If you think you already know this, well, you can skip ahead at your own peril. But it isn't an easy topic – so if we are going to talk about it, we need to agree what we're talking about.

The Federal Deficit is the difference between what the Government takes in and what it spends. It is usually expressed as an annual number, but doesn't have to be. If a government:

1. Takes in $3 trillion from taxes, fees, penalties, et cetera and,
2. Spends $4 trillion on Social Security, aircraft carriers, trips to Mar-a-Lago and the like,

Then the deficit for that year is $1 trillion.[1] They need to come up with that amount from somewhere, usually by borrowing.[2]

The Federal (or, more commonly, "National") Debt is the total amount of all the Federal debt outstanding at a point in time. If the Treasury sells $50 billion of 4-week Treasury bills, the debt increases by $50 billion. When they are paid back in 4 weeks, it will decrease by the same amount (if no new debt is issued).

The deficit and debt are related. The debt is a snapshot, taken at a specific time. The deficit is the

[1] Typically, the deficit is expressed a positive number. If the government took in $250 million more than it spent, this is called a surplus of $250 million.

[2] Or, maybe, printing new money. But that creates inflation, so governments tend to avoid it if they can.

activity of the government over a period. As an approximation, the debt today is equal to the debt 1 year ago, plus the deficit over the last year.[3]

I've heard many times – even in reputable sources – that "President Obama increased the deficit". This isn't true. When he took office, the deficit was $1,413 billion. The 2017 FY budget projects a deficit of $504 billion.[4] So he decreased the **deficit** by around two-thirds. However, because there were deficits, it is true that the debt increased under President Obama.

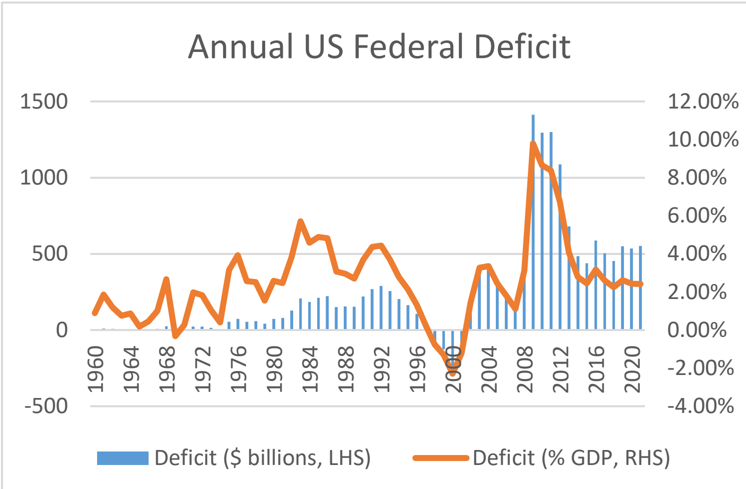


FIGURE 1 - DATA FROM USGOVERNMENTSPENDING.COM

To get a little more technical, the total (or "gross") National Debt has two components:

1. Debt held by the public: all the debt held by people, corporations, foreign governments and the Federal Reserve System. This is around $14.5 trillion.
2. Intra-governmental debt: debt held by other Federal accounts. Most of this is in the Trust Funds for Social Security, Medicare and others. This is around $5 trillion.[5]

When you talk about the debt, should you talk about the total debt or the public debt? Well, it depends; we'll use both at various points.

What are some principles of a good tax policy?

Before getting into the details of how we raise the money, let's discuss the theory, both economic and philosophical, of how we **should** fund our government.[6]

As a society, what should be the goals of our tax policy? There are three generally agreed principles of tax policy: efficiency, simplicity and equity. To be fully consistent, all goals should flow from these. But in order to get closer to direct application, it makes sense to create some goals that are a bit more specific. I think the following is a worthy list, given in my rough order of importance:

1. *Progressivity*: The wealthy should pay a higher percentage of their income in taxes. Sounds controversial – but the math makes it necessary. If everybody paid the same income tax rate (or worse yet, the same dollar amount), many more people would be unable to afford basic necessities to survive.
2. *Straightforward*: All else equal, minimizing the percentage of a country's GDP which goes to tax compliance is a good goal.

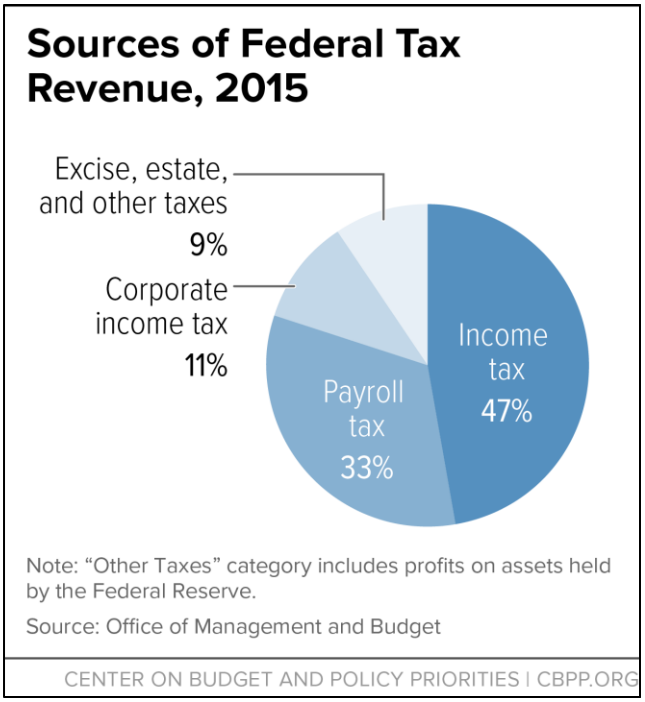
[3] This is not true, nor really that close to being true. There are other transactions that require the Federal Government to issue debt beyond funding deficits. If you want to go deeper, here is Forbes with an explanation of some of the non-deficit effects on the debt. Here is some random site that explains it well. Note: I don't know or vouch for this site.

[4] Politifact discusses Obama's claim that he reduced the deficit. They rate it only mostly true, taking issue that it is based on the 2009 rather than 2008 number. I don't understand this – an incoming President has little ability to affect federal tax or spending policy in their first year.

[5] For Federal fiscal data, there is nowhere like FRED.

[6] This is my personal process, so I'm not including a source. I'm sure it borrows ideas from many places, but so far as I know, it is my synthesis.

3. *Good Incentives*: We assume that citizens will attempt to pay as little tax as possible, as is their right. Try to make it so that in doing so, it creates a beneficial effect. However, we need to be careful about second-order effects and to not ignore Simplification.
4. *Diversification*: When different methods of taxation are used, there is less chance of a certain group being taxed unfairly.
5. *Penalize Bad Behavior*: This one isn't as obvious – clearly using less oil is good for society for many reasons, and taxing gasoline will help accomplish this. But it is a slippery slope; these penalties often break Progressivity or Simplicity.
6. *Countercyclical*: You want to raise more tax revenue in good times and less in bad. This will stabilize the economy without requiring any action be taken.
7. *Go Where the Money Is*: We can't take money from where there isn't any to be taken. This principle implies a strong avenue for government revenues: taxes on assets. The United States currently has no "wealth tax", but other countries do,[7] and they are effective revenue raisers. It is also our first argument in favor of an estate tax. The Dead have money and won't miss it.



One controversial principle is Inertia. I'm not certain about this one. On one hand, it's better to have the second-order effects we know than the ones we don't. On the other hand, is Inertia just an excuse to keep the status quo?[8]

I'm sure there are other principles, but this is a good starter set. Of course, in practice these principles are followed like a blind squirrel: we tend to follow them only through dumb luck.

How does the Federal Government raise tax revenue?

Now that we've been through the basics, it's time to drill down and see specifically how the Federal Government takes all that money out of your pocket.[9] Just over $3.2 trillion to be exact.

- Personal Income Taxes: $1.5 trillion

This is the big one, representing 47% of all Federal receipts. Personal income taxes get the most attention in the press and deservedly so. There are two basic classes of Personal Income tax: Ordinary Income and Capital Gains.

Ordinary Income is what it sounds like: money received for labor you personally have performed, including wages, tips, and bonuses. But income from a sole proprietorship, as well as items like royalties, interest and net rental income, is also treated as ordinary income. Capital Gains are the profits from selling assets, like a stock or a bond; if the asset was held for more than a year, any gain is

[7] Such as France.
[8] Under which system I've personally benefitted in the past.
[9] All of this data comes from usgovernmentrevenue.com, which has a very navigable presentation of the numbers coming from the CBO. All numbers are FY2016.

treated as Long-Term and taxed at a lower rate. So far, so good.

Ordinary Income tax rates are highly Progressive. The first dollar of taxable income faces a rate of 10%; above $441,000 of income,[10] the marginal rate is 39.6%. They are also Countercyclical; when national income slows or decreases in a recession, Income Tax receipts slow faster, providing an automatic stabilizer.

However, for reasons good and bad, individuals can reduce the amount of their income subject to taxation in various ways. The purpose is usually to try to create positive incentives. For example, tax savings for minor dependents are critical for many to start families, which is important for society. These deductions are called tax expenditures, meaning they deviate from the baseline system of taxation. The tax expenditures that are most expensive to the Federal Government are:[11]

Tax Expenditure	$ Billion 2016
Exclusion of employer contributions for medical insurance and medical care	216.1
Capital gains	93.0
Exclusion of net imputed rental income	82.4
Mortgage interest expense	75.3
Defined contribution employer plans	73.9
Deferral of income from foreign controlled corporations	67.8
Step-up of capital gains basis at death	66.7
Earned income tax credit	63.8
Deductibility of non-business state and local taxes	51.2
Deductibility of charitable contributions	47.4
Defined benefit employer plans	46.3
Child Credit	46.3
Refundable premium assistance tax credit	42.7

Deductions are strong candidates to break our rule and Create Bad Incentives. The fact that mortgage interest is deductible encourages homeowners to borrow more than they would otherwise. Deductions for state and local taxes can discourage local government efficiency; the Federal Government is picking up some of the tab. Economists tend to oppose deductions; there is good evidence that raising the same amount of tax at a lower rate, applied more equally, will help the economy. Politicians therefore talk about increasing the base and lowering rates. Unfortunately, most deductions are very popular. For instance, the rationale for charitable contribution deduction is dubious – why should my tax dollars go to support your charity? But I don't know of any politician daring to get rid of it.

Another goal you hear frequently is to "simplify the tax code." I have a humble suggestion on this front. An enormous amount of the effort is expended to structure income so that it is taxed at the lower Capital Gains rate. Eliminating the distinction between Ordinary Income and Capital Gains would simplify things greatly. Now I know the argument – you don't want to "discourage investment." But I don't see any valid economic reason to discourage work (i.e. Ordinary Income) more than investment. If Income Tax is meant to tax the accretion of wealth, each dollar of capital gains is the same as a dollar of ordinary income. This change would raise

[10] For head of household. Other filers have different brackets.

[11] I didn't know the difference between a deduction and a tax expenditure, so I asked Todd Wilkinson, Senior Associate in the Tax Practice at Jones Day. He told me: "What is a deduction to taxpayers is a tax expenditure to the government. A deduction costs something in terms of the tax revenue that would otherwise have been collected by the government. Rather than an outright spend, the government just collects less tax. Deductions are not the only tax expenditures. Tax credits, favored tax rates, and allowing a delay in the recognition of income are also tax expenditures.
A tax expenditure is easier to achieve politically than a direct spend by the government, both procedurally under the rules of Congress and usually in how it appears to voters."
List of tax expenditures from Tax Policy Center.

around $93 billion per year and make our tax code more Progressive.[12] If you liked, the top Ordinary Income brackets could have their rates reduced to make the change revenue neutral.[13]

- Payroll Taxes: $1.15 trillion

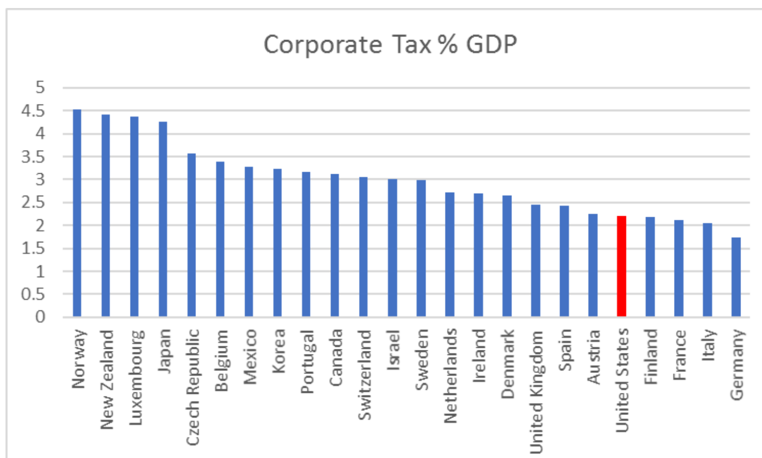
We covered Social Security at good length in Volume 1, so I won't belabor the details. Most Social Insurance taxes are withheld from wages at certain percentages. These withholdings are used to directly fund their related program: Social Security, Disability Insurance, Medicare, Unemployment (and a couple smaller ones).

However, because these withholdings are paid on the first dollar of income, and subject to a cap, they are Regressive: lower earners pay a higher percentage of their income, compared to earners with income greater than $127,200 per year. There are good reasons why this is the case, for example the benefits are usually also capped. But, when you hear on the TV that around 40% of Americans pay no *income tax*, take it with a grain of salt. Everybody pays taxes, and *payroll taxes* are the largest component for most households. In fact, overall individual Federal taxes are not progressive at the highest levels. Warren Buffett was right – he likely pays a lower tax rate than his secretary.[14]

- Corporate Income Taxes: $0.3 trillion

Corporate taxes in the United States are ridiculously complex.[15] Our fine nation has managed to create a system where we have one of the highest corporate tax rates and one of the lowest corporate tax collections. It's impressive.[16]

Country	Average Corporate Tax Rate
United States	**38.9%**
India	34.6%
Brazil	34.0%
France	33.3%
Italy	31.4%
Japan	30.9%
Australia	30.0%
Mexico	30.0%
Germany	29.7%
Canada	26.5%
China	25.0%
Spain	25.0%
Indonesia	25.0%
Euro Area	24.3%
South Korea	24.2%
United Kingdom	20.0%
Russia	20.0%



[12] The top 1%, 0.1% and 0.01% earn an inordinate amount of capital gains income.
[13] As I was going to press, came across this article, which takes a similar tack, and goes further.
[14] Back to CNN. The top 400 earners paid an average of 16.7% in income tax in 2012; because they earned an average of $336 million, payroll taxes will be a rounding error. Based on this simple calculator, a married couple, one allowance, living in NY, no other deductions will pay just over 20%.
[15] Source: Manoj Viswanathan, Associate Professor of Law, University of California – Hastings: "Corporate income taxation is an exceedingly complex area of law, as evidenced by the fact that many tax lawyers charge upwards of $1,000 an hour to advise clients on the subject."
[16] Sources: Tax rates, Trading Economics; Tax Collections: OECD.

Clearly, Corporate taxes break a lot of our rules. They are not simple and create a ridiculous set of incentives. They seem as likely to reward bad behavior as to penalize it. I won't even pretend to offer a way to improve the corporate tax system. Let's leave this one to the experts.

- Ad Valorem Taxes: $0.17 trillion

"Ad valorem" means "according to the value." These are taxes that are charged (generally) when specific things are used. Think alcohol, tobacco, gasoline, airport usage and customs. It is a small part of the total, but helps with Diversification, Simplicity and Countercyclical. They define Penalize Bad Behavior, if that's your thing. Unfortunately, they tend to be Regressive, like almost all consumption-based taxes.

- Estate and Gift Taxes: $0.02 trillion

I put this separately so that we could check off the Tax the Dead box. The money has to come from somewhere. Recall that the first $5.45 million for an individual and $10.9 for a couple is exempted from the Estate Tax. From a societal perspective, is it better to collect tax on multimillionaire deceased persons (or their heirs), or middle-class families earning the median income of $51,939 per year?

I think the worst argument against the Estate Tax is that it is "double taxation," taxing money that was already taxed. There are two major problems with the argument. First, a lot of taxes are double taxes. Sales taxes are paid with after-tax income, as are property taxes. Second, just because an asset is in an estate does not mean that it has already been taxed! Capital Gains taxes are paid only when an asset is sold. So, if an asset appreciates in value, is never sold, and the holder died, then the Estate Tax is the first tax applied. If the Estate Tax didn't exist, then the heir would never pay any tax on these assets, as the tax basis is reset to the current valuation at the time of inheritance. And there are a lot of these types of assets in the largest estates.[17]

- Federal Reserve Deposits: $0.11 trillion

We might get into details of the Federal Reserve in another volume. For now, just know that it is a series of banks that, among other things, holds U.S. Treasury and mortgage-backed securities. When it earns income on these assets, it pays the income to the Treasury. Somewhat circular – the Treasury pays the Fed interest, who then pays back the profits. But with a cool $4.5 trillion on its balance sheet, the income is nothing to sneeze at.

One item of note is that at the Federal level, there is no tax on general consumption. Of course, most states have local sales taxes. While I'm not completely opposed to consumption taxes (they are useful for Diversification), they tend to be very anti-Progressive. We haven't discussed state and local taxes, but once they are included, overall taxation in the United States is not very Progressive at all.

Let's make a completely unrealistic assumption: we are able to come to a basic agreement as to what the government should spend money on. Fixing roads? Yes. National Institutes of Health? Yes. NASA? Yes, but not as much as they want. A new superhighway, tunneling beneath Manhattan? No, too expensive.[18] Sure, some people want to spend a bit more, others a bit less overall. And everybody wants to buy slightly different things. But after friendly debate, we agree to disagree; we need a plan, we have one, and we are going forward.

That money we are spending – it has to come from somewhere. We can borrow some. As a general

[17] Life tip: Buy assets. Live off of borrowings against them. Die. Get the benefit of basis step-up at death. You never pay any taxes. Convince government to repeal estate tax; repeat with the next generation. This is basically a feudalist society.

[18] A wall on the Mexican border? Obviously a nonsense idea, we wouldn't want one even if somebody else paid.

rule, if your economy is growing over time, borrowing a little bit won't hurt you. After that, the rest must be raised through taxes.

You don't like paying taxes. I don't like paying taxes. Nobody likes paying taxes.

You think the government should be more efficient, so that you don't have to pay so many taxes. I do too. I also know that only a very small amount of government spending goes to the famous trio of "waste, fraud and abuse." We'll get into the details later – but trust me that significant cuts to Federal spending will cut things that you care about.

Since we largely agree how much tax to collect, the only question is: how should we do so? This brings me to my favorite way to think about societal "shoulds" – the Veil of Ignorance.

Created by philosopher John Rawls in his landmark book "A Theory of Justice,"[19] the idea is that the people who make decisions of these types should do so from a position of "equality and ignorance". In other words, they know about their society, but not their personal situation. They don't know their personal wealth, intelligence, talents, race, gender, religion or anything else. They make decisions as if they are a member of the society chosen at random.

According to Rawls (and I agree), this is the best way to ensure that the rules of society are set up in a just manner. It applies clearly to tax policy. A tax policy may be good for you – but is it good for society. We can't expect people to be always altruistic – but we can at least try to know when we are not.

Which isn't to say that we can't work to create a better tax system. Our current tax code is riddled with inefficiencies that promote behavior unhelpful to society. Complain about the general unfairness of taxes you must – it's a time-honored tradition. But it's a better use of your energy to recognize the importance of tax policy and work to improve the system.

[19] Available here. It was also famously used in the popular television drama "The West Wing."