Is the U.S. Fiscal System Progressive?

An Intragenerational Accounting of Spending Power Inequality

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Abstract

This study combines the 2013 Federal Reserve Survey of Consumer Finances data and The Fiscal Analyzer, an extremely detailed life-cycle consumption-smoothing program, to a) measure ultimate economic inequality – inequality in lifetime spending power -- within cohorts, b) assess fiscal progressivity, within cohorts, c) calculate marginal remaining lifetime net tax rates facing Americans taking into account all major federal and state tax and transfer policies, d) evaluate the ability of current income to correctly classify households as rich, middle class, and poor, e) determine whether current average net tax rates accurately capture actual fiscal progressivity, and f) determine whether current marginal net tax rates on labor supply accurately capture actual marginal remaining lifetime net tax rates facing U.S. workers.

The analysis is comprehensive. It includes all pre-policy economic resources (all future labor income and net wealth, include equity in homes and other real estate) as well as all major fiscal policies. These policies includes the federal personal income tax, FICA payroll taxation, state income taxes, state sales taxes, the federal corporate income tax, TAFDC welfare benefits, Food Stamps, Supplemental Security Income, Social Security benefits (nine different ones!), Medicaid benefits, Medicare benefits, and Medicare Part B premiums. The study incorporates all major features of each fiscal system. In the case of the federal personal income tax, these features include its exemptions, standard and itemized deductions, the Earned Income Tax Credit, the Child Tax Credit, the Alternative Minimum Tax, preferential capital gains and dividend tax rates, tax-deferred as well as Roth retirement accounts, the taxation of Social Security benefits, and Medicare’s high-income taxation of wages and asset income.

Comparing inequality among households no matter their age ignores the life-cycle pattern of net wealth and human wealth accumulation and decumulation. It also ignores cohort-specific and time-varying changes in labor productivity. Moreover, relating current-year tax payments to current-year income -- the standard means used by Washington to assessing progressivity -- gives the old no credit for taxes paid when young and the young no credit for taxes payable when old. Nor does it net benefits against taxes, even though one is conceptually the negative of the other.

The practice also implicitly measures economic well being based on current rather than remaining lifetime consumption. Life-cycle economic theory enjoins us to consider remaining lifetime inequality based on consumption (spending power) within, not across cohorts and to do intra-generational accounting -- to compare, within each cohort, the remaining average lifetime *net* tax rates of those with different levels of remaining lifetime resources. These net tax rates are cohort- and resource and percentile cell-specific ratios of the total expected present values of remaining lifetime net taxes of all households in the cell to the expected present value of remaining lifetime resources of all households in the cell. The term “expected” references our use of population and resource weights in forming numerators and dominators of these net tax rates as well as our actuarial discounting of future net taxes using resource-specific survivor probabilities generated in a new study by the National Resource Council (2015).

ESPlanner has been modified to include all income and asset tests of each tax and transfer program, permitting the calculation of marginal remaining lifetime net tax rates. These rates are formed by measuring the present value of additional future spending that arises from earning an extra $1,000 in the present where the timing of the additional future spending is determined by ESPlanner’s consumption smoothing. If the additional present value of spending is, say, $400, the marginal remaining lifetime net tax rate on working is 60 percent.

Our findings are striking.

* The U.S. fiscal system is highly progressive. Within each cohort those with the lowest resources face significant negative average remaining lifetime net tax rates. (At older ages, these negative net tax rates are huge.) And those with the highest resources face significant positive average remaining lifetime net tax rates (henceforth referenced simply at average net tax rates). Consider the cohort age 40 to 49 in 2010. Each dollar of pre-tax remaining lifetime resources of those in the top 1 percent of the resource distribution, is taxed, on average and on net, at a 47.2 percent rate. For those in the top quintile the average net tax rate is 40.5 percent rate. But for those in the bottom quintile, every dollar of pre-tax resources is matched by a 27.7 percent net subsidy. I.e., the net remaining lifetime net tax rate is negative 27.7 percent. Within the 70-79 year-old cohort, the average net tax rate of the top 1 percent resource holders is 27.5 percent. It’s negative 508.2 percent among the lowest resource quintile.
* Economic inequality is about the distribution of remaining lifetime spending. It is not about inequality in particular components of lifetime spending, such as wealth or Medicaid benefits. The Fiscal Analzyer’s calculation of annual spending for each SCF household permits analysis of inequality in lifetime spending. Spending (shorthand for lifetime spending or consumption) is much more equally distributed than is wealth. Take, for example, the top 1, 5, and 20 percent of the 40-49 year-old cohort. They own, respectively 17.2 percent, 40.4 percent, and 67.2 percent of all their cohort’s wealth (financial assets less financial liabilities plus home and other real estate equity). But these three percentile groups account for only 11.5 percent, 25.9 percent, and 50.6 percent of the cohort’s spending power as measured by remaining lifetime resources net of remaining lifetime net taxes. Those in the lowest quintile account for only 2.0 percent of wealth, but 4.4 percent of the cohort’s total spending power. The next three quintiles also account for much more of the cohort’s spending power than of its wealth holdings.
* To be clear, the post-fiscal policy distribution of spending remains highly unequal. The fact that 20 percent of the poorest members of American society get to consume only 4.4 percent of everything spent in the country is, arguably, extremely unfair. Our point is that the fiscal system, taken as a whole, does materially reduce inequality, not in what people own or earn, but what they, figuratively speaking, get to eat.
* Our plethora of independently designed fiscal systems and subsystems has left most households, regardless of their resource levels, with high to very high marginal remaining lifetime net marginal tax rates. Among the 40-49 year-old cohort, median marginal remaining lifetime net tax rates (henceforth referenced simply as marginal net tax rates) range are roughly 40 percent in each of the lower three quintiles, close to 50 percent in the fourth highest resource quintile, and above 50 percent in the top quintile. Median marginal net tax rates for those in the top 5 percent and 1 percent of the resource distribution exceed 60 and 70 percent, respectively.
* There is an enormous variation in net marginal taxes across households with the same or similar resources. Among the lowest quintile of 40 to 49 year-olds, the minimum remaining lifetime marginal net tax rate is minus 1534.0 percent, and the maximum is 1977.8 percent! Among the highest quintile in this age group, the minimum marginal net tax is 12.1 percent and the maximum is 88.2 percent.
* The economically appropriate way to distinguish the rich, middle class, and poor is based on pre-policy remaining lifetime resources. But using current income to form this classification can produce huge mistakes. For example, only 70.6 percent of 40 to 49 year olds who are actually in the third resource quintile would be so classified based on current income. Current-income classification also misses 20.0 percent of the richest 1 percent and 23.6 percent of the poorest 20 percent.
* Current average net tax rates dramatically understate the economically relevant remaining lifetime average net tax rates, both when these rates are positive and when they are negative. Consequently, the average current-year net tax rates that Washington commonly uses to assess fiscal progressivity are significantly understating the true degree of progressivity in the U.S. fiscal system. Take, for example, the richest (on a resource basis) 1 percent of those 50 to 59. Their average current-year net tax rate is 18.8 percent, whereas their lifetime net tax rate is 37.8 percent.
* Current median marginal net tax rates are far lower than the economically relevant remaining lifetime marginal net tax rates. Again, for the top 1 percent ages 50-59, the current-year net marginal tax rate is 42.0 percent compared to 68.8 percent – their remaining lifetime marginal net tax rate.

The dispersion in current marginal net tax rates, which is a key determinant of the economic efficiency in the U.S. fiscal system, does not represent a useful proxy for the dispersion in the economically relevant remaining lifetime marginal net tax rates.