

17-28 Tax Overhaul Risks Making the US Tax and Transfer System (Even) More Regressive

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This version corrects some errors in the originally published version in calculating the effect of taxes versus transfers in reducing the Gini coefficients in advanced economies.

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The impending debate in Congress focused on overhauling the US corporate and personal income tax codes has reopened the traditional American fault lines when it comes to raising revenue. The first is whether the change in tax laws will be revenue neutral or deepen the federal deficit. The second is whether it is politically possible to achieve the holy grail of reform, lowering rates while broadening the tax base by removing loopholes and long-cherished tax benefits. The third is whether the changes in the tax code will address the issue of economic inequality in the United States by redistributing the tax burden away from the middle class and toward the wealthy, a promise that even Donald Trump made when he was running for president in 2016.

This Policy Brief argues that the systemic distributional effects of any changes to the federal tax code ought to be the most important objective for policymakers in deciding how to adjust the taxes Americans pay. The brief makes this argument not by invoking ideological or philosophical principles but by comparing the redistributional effects of

tax systems in the club of the world's advanced countries known as the Organization for Economic Cooperation and Development (OECD). The evidence gathered from this global study of taxes concludes that the combination of the US tax code and the US system of transfer payments to low-income American families constitutes the least redistributive transfer and tax system in the OECD.

An earlier proposal put forward this year by House Speaker Paul Ryan and the Republican congressional leadership for a destination-based cash flow tax (DBCFT) as part of any federal tax overhaul would have worsened the progressivity of economic redistribution. It is not as if OECD countries are not reliant on regressive taxes. Many of them have significant value-added or general sales taxes (VAT/GST), which fall more heavily on those with lower incomes. But these countries counter the regressive nature of such taxes by often designing them to explicitly be less regressive and more importantly by spending relatively more on government transfers, such as income supplements, health care, childcare, and other programs. Unless changes in the US tax code are supplemented with increases in government transfers, or designed to be less regressive than the DBCFT, this category of VAT/GST-like revenue generation measures will worsen income inequality in 21st century America.

REDISTRIBUTIONAL EFFECTS OF TAX AND TRANSFER SYSTEMS IN THE OECD

US policymakers should be particularly concerned about the effects of any new tax legislation on the incomes of individuals and businesses because of rising income inequality in the United States and the relatively limited US social safety net financed with government taxes (see box 1 for an overview of current social spending in the United States and other OECD countries).

A comprehensive way to analyze the extent to which countries' tax and transfer systems redistribute income is to rely on the reported differences in OECD members' Gini coefficients for different income categories (OECD 2016). A Gini coefficient of 1 implies perfect inequality (e.g., all income accruing to just one individual) and a Gini of 0 indicates perfect equality (e.g., everyone in the country has the same income).

Box 1 US gross public social spending

In 2016, the US general (federal, state, and local) government spent an estimated 19.3 percent of GDP on cash benefits and social services such as health care, slightly up from 18.7 percent in 2013 and unchanged from 2010, but 5 percentage points higher than in 2000 (OECD 2016). US aggregate public social spending was lower than the OECD average of 21 percent of GDP in 2016 but considerably higher than the 10 to 12 percent of GDP in the least generous OECD members like Chile and South Korea.

Standard OECD definitions of public social expenditure (Adema, Fron, and Ladaique 2011) split the spending category into two main parts:

- *Public social spending on direct cash benefits to individual recipients*, such as old-age and survivor pensions, disability/incapacity pensions, family cash benefits or unemployment benefits.
- *Public spending on social services provided by the government to individual recipients*, including such services as care and accommodation for the elderly/disabled, childcare, healthcare or housing benefits.

In much of the OECD, most government cash benefits are paid out in the form of old-age and survivor benefits, while only a smaller share is distributed to the working age population. This is also the case in the United States, where the latest available detailed data from 2013 show that Social Security and survivor benefits from the Social Security Administration accounted for 7 percent of the total of 9.3 percent of GDP paid out by the general government in cash benefits.

Government healthcare spending accounts for most of the OECD public sector provision of social services. In the United States, government programs like Medicare and Medicaid accounted for 8 percent of the total of 9.4 percent of GDP in US public sector provision of services in 2013.

In short, government old-age pensions and healthcare expenditures account for the lion's share of gross public social spending in the United States.

Estimated Gini coefficients are available from the OECD for three income categories:

1. *Market income Gini coefficients* are based on income before any effects of government policy. These Gini coefficients are typically the highest.
2. *After-tax income Gini coefficients* are calculated from incomes after the collection of direct tax revenue but before taking into account government transfers to individuals. After-tax income Gini coefficients are invariably lower than market income Ginis, as all OECD countries have progressive tax systems and therefore collect more resources in direct taxation from higher-income individuals.
3. *Disposable income Gini coefficients* are based on income after the collection of direct tax revenue and payments of government transfers.

These measures of Gini coefficients allow one to consider the full effects of all direct tax payments and social contributions, as well as all current transfers, to and from all levels of the general government.¹

1. These include transfers from social security (including accident and disability benefits), old-age cash benefits,

Among high-income OECD countries, the United States has the least redistributive government direct tax and transfer system, reducing the inequality of market income by only 22 percent, or about one-fifth, from a Gini coefficient of 0.508 to 0.394. As illustrated in figure 1, this reduction in inequality is less than what smaller countries like Finland, Ireland, Belgium, and Slovenia achieve through taxation and transfers.

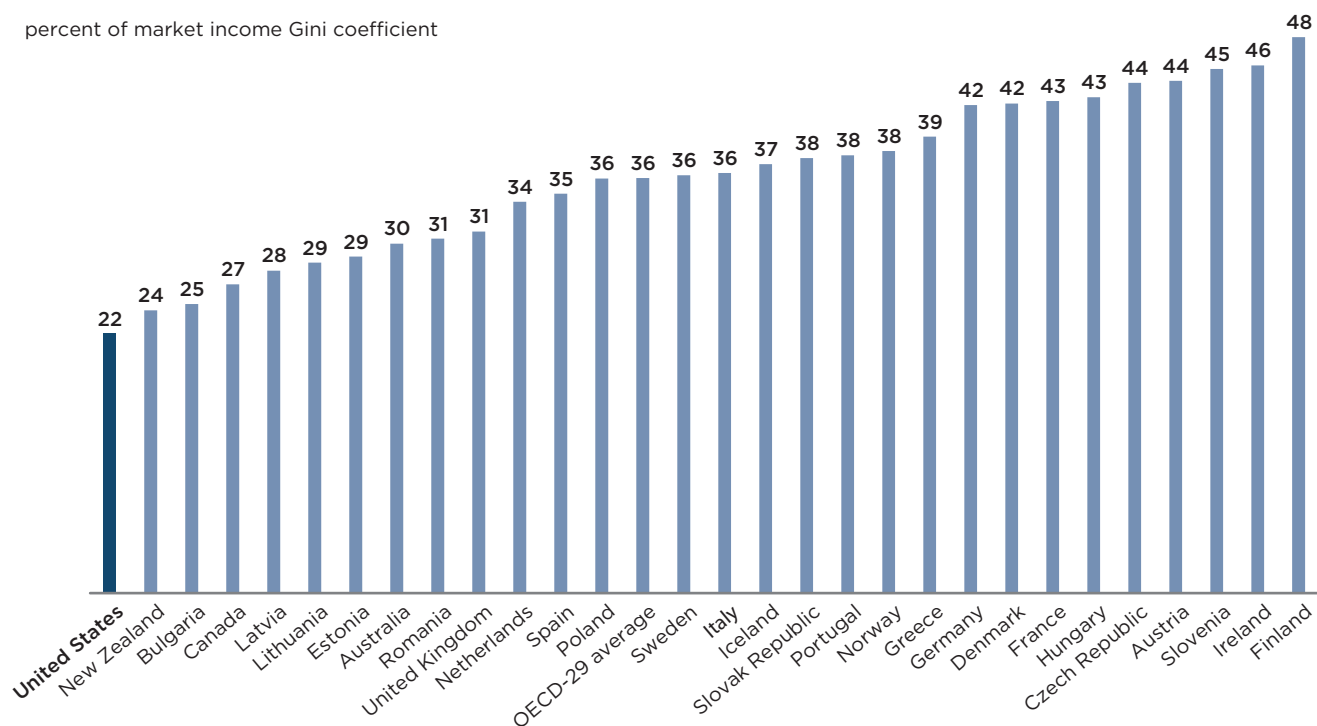
Income is redistributed through two basic but distinct sources: (1) collection of government revenue from direct taxation and social contributions and (2) disbursement of government transfers to individual residents.

Figure 2 decomposes countries' original market income Gini coefficient (the total height of the stacked bars) into its parts by first accounting for the redistributive effect of government direct tax collection (grey part of the bars) and then for the effect of government transfer payments (dark

unemployment benefits, maternity allowances, child and/or family allowances, all income-tested and means-tested benefits that are part of social assistance, including quasi-cash transfers given for a specific purpose (e.g., food stamps), transfers from employment-related social insurance, as well as cash transfers from both nonprofit institutions and other households.

Figure 1 Reduction in Gini coefficient from tax revenue collection and government transfers (latest available data)

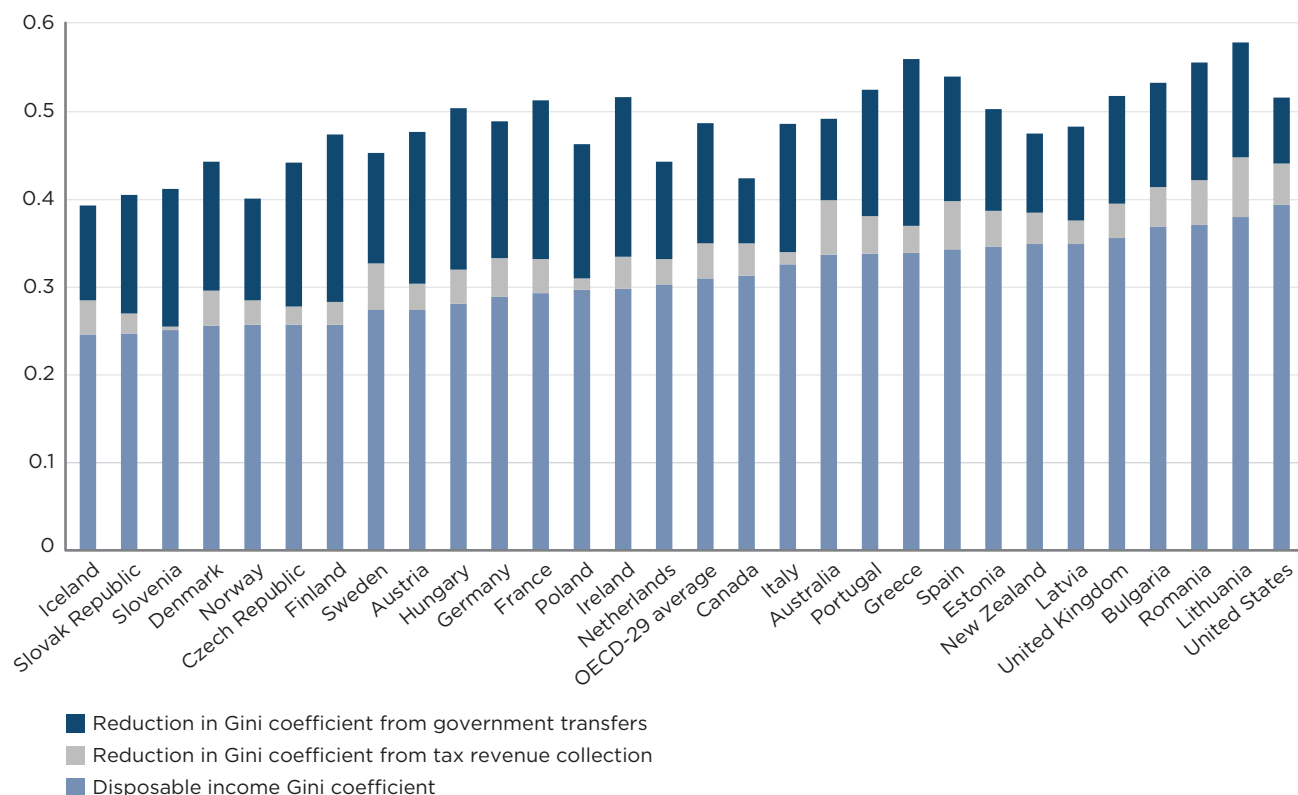
percent of market income Gini coefficient



Source: OECD (2021).

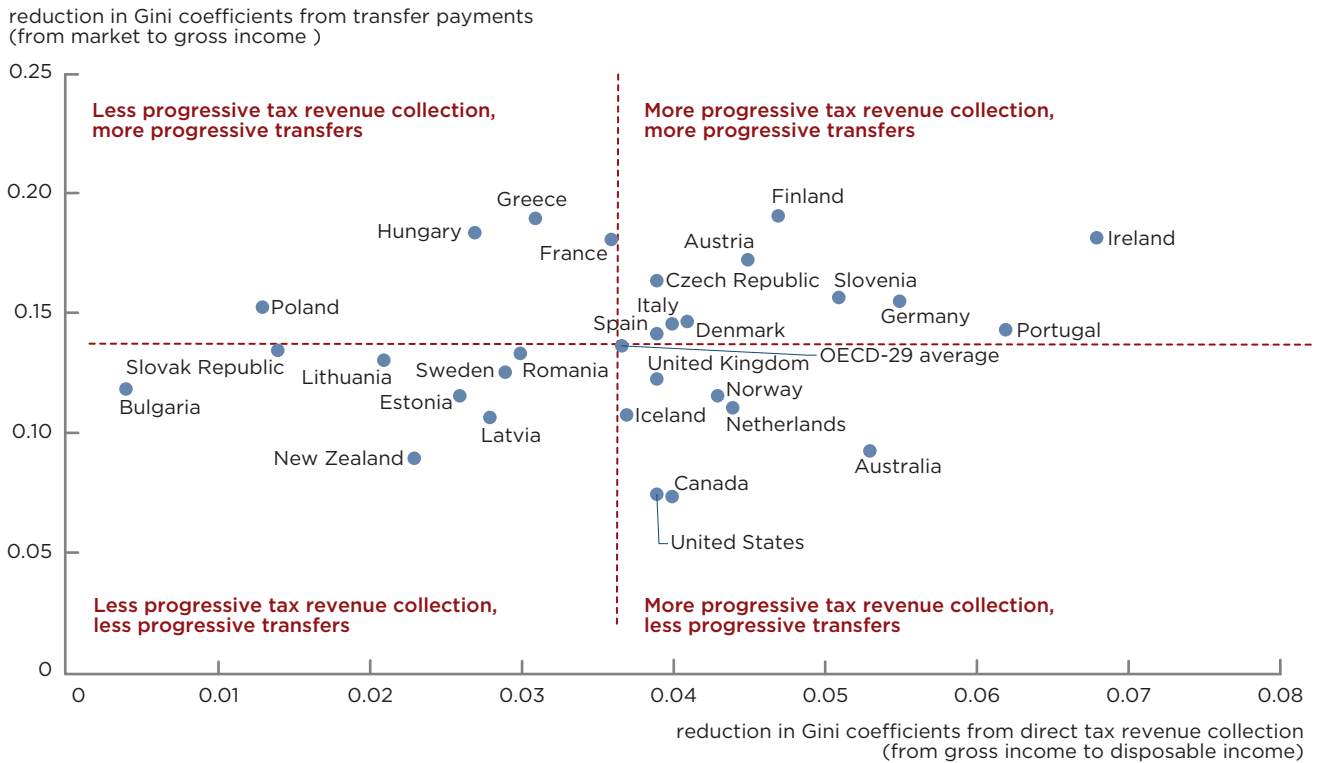
Figure 2 Reduction in Gini coefficients from tax and transfer system, latest available data

Gini coefficient



Note: Combined height of stacked bar = market income Gini coefficient.
Source: OECD (2021).

Figure 3 Impact of tax revenue collection and transfer payments on inequality in OECD countries, latest available data



Source: OECD (2021).

blue part of the bars). The remaining light blue part of the bar—by which OECD countries are ranked in figure 2—equals the country’s disposable income Gini coefficient.²

The figure shows that in OECD countries transfers are the main method employed by governments to reduce market income inequality—around 80 percent on average in the OECD of the total policy-induced reduction in inequality from market to disposable income. Tax revenue collections in the OECD account for only an average of 20 percent of the policy-driven reduction in income inequality, but they account for more than one-third of such reductions in the United States, due to the lower than the OECD average scope of government transfers. US government tax revenue collection is a bigger factor in addressing inequality than in most other OECD governments.

Figure 2 highlights that the United States has the highest disposable income inequality among OECD countries. Yet, the figure also reveals that it is erroneous to believe that the difference in US and European market-based outcomes (or different social norms about acceptable pre-tax wage levels

for CEOs and other top-income earners) is responsible for the generally higher level of disposable income inequality in the United States. The US market income Gini coefficient of 0.508 is not an uncommon level of inequality in the OECD: It is on par with European countries such as Finland, Germany, or Austria and is indeed lower than in France, Italy, Portugal, Greece, the United Kingdom, and a few others.

The United States is more unequal than the rest of the high-income OECD on a disposable income basis because it chooses to redistribute less through direct tax collection and government transfers.

Figure 3 compares the relative importance of direct tax revenue collection and transfer payments in redistributing income in OECD countries. The four quadrants show the relative progressivity of OECD members’ direct tax revenue collection and government transfers. The upper right quadrant contains OECD members with more progressive direct tax revenue collection and government transfers the simple OECD average. The lower right consists of countries with relatively more progressive direct tax revenue collection but less progressive government transfers. The lower left is for the less progressive OECD members, and the upper left is for members with less progressive direct tax revenue collection but more progressive government transfers.

2. Switzerland has been excluded from figure 2, due to the frequent use of nontransparent firm-level tax arrangements for multinational corporations locating in Switzerland, which also includes the personal tax circumstances of workers.

The United States and Canada employ the least progressive government transfers in the OECD, when measured by their ability to reduce the national Gini coefficient (from market income to gross income). Despite pervasive means-testing of US government transfers, the transfers fail to reduce income inequality to the same degree as in other advanced economies. On the other hand, US government tax revenue collection is marginally more progressive than the OECD average, to a degree explained in the next section, reflecting the US lack of reliance on VAT and GST collections. Policymakers should keep in mind that the United States has only an average level of progressivity when it comes to tax collections and limited progressivity when it comes to government transfers.

WHY MANY PROPOSED TAX CHANGES INVOLVING FEDERAL VAT OR GST COULD AGGRAVATE US INCOME INEQUALITY

Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes.

—Benjamin Franklin, 1789³

Any large change in federal tax policies will invariably create winners and losers, both among individual American taxpayers and potentially at different levels of the US general government. Currently, only US states collect GST revenue, while the federal government raises its revenues mainly through income and corporate taxes. This split in tax revenue sources between states and the federal government has been accepted politically but is also a result of concerns over both the scale and distributional impact of a potential US federal VAT or GST. Many US observers, particularly on the political right, worry that a federal VAT or GST once introduced could gradually become a very large source of federal government revenue. Meanwhile, many on the American political left rightly worry about the distributional impact of federal government VAT or GST.

Washington appears to have buried the prospects of introducing a DBCFT in the United States for now.⁴ Whatever efficiency merits a DBCFT might have held compared with the current US corporate tax code, from

an income inequality and redistributive point of view this outcome is welcome.

Advocates of the DBCFT—a central feature of the corporate tax overhaul proposed by House Republicans (Ryan and Brady 2016)—argue that it will yield sufficient revenue to render a reduction of the US corporate tax rate fiscally neutral. The proposed DBCFT would be imposed on the entire value of imports but only the corporate profit part of domestic production, thus discriminating against imported goods and services.⁵

In a frictionless world, exchange rate appreciation and/or wage adjustments would offset the economic effects on consumers of any DBCFT focused on imports. But more credible economic assumptions suggest that the lowest-income Americans are likely to disproportionately bear the burden of higher consumer prices, as they spend a greater share of their income on imported goods. For instance, Americans in the lowest income decile would pay five times more, as a share of their pre-tax income, than would Americans in the top income decile (Russ 2017). This redistributive effect is even more dramatic because the increase in revenue from taxes paid by consumers is intended to facilitate the reduction in the tax on corporate profits, which would benefit owners of domestic equities, who are overwhelmingly high-income Americans (Zumbrun 2014).

The United States is unique among OECD countries in that it does not have any federal indirect tax, such as a VAT⁶ or GST.⁷ At the subfederal level, US states have varying levels of GST and in 2014 collected about \$350 billion, or about 2 percent of US GDP, in revenue through the indirect channel.⁸ Figure 4 reveals that all other OECD countries collect substantially more revenues—an average of 7 percent of GDP in 2014—from VAT or GST than does the US general government.

VAT and GST are typically more regressive than direct taxation of income or property. Because the US general government does not impose indirect taxes on consumption, the purchasing power of US residents' disposable income is reduced less by government taxation of consumption than in other OECD countries.

5. See Cline (2017) for details on how a DBCFT works.

6. A VAT is levied on all stages of a production process, and businesses paying VAT on inputs that will be sold are eligible for a VAT refund transfer.

7. Sales tax is collected by the retailer when the final sale in the supply chain is reached via a sale to the end consumer. End consumers pay the sales tax on their purchases.

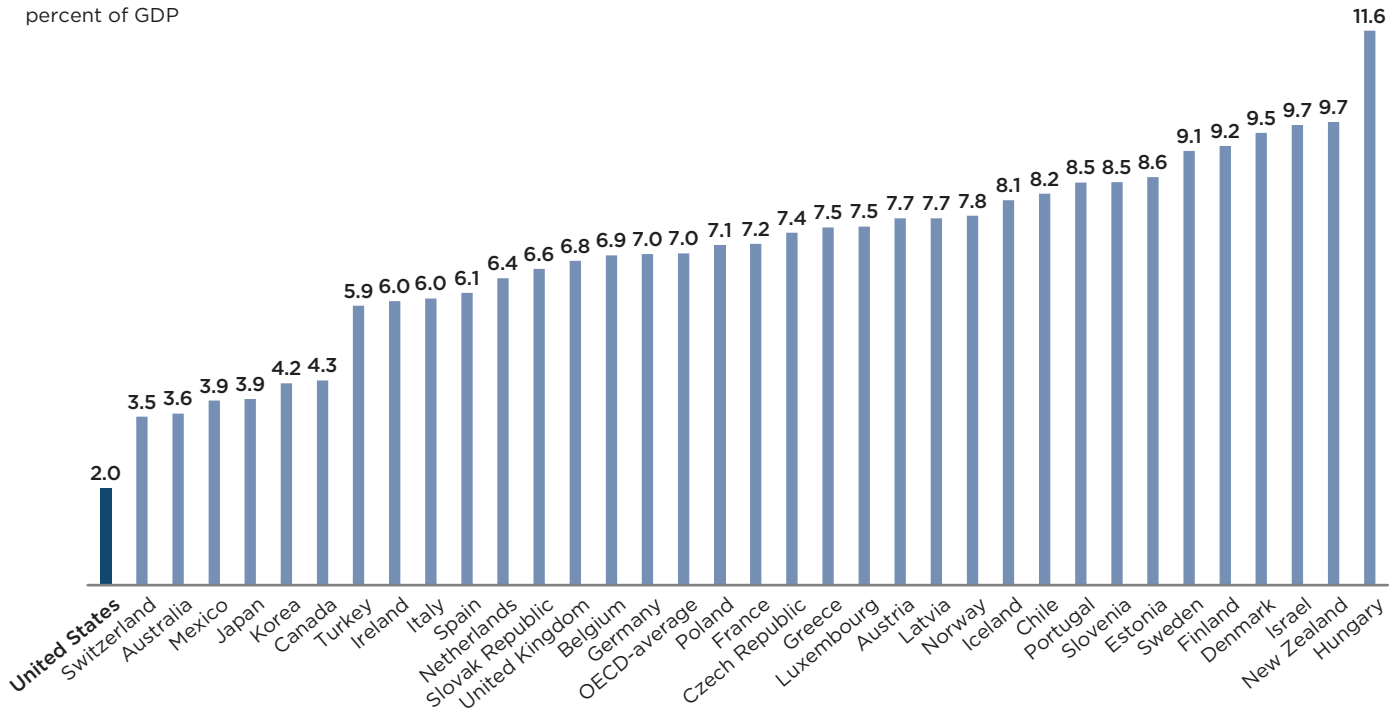
8. Data are from the US Census at https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=SLF_2014_00A1&prodType=table.

3. Fred Shapiro, "Quotes Uncovered: Death and Taxes," February 17, 2011, <http://freakonomics.com/2011/02/17/quotes-uncovered-death-and-taxes/>.

4. See Joint Statement on Tax Reform, July 27, 2017, at www.whitehouse.gov/the-press-office/2017/07/27/joint-statement-tax-reform.

Figure 4 General government value-added tax, general sales tax, and other general taxes on goods and services (latest available data)

percent of GDP



Source: OECD (2016b).

The impact of VAT or GST on actual income inequality is complicated by how they affect the purchasing power of those who receive direct cash payments from the government. Such payments are (almost) invariably made overwhelmingly to lower income groups and are hence progressive and redistributive. Countries with high VAT rates as well as high direct taxation of government cash benefits, however, take back from recipients parts of direct government cash payments. While VAT regimes help self-finance cash payments, they also reduce the purchasing power of recipients, thus limiting the actual income redistribution from such benefits.

As I discussed in Kirkegaard (2015), countries with both high cash benefits and high VAT rates can collect substantial indirect tax revenue from cash recipients' consumption. In 2013, OECD countries spent on average 12.4 percent of GDP on all types of cash benefits and collected 1.8 percent of GDP in revenue from recipients through indirect taxation of their consumption, essentially "clawing back" 15 percent of the amount they spent on cash payments. Figure 5 illustrates the significant scope and variance in OECD countries' indirect tax clawbacks from direct cash payments.

Indirect tax clawbacks from cash benefits are almost a quarter in Hungary and Luxembourg and around 20 percent in countries like Estonia, Norway, Czech Republic, Denmark, and Slovenia. Clawbacks of such magnitude

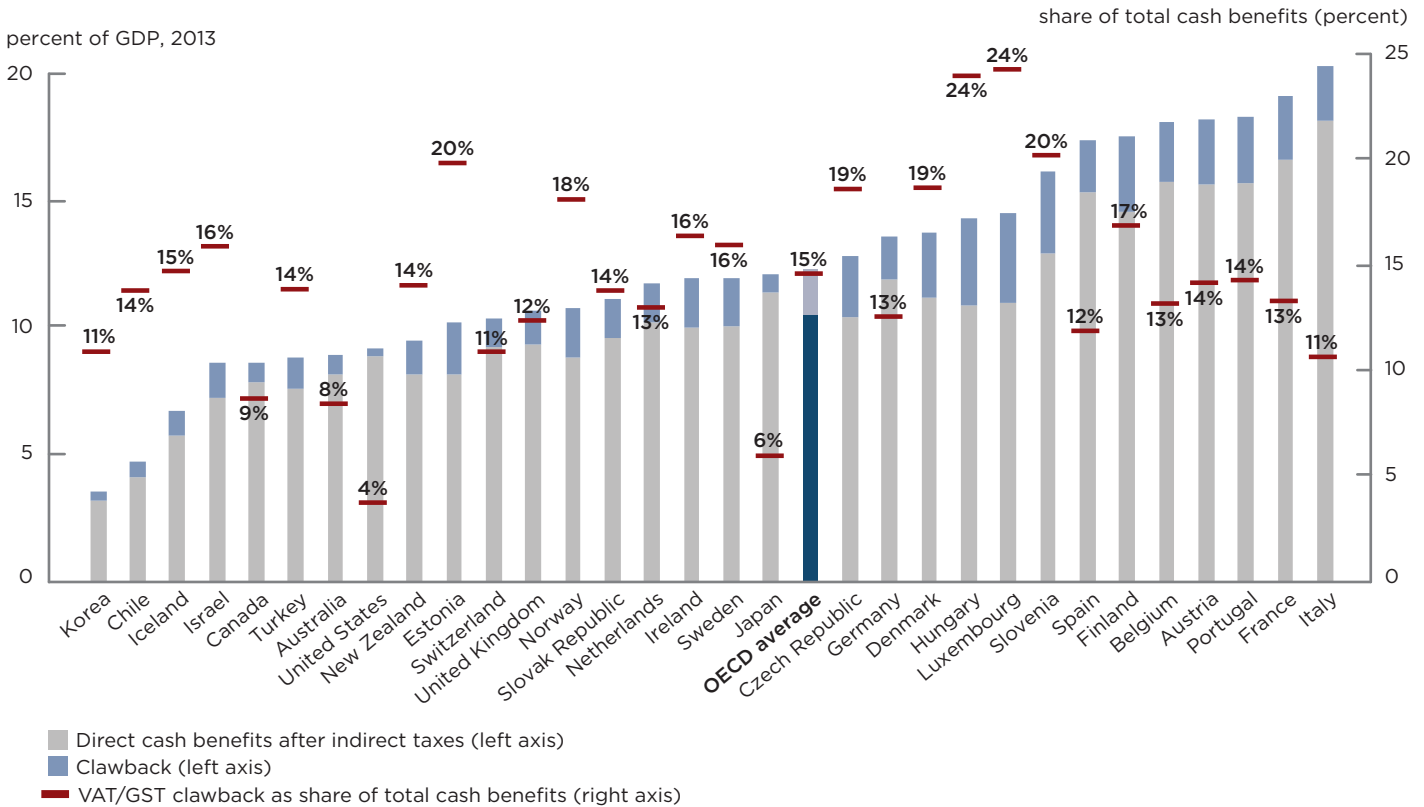
reduce the redistributive impact of cash benefits. On the other hand, the United States claws back just 4 percent and Japan 6 percent. The US general government collected only 0.3 percent of GDP in indirect taxes from recipients of direct cash benefit payments, which totaled 9.3 percent of GDP in 2013. Indirect taxation of direct cash payments, therefore, does not affect reported US Gini coefficients as much as it does in many other OECD countries, as the US general government takes back lower revenues in indirect taxes than elsewhere.

What would happen if the United States introduced a DBCFT-like tax similar to a VAT or GST? For one, the upward-biased US Gini coefficients would no longer be offset by lower indirect tax payments and higher US consumer purchasing power.⁹ This is likely to increase actual income inequality among US consumers.

While not a part of the original DBCFT proposal of the US House of Representatives, one policy option would be to use any DBCFT revenues to increase the amount of

9. When exchange rates are close to fundamental equilibrium levels, the United States has a higher purchasing power parity (PPP) exchange rate than almost all other high-income OECD countries. See OECD comparative data at <https://data.oecd.org/conversion/exchange-rates.htm#indicator-chart>.

Figure 5 Government cash benefit payments and VAT/GST “clawbacks,” 2013



VAT/GST = value-added tax/general sales tax
Source: OECD (2016a).

cash the US government pays to benefit recipients. Evidence from high-income OECD countries shows that using substantial VAT revenues to increase government transfers lowers income inequality and the disposable income Gini coefficient.

This empirical correlation across high-income OECD countries may not be a simple coincidence. Figure 6 illustrates this, and the self-financing effects of broadly levied VAT revenues collected from the consumption by direct cash benefit recipients. The figure reveals several insights.

First, there is a strong relationship between the level of general government VAT or GST revenues as percent of GDP and the overall redistributive effect of government direct tax revenue collection and transfer payments. Higher tax revenues are associated with stronger overall redistributive effects of government direct tax revenue collection and transfer payments.

Secondly, the larger bubbles are concentrated in the upper right corner, illustrating that countries with high levels of tax revenue and redistribution are also the countries that take back the largest amounts in indirect tax revenues from benefit recipients. Put differently, high-income countries that implement VAT-like taxes tend to use a portion of the

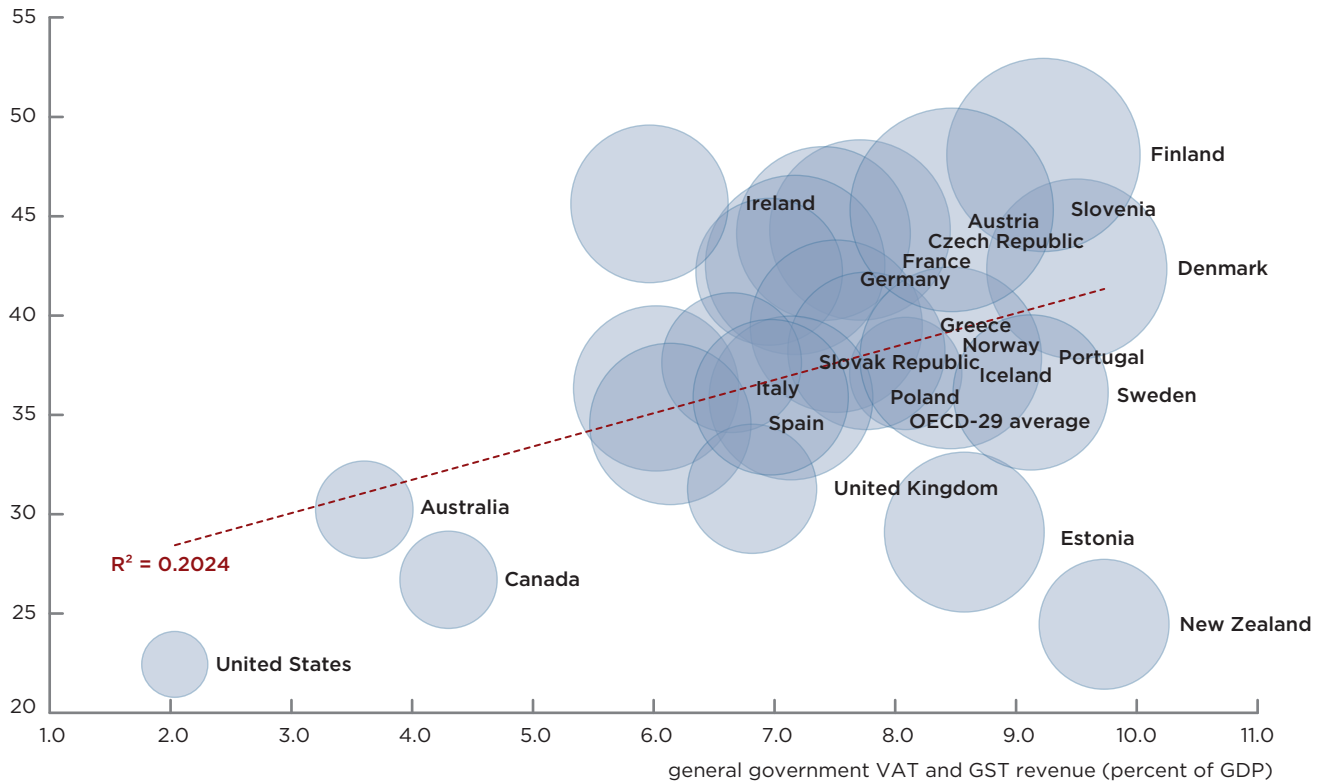
revenue to maintain more progressive government transfer programs. Balancing the tax and transfer system this way can ameliorate the regressive nature of indirect consumption taxes and also generate sizable new tax revenues from the spending of benefit recipients themselves. Many European countries thus finance comprehensive welfare states via low-cost collection of VAT/GST revenues.

Advanced economies that rely on VAT or VAT-like consumption tax revenues—for example, countries in Scandinavia and other parts of Europe—balance the regressive nature of this source of revenue with extensive government-funded social safety nets, meaning that regressive taxation helps fund progressive welfare state transfers. Revenue that the government earns from VAT or VAT-like consumption taxes when recipients of government benefits spend that money also helps control true budgetary costs of government cash transfers. Such a redistributive balance between regressive government tax collection channels and progressive spending to advance social goals is not present in the United States.

To avoid further aggravating income inequality in the United States, revenues from a DBCFT would have to be deployed in a way that would improve America’s social safety net. This in itself would affect DBCFT revenues, as

Figure 6 General government VAT/GST revenues, redistributive effect of tax revenue collection/transfers, and revenue collected from indirect taxation of direct cash benefits (latest available data)

percent reduction in national Gini coefficient from taxes and transfers (from market to disposable income)



VAT = value-added tax; GST = general sales tax

Note: Size of bubbles indicate the percent of GDP collected in general government revenue from indirect taxation of direct cash benefits.

Source: OECD (2016b, 2021).

the beneficiaries of new US general government direct cash benefit payments would also consume imported goods and services subject to the DBCFT.

While it would aggravate US income inequality, the DBCFT, as conceived by the congressional leadership in 2017, is merely one VAT/GST-like revenue collection opportunity. US lawmakers could implement variations of a federal government VAT/GST that would be far less regressive in terms of revenue collection than the DBCFT.¹⁰ Many OECD countries have such diversified VAT/GST tax systems (OECD 2016b), often explicitly aimed at reducing their regressive impact. Such systems consist of reduced VAT/GST rates (e.g., lower than the standard general VAT/GST rate) on specific items, such as food or clothes, that make up a sizable share of lower income groups’ consumption basket. Or they involve reduced

VAT/GST rates for certain regions, often low-income areas or regions next to an open international border with a country with lower VAT/GST rates. Or low-income groups get additional income tax credits to compensate them for the relatively higher burden of the VAT/GST taxes they pay. US lawmakers could introduce a federal VAT or GST that would not have a major negative redistributive impact, provided they have the political will and design the measure with that goal in mind. To date, however, they have chosen not to do so.

CONCLUDING REMARKS

US market income inequality, calculated before government taxes and transfers, is not noticeably higher than in many other OECD countries, including those in continental Europe. Disposable income inequality—after taxes and transfers—however, is higher in the United States than elsewhere in the OECD because of how it distributes government transfers and collects tax revenue to finance its general government. Inequality and redistribution questions should

10. ONS (2016) shows how indirect taxation in the United Kingdom—despite the standard VAT rate of 20 percent but 5 or 0 percent on certain goods—increased income inequality by only about one-tenth.

always be at the center of current debates about government transfers, but also when the discussion is about overhauling the federal tax code.

The United States collects only a relatively limited share of tax revenue through indirect taxes, so introducing a DBCFT or similar VAT or GST would further aggravate income inequality in the United States as lower income groups would see their purchasing power decline. A regres-

sive indirect tax would be redistributively defensible only if the United States (1) balanced it with additional progressive government spending or (2) imposed lower rates on some items or regions to minimize the impact on income inequality or (3) gave low-income Americans additional income tax credits to offset its effects.

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