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Scott Hodge: Hello, I'm Scott Hodge, president of the Tax Foundation. Welcome to another edition of the Tax Foundation's Tax Policy Podcast. I'm very pleased to be joined today by one of the Tax Foundation's own economists, Andrew Chamberlain. Andrew and his colleague Gerald Prante are coauthors of a new Tax Foundation study, very impressive, titled "Who Pays America's Tax Burden and Who Gets the Most Government Spending?" In other words, the study measures who pays the taxes in America and who's the target of government spending.

Andrew, what was the impetus for this study—were you at all surprised by some of the results that you found?

Andrew Chamberlain: Well, Scott, like with most of the studies that we do, when we started out we really didn't know what we were going to find. The impetus really started about a year ago. Myself and a couple other economists were at a tax analyst panel here in town and one of the panelists had a smart remark and in passing said, "You know, there's this basic problem with tax distribution studies, that they're ignoring a lot of what's going on the spending side and, there's more and more things that look like spending that are happening through the tax code today." And so we thought, well, maybe tax distributions aren't telling the whole story. So that was where we got the idea.

We headed back to the office and talked it over and started thinking about it and that ultimately resulted in our study that came out in March. The idea behind it is really very simple. Tax distributions, they tell the story that taxes make people worse off and they show which people bear the tax burden. But when we pay taxes, the government taxes those and spends those back on people. For example, they might pay your medical bills through Medicare or they might send you a Social Security check or pay for public school that you're going to send your children to. And those things presumably make people better off. So what really matters isn't just the tax burden that you pay, it's the net burden or the fiscal burden when you take account of both taxes and the spending side.

So the more we worked on this, the more we realized this was a radical shift from current thinking in Washington because tax policy here in town is driven almost exclusively by tax

progressivity and tax distributions. And what our study shows is that it's very hard to justify that. And drawing this artificial line in the sand between taxes and spending is kind of phony and really doesn't hold up anymore.

Just to give one example of the grey area between taxes and spending: Most tax distributions, they take the EITC -- the refundable portion of that -- which gives basically a cash payment to low-income households-- and they count that as a tax reduction. So that's counted as an increase in progressivity. But if you were to instead do the same thing by increasing TANF spending, which basically gives cash payments to very similar kinds of households, that's not counted as an increase in progressivity. And so the question is, "Why?" Both basically achieve the same goal. But one is counted under current practice and one isn't. It's hard to see why that makes any sense.

Scott Hodge:

Well, if you look at this as a trade-off or as an exchange, obviously some people must get far more back in spending compared to what they pay in taxes. And I would assume that there are some people that get far less back in government spending.

Andrew Chamberlain:

That's right. What our study found is that, as everyone knows, the tax system is progressive overall. But what many people don't realize is that the spending side is slightly progressive also. So when you put them together, the fiscal system is a lot more progressive than just the tax side alone. We found that if you look at government spending at all levels, on all things, it's pretty evenly distributed on a per-household basis across income groups. But because of huge differences in tax burdens across households, when you compare the spending people receive to the taxes they pay, there are big discrepancies.

So here's the bottom line. We found that people in the lowest earning group, which is households that earn below about \$23,700 a year, we found that they got about \$8.21 in government spending for each dollar of taxes that they paid. And that includes all government spending, so that's everything from welfare payments to schools to roads. Households in the middle fifth of incomes got about \$1.30 in spending back for every tax dollar they paid. And households in the top income quintile got about \$0.41. And we also looked at those ratios over time. We looked at it for a decade and a half and they've been fairly stable, and have actually grown slightly since the 1990s.

Scott Hodge: So obviously this means – if folks in the top are getting less back in what they pay in taxes that obviously means that there's a considerable amount of redistribution that's going on. What does that amount to? How much is government actually redistributing resources from one group of Americans to another?

Andrew Chamberlain: Right. Well, on a net basis we found that the two top income groups that contain 40 percent of individuals paid more taxes than they received in all government spending. And in contrast the bottom three income groups which contain 60 percent of people actually were targeted with more spending than they paid in taxes. So if you look at the difference between those two numbers, it's what we call "fiscal redistribution" in our study, and it's between \$1 trillion and about \$1.5 trillion for 2004. So that's a lot of money.

Scott Hodge: Wow. Well, but I guess lost in what you just said is that 60 percent of American households are getting more back in spending than what they're paying in taxes? Is that what I understand it to say?

Andrew Chamberlain: That's exactly right. I mean, if you look at where government spends dollars at all levels on all things, the three bottom income groups that contain 60 percent of people, the government spends more money on them than they actually pay back in taxes as a group. Of course, there may be some individuals within those groups that fare differently. But as a group, those bottom three quintile come out ahead, which is kind of a surprising result.

Scott Hodge: Now, you're – you've looked at this in the aggregate and that is, all spending, all taxes from local property taxes, all the way up to federal income taxes. Now, I assume that this breaks down differently at – if when you just isolate the state and local tax and spending distribution versus what you see at the federal level. Tell me about some of those differences if we take those apart and isolate just the federal versus the state and local.

Andrew Chamberlain: Yeah, you're right that there are very big differences between state and local spending and federal spending. And that's because they are focused on very different things. Federal spending is heavily composed of transfer payments -- much more so than at the state and local level. That includes things like the refundable portion of the EITC that we talked about earlier, but the big ones are Social Security and Medicare payments, things like veteran's benefits, and then there are other things like Medicaid and so on. Those

make up a huge component of federal spending, and as a result that shows up in the numbers.

Before we said the lowest income group received about 8.21 in total government spending for every tax dollar paid. That was the total. But at the federal level, that lowest-income group received about \$14.76 in federal spending for each federal tax dollar. And the top income group received about \$0.32 for every tax dollar. So that's a very striking difference and it's mostly because the federal tax system is highly progressive and the federal spending system is more progressive than the state and local system also.

At the state and local level you get less of that. There's less fiscal redistribution going on, and the reason is because state and local governments spend an awful lot on education. In 2004, state and local government spending on education at all levels was actually larger than federal government spending on national defense, which I think would surprise a lot of people. A lot of upper-income families in the top income groups tend to have a lot of kids, or another way to think of it is large families have a lot of earners. They have two people working and that throws them up into the top income quintiles. As a result, education spending tends to disproportionately benefit some upper-income groups and that flattens out the state and local distribution. So at the state and local level we found that the lowest income group got about \$4.03 for every tax dollar paid in. And upper-income households got about \$0.61.

Scott Hodge:

Now, you've included, obviously, all spending, which means a lot of what you might call public goods like national defense, what – there is probably some health spending in there, that sort of thing. How does that sort of impact the overall distribution of spending versus taxes, and some might say that it's probably, maybe unfair to lump that in since, gosh, you know, we all benefit from those things. What if you take those out, how does that change the basic result?

Andrew Chamberlain: Right. Well, all throughout our study we show all the results with and without what we call “public goods.” And public goods are things where once the government supplies them to one person, basically everyone gets them and they can't stop anyone else from using them. And so, because our study just looks at where government spends dollars and it doesn't look at how much people subjectively benefit from government spending, those things are supplied evenly by governments to households. In our study

public goods are about \$8,000 per household at all levels of government.

So if you pull out public goods, it drops the amount of government spending that all households receive down by the same amount, but it doesn't change the overall trends between the two. So in our study, instead of \$8.21 for every tax dollar, the lowest income group would receive \$6.33 if you pull out public goods. And the top group, instead of getting \$0.41, would get \$0.31.

In our study we wanted to look at the total fiscal picture, every tax and every government spending program, because we wanted to look at the priorities of the state -- where the state was getting dollars and where it was spending them back. So we included every kind of government spending. But for some purposes people might only want to look at cash transfer payments because they might want to look at how government activities affect the income distribution, for example.

Now, in a future project we're going to take that up. But in this one, in its first step, we decided to include public goods because we felt like leaving them out just left this huge hole in the project. I mean, leaving them out gives the impression that those dollars are simply wasted, as though they were going to no one, and that's obviously not true. Environmental protection and defense and other public goods, they go to somebody. And in our study they go to every household equally, because that's the way they're supplied by governments, regardless of how much different people might value what is provided to them.

Scott Hodge:

Now, you – you're obviously looking at the big picture in this particular study, but I understand that you were going to start looking at this sort of spending and tax distribution in different ways and according to different sorts of demographic profiles, if you will. What kind of ways are you looking at this and what are some of the things that it can tell us about the distribution of spending and taxes either generationally or in other cases which we might see in society?

Andrew Chamberlain:

One of the good things about what we've done is we did all this research in a microdata model that economist Gerald Prante and I developed last year. So we've generated an enormous amount of data. And you can look at this information by age group, by household size, by marital status and other characteristics. The first project we did is by income groups, and that resulted in a 120-page paper that's up on our website now at www.taxfoundation.org.

The next project is we're going to look at taxing and spending by age groups, and try to show how over a lifetime taxes and government spending affect different groups, and look at different generations to see who comes out better or worse. When you look at this by age group, things look very different. Over the course of a lifetime, government spending looks like a bowl-shaped distribution where young people tend to get a lot of spending from education and from transfer payments like income support and so on. And then during working years, you tend to pay higher tax burdens from payroll taxes and income taxes and you get lower amounts of government spending. And then when you retire, old age insurance programs kick in like Social Security and Medicare and you end up getting a lot of spending.

And so, we find that there are huge differences in a snapshot between age groups. However, one interesting question that we looked at is we asked ourselves, "So what happens if you control for age and you just look at one age group, and look at within that age group how different income groups fare?" And we found that when you do that, the same basic story holds up even within each age group. When you control for age, you still find enormous differences between taxes and spending between income groups. So that was kind of encouraging to us because it showed that under a whole host of different alternative ways of looking at the problem the basic story that we're telling holds up. You have to really torture the data to get rid of our basic results.

Scott Hodge:

Well, you know, on the issue of age, the baby boom generation turns 65 in three years and we know that there's a tsunami of entitlement spending that's gonna follow or be targeted at the baby boom. What – you know, a study like – that you've produced is obviously has policy implications in many different respects. How would you suggest that lawmakers use this type of study? You know, what can they take away from it? How can they apply it to the decisions that they make when looking at the – budget decisions whether it's on the spending or the tax side?

Andrew Chamberlain: Well, it's funny you mention this. A few months back this podcast interviewed economist Laurence Kotlikoff about his work on what he calls the "coming generational storm," by which he means the fiscal crisis that's over the horizon if we don't do something to reign in entitlement spending, mostly on Medicare but also Social Security. And, as you know, the growth of these programs is probably the single biggest problem facing the federal government right now. Kotlikoff actually argues that the country is essentially

already bankrupt and that at this point all we're trying to do is just minimize the damage. I'm not sure if that's right or not, but the irony here is that this is the nation's biggest fiscal crisis, the biggest problem on the table for Congress, and there is basically not a single federal government agency that is doing any distributional analysis of government spending. There's absolutely nothing on the spending side to guide lawmakers through entitlement reform.

There are three federal agencies that do tax distributions, and there's a whole host of think tanks including us and several others who do them, but there's nobody doing it on the spending side. And without that, the big risk is that entitlement debates are just going to be driven by anecdotes and whatever misperceptions lawmakers have about the fiscal system.

So what policy implications does our study have? Well, the bottom line is that we think the CBO and other folks like the JCT and Treasury should be looking into this kind of study and they should be trying to do this. They should be trying to look at both taxes and spending together and trying to provide Congress with some kind of map of the landscape of where government dollars are coming from and where they're getting spent out.

For many decades, agencies in the UK and Australia have been doing this kind of study. The World Bank and IMF have done studies like this before. There's about 50 years of economic literature on this, and the Tax Foundation's even done two previous studies on this in 1967 and 1981. So there's really no excuse why anybody should be ignoring the spending side.

Unfortunately, I don't know the answer to why they're not doing it and unfortunately I don't think there's a good one. But what we hope to show with our study is that it is possible to do this, that both Democrats and Republicans can get better policy by doing this, and we hope to persuade them to start merging together the tax and spending sides in their distributional studies.

Scott Hodge:

Well, one of the last conclusions of your study is about the president's tax reform panel and the implications that it was hamstrung by the requirement that the recommendation had to be revenue-neutral on the tax side. But your study really suggests that looking at the whole picture can provide some more guidance for fundamental tax reform. Just wrapping up, how – what can this tell us about the fundamental tax reform debate moving forward?

Andrew Chamberlain: Right. Our study shows that tax progressivity is not the only thing that matters. There are two ways to get progressivity. You can get it on the tax side or you can get it on the spending side. Now, when the president issued an executive order and started up the tax reform panel in 2005 he said their plans had to be “appropriately progressive.” And when the panel got started, they interpreted that to mean “distributionally neutral.” But the problem is that they only meant distributionally neutral on the tax side. And what our study shows is that this is really just missing half the picture. What should matter instead is *overall fiscal distributional neutrality*, not the artificial criterion of tax distributional neutrality.

So when you start thinking about fiscal distributions instead of just tax distributions, win-win possibilities on policy pop up that are invisible when you only focus on tax progressivity. For example, you can get more efficiency in the tax code sometimes, but it comes at a cost of sacrificing tax progressivity. But what we show is that you can satisfy people who want to maintain whatever level of progressivity they want by making up for it on the spending side. So you could in theory have a completely distributionally neutral proportional tax system and you could have it be strongly progressive fiscally just by adjusting the mix on the spending side. So by focusing only on tax distributions, we’re really cutting off policy options from ourselves.

I can give you another example. One of my favorite examples of this is with the estate tax and farm subsidies. This is one I always bring up, and it always gets people’s attention. The estate tax is highly progressive. So whenever eliminating it comes up, the controversy is that it reduces tax progressivity and...

Scott Hodge: You mean the wealthy would benefit the most.

Andrew Chamberlain: Exactly, right, because the incidence of the estate tax is assumed to fall on wealthy households. But on the other hand, if you look at farm subsidies, those are highly regressive. Almost all farm subsidies end up in the top two quintiles of income. In fact, in our study, farm spending was the most regressive of all the spending categories that we looked at. Of 59 spending categories it was the one that ended up mostly on wealthy households.

Now, changes in either one of those programs face strong opposition on fairness grounds. But if you lump them both together and pulled them away, dollar for dollar, the distributional effects basically cancel out. So, that’s one way you can use our study to set aside arguments about fairness and sort of get people talking

about efficiency and everybody gets better policy for the nation as a whole.

Scott Hodge:

This is a fascinating study and I appreciate the time that you've taken to spend with me and to describe some of the results, and I hope that the lessons and insights that come out of the study begin to infuse themselves into the policy debate because you're right. We get focused only on one side of it and we forget entirely about the three trillion-plus dollars the government spends on people and get focused only on the tax side of the debate. So thank you very much for taking time and best of luck on the future studies.

Andrew Chamberlain: Thanks, Scott.

Announcer:

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