

How to Increase Taxes on the Rich (If You Must)

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Essay for Combating Inequality, edited by Olivier Blanchard and Dani Rodrik

October 18, 2019

I would like to begin with what I hope is a noncontroversial proposition: Rich people are not all the same.

I bring up this fact because we live in a time when inequality is high, when demonizing the rich is popular in some political circles, and when various policies are being proposed to increase the redistribution of economic resources. In this brief essay, I won't comment on whether we should redistribute more. That question is hard, and it involves less economics than political philosophy, which is not my comparative advantage. Rather, I will assume we are going to increase redistribution and discuss alternative ways to do so. As we evaluate the many proposals, it is worth keeping in mind some of the ways rich people differ from one another.

Consider two hypothetical CEOs of major corporations. Each of them earns, say, \$10 million a year, putting them in the top one-hundredth of one percent of the income distribution. But other than in their incomes, the two executives are very different.

One executive, whom I will call Sam Spendthrift, uses all his money living the high life. He drinks expensive wine, drives Ferraris, and flies his private jet to lavish vacations. He gives

large amounts to political parties and candidates, hoping these contributions will get him an ambassadorship someday. When that does not work, he spends large sums financing his own quixotic run for the presidency.

The other executive, whom I will call Frank Frugal, makes just as much money as Sam, but he takes a different approach to his good fortune. He lives modestly, saving most his earnings and accumulating a sizable nest egg. He forgoes the opportunity to influence the political process. Instead, he invests his money in successful start-ups, which he is quite good at identifying. He plans to leave some of his wealth to his children, grandchildren, nephews, and nieces. Most of his wealth, however, he plans to bequeath to the endowment of his alma mater, where it will support financial aid for generations to come.

Ask yourself: Who should pay higher taxes? Sam Spendthrift or Frank Frugal?

I can see the case for taxing them the same. After all, they have the same earnings. One might argue that how they choose to spend their money is not an issue for the government to judge or influence.

I am more inclined, however, to think Mr. Frugal should be taxed less than Mr. Spendthrift. The argument is Pigovian. Mr. Frugal's behavior confers positive externalities, both on members of his extended family and on the beneficiaries of his charitable bequest. Moreover, by increasing the economy's capital stock, his saving reduces the return to capital and increases labor productivity and real wages. If one is concerned about the income distribution, this pecuniary externality can also be viewed as desirable.

What I find hard to believe is that Mr. Frugal should face higher taxes than Mr. Spendthrift. But that is what occurs under some of the policy proposals now being widely discussed. I am referring in particular to the wealth taxes advocated by Senators Elizabeth Warren and Bernie Sanders, both of whom are now running for the Democratic nomination for president. These taxes, if successfully implemented, would hit Frank Frugal hard but would be much easier on Sam Spendthrift.

There are better ways to redistribute economic resources, ways that do not penalize frugality. In particular, I am attracted to the policy now being championed by Andrew Yang, the former tech executive and entrepreneur who is also running for the Democratic nomination. Mr. Yang proposes enacting a value-added tax and using the revenue to provide every American adult with a universal basic income of \$1,000 per month, which he calls a “freedom dividend.”

It’s easy to see how the Yang proposal would work. Value-added taxes are essentially sales taxes, and they have proven remarkably efficient in raising revenue in many European countries. And because the dividend is universal, it would be simple to administer.

The idea of a universal basic income is not new, but it is bold. Of course, the idea has its critics. But, from my perspective, the critics often rely on arguments that do not hold up under scrutiny. Let me use an example to explain why.

Consider two plans aimed at providing a social safety net. (For our purposes here, let’s keep things simple by assuming both are balanced-budget plans.)

A. A means-tested transfer of \$1,000 per month aimed at the truly needy. The full amount goes to those with zero income. The transfer is phased out: Recipients

lose 20 cents of it for every dollar of income they earn. These transfers are financed by a progressive income tax: The government taxes 20 percent on all income above \$60,000 per year.

B. A universal transfer of \$1,000 per month for every person, financed by a 20-percent flat tax on all income.

Would you prefer to live in a society with safety net A or safety net B?

When I asked this question to a group of Harvard undergraduates, over 90 percent concluded that plan A is better. Their arguments were roughly as follows: Plan A targets transfer payments on those who need the money most. As a result, it requires a smaller tax increase, and the taxes are levied only on those with high incomes. Plan B is crazy. Why should rich people like Bill Gates and Jeff Bezos receive a government transfer? They don't need it, and we would need to raise taxes more to pay for it.

Superficially, those arguments might seem compelling, but here is the rub: The two policies are equivalent. Look at the net payment—that is, taxes less transfers. Everyone is exactly the same under the two plans. A person with zero income gets \$12,000 per year in both cases. A person with annual income of \$60,000 gets zero in both cases. A person with income of \$160,000 pays \$20,000 in both cases. And everyone always faces an effective marginal tax rate of 20 percent.

In other words, everyone's welfare is identical under the two policies, and everyone faces the same incentive. The difference between plan A and plan B is only a matter of framing.

This example teaches two lessons. First, if you find something like plan A attractive and you recognize the equivalence of plan A and plan B, you should find something like plan B attractive. Many critics of universal basic income fail to make this leap because they do not notice the equivalence of these two approaches. Once you see the equivalence, Plan B is easier to embrace. And it looks even better when you realize that universal benefits and flat taxes are easier to administer than means-tested benefits and progressive taxes.

The second lesson from this example is how misleading it can be to focus on taxes and transfers separately. It is accurate to say that Plan A has lower taxes, more progressive taxes, and more progressive transfers. But so what? Those facts do not stop it from being precisely equivalent to plan B. The equivalence is clear only when taxes and transfers are considered together.

I stress this fact because it is all too common to see academic papers and media articles describe the distribution of taxes without considering the distribution of the transfers they finance. Such presentations of the data are incomplete to the point of being deceptive. With incomplete reporting, one might be led conclude that a society using plan A is more progressive than a society using plan B. But that is not the case because the policies are functionally the same.

Finally, I should note that the safety net described by either plan A or plan B is just a version of the negative income tax that Milton Friedman proposed in his book *Capitalism and Freedom* back in 1962. I remember reading about it as a student 40 years ago and thinking it was a good idea. And I was not alone in that judgment: In 1968, more than 1000 economists signed a letter endorsing such a plan, including luminaries like James Tobin, Paul Samuelson, Peter

Diamond, and Martin Feldstein. Andrew Yang's version, which focuses on taxing consumption rather than income, is even better than Friedman's, because it wouldn't distort the incentive to save and invest.

Could 1000 economists all be wrong? Well, yes, they could. But my judgment is that, in this case, they are not. A universal basic income, financed by an efficient tax like a value-added tax (or perhaps a carbon tax), might be a social safety net well worth considering.

I am not predicting that this idea will have much success in the current political environment. But I find it reassuring that good ideas keep popping up in the political discourse. Maybe someday they might even influence actual policy.