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You're A Socialist Too

Edward D. Kleinbard
Professor of Law
USC Gould School of Law
Los Angeles, California
ekleinbard@law.usc.edu

The swarms of conservative activists who recently descended on Washington represented dozens of different interest groups and agendas, but found common cause in their commitment to defend the country from what they perceive as an aggressive new socialist agenda emanating from the White House. To all these concerned citizens I say: Get over it. You're already more of a socialist than you can imagine.

Americans depend throughout our lives on a large public sector to deliver important financial subsidies to us. The federal government subsidizes the retirement and medical benefits of millions of Americans, it subsidizes every 'conforming' mortgage originated in the United States, and it subsidizes home ownership, employer-sponsored medical insurance, and hundreds of other personal and business activities through the tax system. The difference between the United States and Europe is not so much the relative size of government (although to be sure the United States remains at the smaller end of the scale) as it is the success of U.S. administrations, both Democratic and Republican, at hiding these government programs from its own citizens.

We live in a fog of *fiscal illusion*. Just as optical illusions make us see things that are not really there, fiscal illusions create the impression that we occupy one environment with respect to the size and operations of our government, when in reality we inhabit a completely different fiscal landscape. Our fiscal miasma is not, however, an accident or an artifact of human behavior, but rather the result of calculated political strategies stretching back decades, all of which are designed to give Americans what we really want (lots of government services), without challenging our belief in our unique national identity as a country of rugged individualists.

Government programs are structured to hide in plain sight through several overlapping strategies. For example, lawmakers rely on the illusion of personal accounts for social security

benefits, or hide the relevant government apparatus from the consumer and expose it only to the providers of services (as in the case of Medicare or subsidized mortgages), or deliver government *spending* programs through the tax system, in what specialists call *tax expenditures*. Tax expenditures in particular are the current fiscal illusion policy tool of choice, and are now abused to the point where they threaten to swamp our government's ability to finance itself.

Social security is the best-known example of the deliberate tactical use of fiscal illusion to accomplish social goals. The system was established from the get-go to create the impression that we each pay into a personal account from which our retirement benefits later are funded, but of course that is not true.

Social security "contributions" paid into the social security "trust fund" are taxes, plain and simple. The government does not maintain an account with your "contributions" earmarked for you, and your future benefits, while measured to some extent by your *wage* history, depend for their payment largely on future taxes collected from future generations of workers. The trust fund invests in U.S. Treasury bonds; the money, thus transferred to the operating side of the government, is simply put to work on a current basis funding current government programs. The trust fund thus is nothing more than a promise by the government to itself – by the left pocket to the right pocket – to collect enough taxes *in the future* to pay off those bonds, and thereby move money through the trust fund to social security beneficiaries.

The rhetoric of "contributions," "trust funds" and "accounts" was an extraordinarily clever tactical device that enabled the Franklin Roosevelt administration to sell social security to the country and to the Congress. That rhetoric no doubt bought public support for the program and has protected social security benefits from regular Congressional incursions. But by the same token, it leaves most Americans today with the misimpression that social security benefits are not really a government subsidy of the elderly, but are instead our personal financial investments being repaid to us. This in turn leads to a pervasive misestimation of the government's role in our lives, and understandably would encourage citizens confronted by a hypothetical threatened cutback in social security to see that change in policy as naked government expropriation, rather than an adjustment to (if you prefer, renegeing on) essentially unfunded government promises of future government subsidies.

Medicare and home mortgage originations are two examples of the government weaving the web of fiscal illusion through hiding its role from the consumer. The tactical genius in the design of Medicare was to leave the (false) impression that nothing had changed but the ultimate source of payment, and through the same “trust fund” metaphor as is employed in social security to encourage the belief that this ultimate source is the patient herself. To judge from the town hall meetings of this summer, many Americans do not even appreciate that Medicare is a government-subsidized program; again, they incorrectly believe that their past payroll contributions have funded their current benefits. Moreover, Medicare patients choose their own medical providers and do not deal directly with the government insurance system; providers do. As a result, patients are unaware of the enormous government apparatus that behind the scenes today shapes their care, for example through the pricing of reimbursement rates for different procedures, or through more direct regulation.

The same is true for every ‘conforming’ mortgage in the United States. The consumer deals with a private lender or mortgage broker, and may be aware that, through some dimly-perceived magic, loans meeting certain criteria have reduced interest rates attached, but rarely understands that the reason is that government-sponsored (now government-owned) enterprises stand by ready to buy those ‘conforming’ mortgages from private lenders and to hold those loans on their own books. Even before the official government takeover of Fannie Mae and Freddie Mac, the reason the magic worked was that these conforming loans were (indirectly) financed by the U.S. government itself.

Tax expenditures, however, are the most pervasive current tactic for delivering government services while deliberately preserving the fiscal illusion of small government. Tax expenditures are government subsidies, plain and simple – spending programs by another name – that are run through the tax system.

Tax expenditures have grown in importance to the point where they are now the dominant instruments for implementing new discretionary spending policies. And critically, because tax expenditures do not appear at all on the face of the federal budget, but rather are accounted for as simple reductions in government revenues, these government spending programs are almost completely invisible to American citizens (and to most of Congress).

As I developed at length in a recent article in *Tax Notes* magazine,¹ the nonpartisan Congressional Research Service (building on data provided by the equally nonpartisan Staff of the U.S. Congress's Joint Committee on Taxation), reported that for fiscal year 2008, the tax code contained some 247 government subsidy programs hidden in the tax code; the sum of these hidden spending programs for fiscal year 2008 alone totaled roughly *\$1.2 trillion*. (Ninety percent of this represented subsidies to individuals, and ten percent -- \$118 billion -- subsidies to businesses.) This sum is not the result of the current fiscal crisis: we have relied on tax expenditures to hide government spending programs for almost as long as we have had a tax system, but the extent of our reliance has grown rapidly in the two decades since the last comprehensive effort to address the problem (the 1986 tax reform act).

How can I put \$1.2 trillion of 2008 tax expenditures into context? That sum is greater than the entire amount raised by the individual income tax in that year, or for that matter all federal discretionary spending in 2008 (in each case, about \$1.1 trillion). Indeed, it is more than twice as much as all nondefense discretionary government spending in 2008 (\$528 billion).

What makes tax expenditures irresistible to a member of Congress from either political party is this ability to describe oneself as a tax cutter, while actually spending money – and thereby guaranteeing that some future cohort of Americans will pay more in tax. The same politicians who decry a new explicit government spending program as wasteful or a sign of creeping socialism are the first to congratulate themselves on adopting a new tax expenditure program, calling it “targeted tax relief.” There is no such tax policy concept as “targeted tax relief;” it is just an instance of the rhetorical and procedural devices through which tax expenditures exploit our willingness to suspend disbelief when it comes to matters of fiscal illusion.

Most economists would agree that the \$118 billion per year in business subsidies delivered through the tax system is almost entirely wasted money. These spending programs are motivated by old-fashioned political favoritism, not economic criteria. Yet they hide in plain sight, buried in technical language as appendices to budget documents. If instead they were presented for what they really are – a sort of ersatz Soviet-style five-year plan, in which the

¹ Kleinbard, “How Tax Expenditures Distort Our Budget and Our Political Processes,” *Tax Notes*, May 18, 2009, p. 925.

Congress intervenes in the private sector to give a boost to favored industries or companies – almost all would rightly be rejected as both socialist and stupid. Yet Congress cynically adds new business spending subsidies every year, cloaked in the rhetoric of “targeted tax cuts,” thereby enabling bad policies to pass for virtuous ones.

Personal tax expenditures are more complex, simply because many of them are not stupid. In some cases, for example, the tax system is the most efficient delivery mechanism for federal support of the family or other shared values. (The earned income tax credit and the charitable contribution deduction are examples.) The fact that many of these quasi-spending programs are desirable does not, however, change the fact that they are spending programs. The fiscal illusion of their budget presentation (where they do not appear at all, except as reductions in net government revenues) means that we collectively are unaware that we spend about \$1 trillion per year more on ourselves through the intermediation of the federal government than we imagine.

Moreover, the principal beneficiaries of many personal tax expenditures are *not* the very richest or the very poorest, but rather the great middle of our society. The conservatives who marched on Washington, like most of us, take mortgage interest deductions, exclude from their income tens of thousands of dollars each year in wages paid to them in the form of employer-provided health insurance, and so on. Yet if you were to ask each marcher whether he took government handouts, how many would have the clarity of fiscal understanding to admit that yes, he was subsidized today by the government he fears is slipping into socialism?

Again, the ultimate point is not that all these social tax expenditure programs are undesirable (many are useful), but that they are invisible. They do not appear on the face of our budget, they therefore do not figure in our annual budget debates (that is, our debates as to how we should best allocate our collective resources to make a stronger and happier society), and they do not register even with their beneficiaries as government programs.

By virtue of the fog of fiscal illusion, we are today more reliant on, and connected to, the federal government than most of us can begin to appreciate. What we need is not just tax reform, but budget process reform and fiscal education: we need to shatter fiscal illusion, whatever its mode, and force a more honest accounting to ourselves as to how we really relate to our government.

Today, when a President who does not believe in spinning a web of fiscal illusion asks us to confront honestly an issue of enormous fiscal and moral importance to the country, we cannot handle it. Our fiscal illusions run so deep that we cannot shake them, and so our debate on healthcare is reduced to expressing raw emotions and logical non sequiturs, while standing on a soapbox of false premises. Here then is the real damage done by our decades-old tactical decisions to garb government programs in the rhetoric of private accounts, or to hide the government apparatus from the consumer, or to rely on tax expenditures: by encouraging fiscal illusion, we disassociate citizens from government. Our collective contempt for our government might be mitigated a bit, and the quality of our debates enhanced, if we realized how intimately all of us rely on today on the federal government to obtain our personal financial wellbeing.