WE ARE BETTER THAN THIS

HOW GOVERNMENT SHOULD SPEND OUR MONEY

EDWARD D. KLEINBARD

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To the memory of my father, who delayed my entry into academia by 30 years—
just long enough for me to have something useful to say

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INTRODUCTION

A NATION OF JERKS?

Let me ask you a question: What do you believe our government is good for?

I can almost hear the chortling—the nearly irresistible urge to answer my question with a hearty "Nothing!" and then to turn back to one's private pursuits. But I ask that you consider for a moment the possibility that the answer is not quite this obvious, and that in fact government—which is to say, all of us, acting collectively—can make our country healthier, wealthier, and happier, if we put government to useful work in those areas where it most productively complements our private markets.

That is what this book sets out to demonstrate. Its purpose is to encourage readers to resist the gravitational pull that naturally tugs us in the direction of becoming what one recent opinion piece termed a nation of "jerks."[1] That short article summarized research suggesting that the fraction of Americans who believed that government should guarantee each person enough to eat and a roof over her head fell by 10 percentage points over the five-year period since the onset of the Great Recession, declining to fewer than three out of five Americans in 2012. It would be nice if this disenchantment with government were a consequence of government's displacement by nationwide movements that actually funded and operated community-organized food banks and shelters sufficient to the national task, but the data contradict this convenient claim. Millions of American citizens are hungrier today than they were in 2007, and the reason is simply that those of us who are not acutely hungry are more anxious about ourselves and our own economic security.

As I write this in late 2013, our economy still underperforms for most Americans. As a result, this personal economic anxiety is understandable. But

We Are Better Than This shows that the path forward to a better economic environment for all of us lies through more government involvement, not less. When we starve government of resources, it turns out that we largely are starving our own long-term prosperity.

We are inundated today by economic noise and fog designed to generate superficially plausible rationales for what at bottom are simply jerk-like instincts. You see this machinery at work, for example, when you read editorials making the "leveling down" argument: you cannot make the poor rich, the writer sadly notes, by making the rich poorer—there's just not enough money to go around to do that. In your naïve ambition to level up the poor, you will only succeed in leveling down the rich. The regrettable slaughter of the goose that laid the golden eggs is sometimes invoked. The writer then typically draws from this purported iron law of economics the conclusion that, since the rich cannot shoulder the whole burden, why ask them to do anything at all?

We Are Better Than This refutes these and similar exercises in false economic syllogisms. The book demonstrates that we effectively leave long-term prosperity and happiness off the table through our current penchant for minimalist government. And it makes the economic case for a more muscular federal government that complements the private sector through sensible investment and insurance programs.

In making the economic case for government investment and social insurance functions that work with, not against, the private sector, *We Are Better Than This* shows that we can afford to pay for government to take on a larger role, and that our semi-annual budget emergencies are largely false fiscal crises. It calls for somewhat higher federal income tax rates than those in force in 2013 (except at the top!), but not materially higher than those in 1999, when the economy was humming. There is nothing terribly radical in the book's programmatic aims (except perhaps in its fundamental business tax reform suggestions, all the way at the end of the book). I am not a closet Trotskyite. I am, in fact, a friend to business—in a Dutch uncle sort of way.

Along the way, the book marshals a great deal of evidence, and assists readers in becoming much more sophisticated consumers of claims regarding tax and budget policy. The reader who makes it all the way to the end may well not agree with me at every turn, but he or she will be a better informed citizen, and much less likely to be a fiscal jerk.

TAXING AND SPENDING, OR SPENDING AND TAXING?

As the actor Edmund Kean lay on his deathbed, a tactless friend inquired whether dying was difficult. "No," Kean replied, "Dying is easy; *comedy* is hard."

And so it is with fiscal policy—that is to say, the art of government spending and taxing. Households find it difficult to earn money and easy to spend it. But for governments, taxing—the side of fiscal policy that seems so difficult and abstruse from the outside—turns out to be relatively easy as a technical matter; it is the policy underlying government spending that is maddeningly difficult.

This conclusion is something of an embarrassment to me, as I have spent 35 years meditating on federal tax matters, as a practitioner, government official, and academic, but it nonetheless is true. Colbert—not contemporary pundit Stephen, but rather Jean Baptiste Colbert, finance minister to King Louis XIV of France—explained the essence of tax policy neatly 350 years ago: "The art of taxation," he wrote, "consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing." All of contemporary tax policy analysis is just an elaboration.

Since the time of Colbert, we have learned a great deal about how to pluck the goose as quietly as possible. Public finance economists (the subspecies who study the effects of tax and government spending policies) now have a reasonably clear idea of which tax policies lead to the fewest squawks, in terms of unintended economic consequences. Government spending, on the other hand, is completely different. There are no generally agreed-upon technical solutions to the question, what is the proper role of government? This question, it turns out, ultimately does not even reside solely in the domain of economics (although many economists resist this). Instead, the issue implicates questions of moral and political philosophy with which thinkers since Aristotle have wrestled.

So all of our technical knowledge on the economic side effects of taxation cannot resolve the fundamental fiscal issue that dominates contemporary political discourse, which is how much tax revenue our technical expertise should be harnessed to collect in the first place. But in turn, government taxing and spending are completely bound to one another, so that policies in respect of one side cannot be developed without considering the other.

The famous economist Milton Friedman summed things up with the maxim, "to spend is to tax." That is, every decision by government to spend money necessarily requires an offsetting commitment to raise the revenues to pay for that spending. Friedman's aphorism is as close to a Newtonian law as economics gets.

Of course, government has a few choices of how to relate taxing to spending, some of which are more disreputable than others. Its honorable choices are to tax now to pay for current spending, or to issue bonds (IOUs) today, and collect taxes tomorrow (or the day after tomorrow) to repay those borrowings. Government's seedier options include borrowing today and then relying on inflation to minimize the tax burden tomorrow, but that is just a way of saying that inflation itself is a hidden and pernicious sort of taxation, in this case on lenders. And finally government can amaze the world by borrowing today and defaulting tomorrow, but this tactic turns out to be so cataclysmic in its implications that only a modern Nero would contemplate it.

Tax policy is the handmaiden, and spending policy the sovereign: we need to decide on what projects to embark collectively through the intermediation of government before we can design a tax system to meet those needs. Our greatest public finance policy mistake over the last few decades has been to obsess over tax policy, while simultaneously failing to have serious and rational debates over spending policy. We quibble over tactics without really engaging in the more difficult enterprise of forging a national consensus on our strategic objectives.

And therefore this book, which in its embryonic form was an explanation of the tax policy choices that confront us as a nation, necessarily has evolved into a more discursive inquiry into what we fairly should ask our government to do by way of spending our money. It is also a confession by a longtime tax geek that I, like many others, have elevated the tactical issues of tax system design beyond their ultimate importance to our society. Instead of arguing about tax rates or even levels of tax revenues in the abstract, we must focus instead on the real question, which is what we think our government is good for.

WHAT'S MORAL PHILOSOPHY GOT TO DO WITH THIS?

Fiscal policy recommendations in the end always are normative—they embody a point of view about our values, our relationships to each other, and what those values and relationships should be. Spending may be the sovereign, and tax policy the handmaiden, but *what* we choose to spend on is determined by our values and belief systems. And these in turn should be discussed more directly than they usually are, even by those of us whose inclinations tend more toward action than rumination.

This means that the book necessarily must touch on moral philosophy. To be clear, I hate philosophy just as much as does the next red-blooded American. Most philosophical texts are too convoluted and abstract to gain much traction with me, and I have the urge to tell any philosopher I meet that he should just lay off the word games, get outside, and throw a football around with the other fellows. But it turns out that all fiscal policy recommendations rest on a foundation of moral philosophy: the only question is whether we are conscious of that fact.

My values are old-fashioned progressive values. I internalize these values for two reasons. First, I believe that almost all of us embrace the dignity of work as a central organizing principle in our lives. I do not accept the picture of America that some like to paint, of a vast underclass interested only in leeching, or mooching, or whatever the verb of the moment is, off a virtuous super-class of authentically productive people. And because I believe that government serves all of us, I tolerate the occasional counterexample, if rooting him out comes at the cost of failing to help thousands or millions of others to achieve as much as possible out of their lives.

Second, I see the pervasive hand of fortune—of simple luck—at work everywhere. I am very industrious, and I have achieved some success and material comforts, but I could fill a book longer than this one with all the good fortune that has come my way, starting with my native intelligence. Those who ascribe everything they are and have achieved to their "native" talents, and who view with derision those who have not achieved comparable success in the world, not only willfully overlook the good luck that has come their way, but more fundamentally fail to consider why it is they are blessed with those congenital qualities that the world rewards. Their fiscal thinking—usually articulated as a confusion of personal financial freedom with a society's political freedoms—ultimately rests on thinly veiled narcissism, or the embrace of a cartoon version of Calvinist predestination. Both are distasteful and un-American.

We Are Better Than This focuses mostly on economic claims and arguments, because that is the arena where modern fiscal debates actually take place. But I do think it worthwhile to hold up our moral premises for examination from time to time. I do this in particular by exposing readers briefly to the moral philosophy of Adam Smith. He would have been appalled by the affixing of his name to a belief system in which personal selfishness entirely explains individuals' behavior and life goals, and in which government exists principally to get out of the way of market transactions. By glancing occasionally at what Adam Smith actually thought, we can see how impoverished our moral discourse has become.

A DUTCH UNCLE TO ALL

I am a friend to business, even if the affection is not always reciprocated. I worked for decades on Wall Street, and my own conversion on the road to Damascus lay in the direction of engagement with fiscal policy in a broad sense, not in a repudiation of Big Business, or anything as silly as that. There are no rants in this book about the inherent evils of business, or business people. I fully accept that all else being equal, it is better to be richer than poorer, and that it is natural and appropriate to aspire to wealth.

But that does not mean that life revolves around these themes alone, or that they justify structuring our society as a winner-take-all contest fought in the marketplace rather than the forests of Panem.[2] As Adam Smith said, "When the happiness or misery of others depends in any respect upon our conduct, we dare not, as self-love might suggest to us, prefer the interest of one to that of many."[3] As chapter 2 demonstrates, Smith was vitally concerned with living a life of virtue, one in which rational self-centeredness in the marketplace plays only a small part.

On the other hand, I also am not a cheerleader for the Democratic Party, President Obama, or some standard tropes popular in progressive political circles. I do not think very highly of the fiscal implications of the Affordable Care Act. And I certainly do not propose to apologize for the October 2013 rollout of the infamous website by which citizens engaged with their new health insurance options. It was inexcusably awful, of course.

But by the same token, I do not draw any particular inferences from that debacle for the themes of this book. New Coke was a disaster, but it did not prove the futility or incompetence of capitalism in general. Similarly, the healthcare.gov website screw-up is not a particularly persuasive indictment of the utility of government in all cases, although it does suggest some concrete lessons for how large-scale IT rollouts should be handled in the future. As chapter 11 discusses, we often are quick to make a classic error of logic when we abstract from one concrete instance to a general claim about large-scale institutions. The only larger lesson to be drawn from the healthcare.gov rollout is that there are costs to decades of deprecating government service in general, and failing adequately to maintain agencies' infrastructures.

We Are Better Than This in fact argues that the progressive movement in the United States has made three fundamental strategic blunders over the years. First, the movement allowed conservatives to corner the market in encomia for the virtues of thrift, hard work, and personal responsibility. Progressives also embrace these virtues—they just are sensible enough to see the pervasive role that luck plays in actual outcomes. Because outcomes are uncertain, the collective purchase of reasonable levels of social insurance promotes socially useful risk-taking and enhances the overall welfare of society.

Second, the progressive movement allowed "redistribution" to be viewed as a value-neutral term, when it is not. You can observe this when reading a passage by substituting "social insurance" for "redistribution" every time the latter appears, and then noting how the sense of the passage changes.

Third, and most surprisingly, progressives have been fixated for over 100 years on the progressive income tax as their policy objective, when in fact what they should focus on is promoting a progressive fiscal system—that is, the net of all the "gives" and "gets" between a citizen and her government. Again, spending, not taxing, is the real purpose of government in its fiscal capacity, and it turns out that regressive taxes can and do fund genuinely progressive spending programs that, net, lead to more progressive outcomes.

THE BOOK'S AMBITIONS

Beyond its overarching goal of encouraging resistance to the gravitational pull of fiscal jerkdom, *We Are Better Than This* incorporates several congruent ambitions, all filtered through my unbridled enthusiasm for tax and budget policy. Rethinking what we ask of government requires our active engagement in the political process, armed with accurate information about what we are doing today, how well we are doing it, and how much it might cost to do it better. I therefore situate the United States as one country among many, and I construct report cards for the current health and performance of our society and our government across a range of important functions. When these report cards are examined objectively, we emerge as much less exceptional than we pretend to be, except in some unhappy ways, like our insistence on spending much more on healthcare (nearly $1 trillion ever year in excess spending) than we would if we were to spend the same per capita as the next most profligate country in the world—without materially better outcomes in most cases.

Second, I present in an accessible manner current academic research into fundamental questions about the structure of our society and the trade-offs we face when a government tries to intervene. Who really pays the corporate income tax? Is inequality really growing, or is that just an artifact of how we measure it? Do tax cuts pay for themselves? There often are consensus answers among academics to these sorts of question, but the fruits of the research are poorly disseminated. More disturbingly, our information channels are choked with disreputable rascals who employ sophisticated rhetorical sleights of hand to make superficially plausible arguments to advance political agendas, rather than to increase understanding of our tax and budget policies. I therefore do my best to dissipate the fog of our fiscal wars. The result often is not one inevitable answer, but at least a narrower range of sensible options than our current overheated debates might suggest.

With this grounding in economic facts and analytical methods, the book turns to how government might usefully make things better, in ways that reflect our deepest values. These values include our strong commitment to private enterprise, both because private enterprise in general is the path to greater national wealth and because the circumstances in which it flowers also are conducive to the preservation of personal liberties. I therefore look for channels where government can productively complement the private sector, not replace it. I emphasize two: public investment and social insurance. The second in particular is conceptually important, because it brings into focus the important question of the role of luck in life's material outcomes, and what inferences we should draw from that.

Finally, the book returns to the area of my own academic work, which is the design of our tax system. Again, government does not exist to tax: it exists to spend, and tax design is just a question of how efficiently to raise the necessary revenues to support productive government spending. But of course there are smart and dumb ways to impose taxes, and I therefore suggest how we might move past some of the bad ideas that we currently embrace.

THE BOOK'S DATA SOURCES

Writing a book like this sometimes has the feeling of chasing one's own tail, because governmental agencies regularly update the data that they publish on our government's spending and taxing, and because new studies come out constantly. Whenever possible, I draw my data from the most reliable nonpartisan resources, such as the Congressional Budget Office, the staff of the Joint Committee on Taxation, and the Organisation for Economic Co-operation and Development. The book's data generally are current as of December 2013. Nonetheless, the fiscal trends that the book describes and the fundamental tensions that bedevil our public discourse surrounding our conception of government will not disappear in the immediate future, and I therefore hope that the book will be found useful even after the bloom is off the rose of the data I present.

Since this book entered production, a new book by Thomas Piketty, *Capital in the Twenty-First Century*, has rightly attracted enormous interest. Piketty's new volume appeared too late to be incorporated directly into this book's arguments, but I do rely on several of his earlier papers. Serendipitously for me, the two volumes are complementary in their objectives. Piketty studies long-term historical trends in inequality, and emphasizes that in low-growth eras capital, if left unchecked, can grow to levels where "patrimonial capitalists" dominate society and erode democratic values. Piketty's solution, which he himself acknowledges to be unrealistic, is a global wealth tax.

This book also recognizes the central importance of economic inequality, but paints a somewhat broader picture of the welfare of contemporary Americans. Instead of looking back through history, I emphasize cross-country comparisons across a wide range of welfare metrics among contemporary affluent countries. I do this to puncture the narcissistic bubble of American exceptionalism in which so many Americans live. I also focus on the vagaries of American political rhetoric and budget processes, which of course are not germane to Piketty's magisterial exploration of economic history.

Ultimately, this book tells a more optimistic story than does Piketty's major contribution. Early on, I deliver our dismal national report card, but I then explain how all of us, working together through the medium of government, can complement private markets in ways that lead to better economic outcomes (in the narrow sense) and welfare for all Americans, not just the patrimonial capitalists—in other words, how all of us can participate in improvements in our country's future national report cards. This book thus is a principled call for the reinvigoration of government as a positive complement to private enterprise in contemporary America. Finally, my substantive proposals, and in particular my ideas about comprehensive tax reform, are targeted to the immediate needs of the United States, which again was not the goal of Piketty's volume.

A CLOSING APOLOGY

This is a long book, but one that covers a great deal of ground. I have endeavored to give useful citations to important academic contributions in each field that I discuss; in general, I err on the side of citing recent contributions, on the theory that they typically incorporate discussions of earlier foundational works.

To every academic who picks up this volume, checks the references in the back, fails to see his name, and therefore assumes the work to be useless tripe, I ask your forbearance. If I were to cite every paper that has any relevance to the topics I cover, the endnotes alone would occupy several volumes. I hope that I have captured the sense of current academic debates on the themes I develop, but I cannot possibly identify every contribution to those debates.

More generally, I am profoundly grateful to the academic community as a whole for the kind welcome I have received in academia, despite my *arriviste* status. Writing this book has been a forceful demonstration of just how demanding our discipline is, and I am filled with admiration for those who have pursued it productively for decades.

WE ARE BETTER THAN THIS

PART I

OUR FISCAL SOUL IN PERIL

CHAPTER 1

THE HAPPINESS OF SOCIETY

Nothing tends so much to promote public spirit as the study of politics.... [P]olitical disquisitions, if just, and reasonable, and practicable, are of all works of speculation the most useful. Even the weakest and the worst of them are not altogether without their utility. They serve at least to animate the public passions of men, and rouse them to seek out the means of promoting the happiness of the society.

—ADAM SMITH, *The Theory of Moral Sentiments*, Part IV, Chap. 1.

FISCAL POLICY AND OUR HAPPINESS

We are a nation consumed by one great imperative, which is to protect our freedoms. But somehow many of us have confused our personal wealth with our political liberties, and in doing so have precipitated both an endless series of arid political debates over the role of government in our lives, and one unnecessary federal budget crisis after another. These debates have obscured from view the real topic that should interest us, which is, what can we do to enhance what Adam Smith meant by "the happiness of the society"? To answer this question requires an inquiry into how states help their citizens to be happier within a society than they would be on their own.

The essence of a state as a political construct is that it exercises the power of coercion over its own citizens. Anything else is a club, or a charity. The great virtue of a democracy is that all citizens participate at least indirectly in how government's power is exercised over them, and each citizen's vote is weighted the same as every other's. These are the political liberties on which our government was founded. But even democracies compel their own citizens' actions.

Many in the United States today argue that government as a concept is fundamentally suspect for the very reason that distinguishes a state from a club or a charity. Personal economic liberty—in short, an unalloyed right to keep what is mine—is seen as the only value that leads to the happiness of society; the police function of protecting personal economic liberty in turn is seen as government's one proper role.

The irony is that the United States applies a particularly light touch in this regard to Americans not currently incarcerated—with one great exception, which is taxation, and one minor one, which is jury duty. But from this failure to distinguish a state from a club springs a hatred of taxation wholly disproportionate to the reduction in our personal consumption that taxes entail, because taxation is the only significant manifestation of direct government coercion that affects most of us each year.

This book argues that the strand of contemporary American political thought that defines itself through its hatred of taxation is narcissistic self-pleading wrapped in a flimsy sheath of economic lingo. Personal economic liberty, of course, is one foundational principle of our country and our economy, but it is not the only principle that defines us; and the emaciated government that this philosophy demands is not the way to promote the happiness of society, if by that we actually mean the society composed of all of us who identify ourselves as Americans. Our fixation on taxation means that we have turned our thinking upside down: instead of focusing on what government might usefully do, and whether we can afford it, we obsess over the taxing side of things, and ignore the purposes to which those tax revenues are applied.

This book responds to these narcissistic false syllogisms. Its purpose is to provide readers with a fair and comprehensive review of how we collectively are doing in promoting the happiness of our society, to explain fundamental economic and political precepts relevant to analyzing our options, and to propose programs by which government spending can enhance our welfare—meaning both our material prosperity and the intangible values that contribute to our society's tranquility and happiness. Finally, the book addresses how best to design tax systems to finance those spending programs, keeping in mind our national preferences for modesty in tax demands and the central importance of private enterprise.

In other words, this is a book about *fiscal policy*—the technical term for government spending and the taxes that finance that spending.[1] It is also a book about limits: every government intervention has costs, and not every moral imperative can be wholly honored. The art of fiscal policymaking lies in deciding these hard cases in rational ways that honor *all* the deep values of a society.

My metaphor is that of our "fiscal soul": it captures the idea that we choose to articulate many of the values that distinguish us as a country, and that advance our society's happiness, through the mediation of government. As former congressman Barney Frank was fond of saying, government is just the things we decide to do together. We give expression to the shared values we wish to promote in large measure by deciding to invest in them. We all kick in money into a central pot through taxes, and we spend that money to promote the happiness of our society. To breathe new life into the common themes that define us as Americans, we must reclaim our fiscal soul, by embracing opportunities where government (that is, all of us, acting together) can improve our collective welfare through thoughtful spending programs.

Our fiscal soul is malleable, and our articulation of it often aspirational. Nonetheless, most of us would agree that the shared values to which we aspire include a commitment to genuine freedom of opportunity for all Americans, which in turn requires access to adequate nutrition and to high-quality education, regardless of income levels. We are appalled at the thought of seniors, or children, or veterans, living in grinding poverty. We reject racism, sexism, religious intolerance, or other invidious distinctions among us. We love the American landscape, and embrace the importance of clean air and water. At the same time, our shared values include respect for individual autonomy, and impatience with centralized meddling without good cause. And to a large extent we Americans define ourselves by our work; as a result, we are committed to the idea that every working-age American should have the opportunity to find and prosper at a satisfying personal work career. Thoughtful fiscal policy—the spending we decide to do together—breathes life into these aspirational values.

Stephen Colbert (the comedian, not Louis XIV's finance minister of France) once remarked that the United States is the new Sparta, except less tolerant of homosexuality. It is true that we spend an extraordinary amount on our military—about 42 percent of the entire world's military budget—but the metaphor of our fiscal soul reminds us that we define ourselves as more than a standing army, and that thoughtful government spending and taxing actually advance the values we hold dearest, and thereby the happiness of our society.

THE INSTRUMENTS OF FISCAL POLICY

Moral imperatives and collective economic opportunities align particularly well in two broad categories of fiscal intervention: social insurance and investment. Social insurance (the subject of chapter 11) is the easier of the two to visualize, and is an instrument that we already employ in many instances, like Medicare or Social Security.

Insurance is fundamentally about risk transfer and risk distribution. An individual transfers the financial risks of some adverse fortuity—a car accident, a house fire, or dying prematurely, to take three familiar cases—to a larger group, thereby distributing the risk across the group. Risk distribution from an individual's perspective turns an uncertain but very large cost into a certain but small and predictable one—the insurance premium. So long as the adverse fortuities are uncorrelated with each other (my house fire is not causally connected to your house fire), insurance companies can rely on the law of large numbers and actuarial research to turn the unpredictability of a single adverse event into a predictable stream of outflows across the larger group, which enables insurance premiums to be priced.

Private insurance markets are not complete: we cannot insure through private markets against every adverse fortuity that we might wish to. In other cases, private insurance is essentially inefficient, because of the fundamental problem of adverse selection—the tendency of those with private information that they are more likely to need insurance to be the first to step forward to buy it. Voluntary private health insurance is riddled with adverse selection dilemmas, and the methods used by private insurers to address this problem make the market expensive and incomplete.

Governments are extremely effective at complementing private insurers, because the tools of insurance are right at governments' fingertips. Governments typically have available to them a large captive pool of risks (their residents or citizens), thereby making risk distribution possible. If the insurance pool is defined broadly enough and is mandatory, government can remove in one blow the problem that bedevils private insurers of adverse selection. Governments have available low-overhead mechanisms to collect the requisite premiums: taxes. Finally, a government insurance program is an exercise in the pure mutualization of risks: the government as insurer is in the game to administer the transfer of risks among the participants in the pool, and to pay out claims from the premiums collected, but not to make a profit for itself.

The case for government as insurer thus is often an easy one to make. Indeed, this is why most developed countries run health insurance as a government insurance program.

At a more fundamental level, we cannot insure in private markets against all the random allocations of bad fortune that drive many of life's outcomes. Those who are born with the requisite genes to grow up tall, handsome, and clever often are befuddled by why others seem to struggle so hard to accomplish so little, or worse yet give up struggling. If we think about things a bit, though, we should appreciate that our founding fathers really did not create a government premised on the belief that happy material outcomes are outward manifestations of inner good karma stored up from past lives. Good fortune makes prosperous outcomes much easier, as the discussions later in this chapter and throughout the book demonstrate.

To acknowledge the pervasive role of fortune in our material lives does not imply a conspiracy to "level down," or to "mooch" off the productive elements in society, but rather a commitment to offer all members of society a reasonably fair foundation on which to build productive lives. In the end, we as a society are richer, not poorer, through these interventions, and we also are more tranquil, and therefore happier. The question remains, however, just how much of this sort of insurance we can afford to buy. That is what makes fiscal policy interesting and challenging, once we get past the convenient mythologies that we invoke to shield ourselves and our assets from serious engagement with the issues.

Government investment (chapter 10) has a disreputable air about it, as if by this term I am going to advocate ersatz Soviet-style five-year plans, in which the federal government either props up private firms that cannot survive on their own or tries to pick the Next Big Thing in which to invest. Everyone understands this to be a loser's game, at least in normal times: the government is a mediocre venture capitalist, at best, and the case for this sort of intervention generally is difficult to make.[2] Where private markets function smoothly, there is, or should be, a heavy presumption against government investment. Indeed, the problem we confront in this regard is exactly the opposite: we use the tax code today to make all sorts of government interventions in private markets, by subsidizing one or another industry or type of private investment. The trick here is not for the government to intervene more, but for us to recognize how often, and how pointlessly, it intervenes today through the hidden mechanism of tax subsidies.

But not all government investments are disreputable. Education is one obvious and critically important example that I will return to several times over the course of this book.

Tangible public goods like infrastructure investments also can work very well as government programs. Governments can appropriately take a broader view than can a private firm of the returns to an infrastructure investment, because a government ultimately cares (or should care) about the well-being of its citizens. So infrastructure investments that generate good construction jobs (and perhaps in difficult economic times enable people to preserve work skills and avoid falling back on government safety net programs) have positive spillover benefits that a government—that is, all the people, acting together—can take into account along with the direct returns from the investment, but that would not show up on a private firm's profit and loss statement.

Governments also can take a longer view of an infrastructure investment's payback period than can most private firms, since a government's long-term viability is largely assured. Private firms must price into any "public-private partnership" infrastructure project the risks of future government administrations trying to renegotiate or cancel the deal, but the government does not have to charge a premium to itself to cover any possible future bad faith behavior by it. Governments typically have lower costs of debt finance than do private firms, particularly in the construction industry. And the government, unlike a private firm, does not need to earn a profit on its infrastructure investments. For all these reasons, it is unsurprising that private toll roads and the like remain a small fraction of public infrastructure investment in the United States.

OTHER TOOLS OF GOVERNMENT

Government can wield other instruments of coercion beyond the power to tax. In particular, government can choose the instrument of regulation. Regulation, under the rubric of "job-killing red tape" or the like, is possibly even more despised than is taxation. Much contemporary political rhetoric in this area has an odd Homeric quality, but without the hexameter: all the leading figures and institutions are everywhere preceded by their epithets. So, instead of "rosy-fingered dawn" and "wine-colored sea," we have "job-killing red tape." I sometimes imagine a missing chapter of the *Iliad*, in which swift-footed Achilles battles job-killing Red Tape below the towers of Troy.

Government also has available the instrument of conscription; that is how we used to staff our armed services, and how the pharaohs built the pyramids. Conscription, however, is not part of our current culture.

Regulation includes the quasi-police function through which government ensures that private markets in fact operate efficiently (e.g., through the disclosure rules of the Securities Exchange Commission). But more interestingly for this book, regulation also can function like a form of hidden taxation, but one in which private actors retain a bit of operational control.

This book is not about choosing among these different instruments as much as it is an exploration of how government spending (and the taxing necessary to fund it) can be restored to its rightful place as an instrument to promote the happiness of our society; regulation by itself does not lead to better government insurance or investment programs. Nonetheless, regulation and taxation can sometimes serve as substitutes for one another. The right place to begin in every case is whether a government intervention of some sort is warranted, and if so, what is the right tool to effect that intervention—regulation or taxation?[3] The usual questions are: Which is administratively easier? Which is fairer? Which is better targeted to solving the problem without unnecessary additional burdens?

A good example in the arena of fiscal policy is the theme known in policy circles as "making work pay." The idea is that there are substantial positive returns to society from helping adults to enter and remain in the workforce, through assisting them in overcoming some of the hidden costs (child care arrangements, bus fare, cost of uniforms) that make the first step from unemployment to employment surprisingly costly. One strategy is a subsidy delivered to low-income wage earners through the tax system (known as the earned income tax credit). Another is the minimum wage. One is nominally a tax solution (formally, a tax rebate), and the other a regulation, but the two point in the same general direction. The principal difference between the two is where the burden of the rule falls in the first instance—on all taxpayers (the earned income tax credit) or on employers (the minimum wage). (There are meaningful second-order differences as well: some portion of the intended tax subsidy can be captured by employers reducing employees's wages, and some beneficiaries of the minimum wage are the children of affluent families holding after-school or summer jobs.)

In some cases, direct regulation that either mandates some positive behavior or forbids some undesirable one is the right instrument. Immunization is a good example of this last category. To achieve "herd immunity" and thereby suppress a disease even among those not immunized, it is necessary that a large proportion (say 85 percent) of a population be vaccinated. In this case, your decision to forgo vaccination affects not just your health but that of your neighbors as well. For this reason, governments (under our Constitution, typically state governments) often require that individuals receive vaccinations. Even though vaccination rates can never reach 100 percent, the herd immunity effect can protect the minority of the population that is not vaccinated, but the government effectively must compel every member of society that it can reach to be vaccinated, to ensure that the herd immunity threshold is reached, and because it would be viewed as unfair for one citizen to declare that he is the only one who is permitted to opt out.

Fundamental civil rights legislation, or Title IX (requiring equal treatment of female and male athletes in school athletic programs), or the Americans with Disabilities Act (requiring that facilities open to the public be made handicap-accessible) are other examples of regulations that prohibit certain behavior, or that mandate new behaviors. As such, they do not contemplate the fine-tuning of responses that a pollution tax does, because our society decided that no one should buy his way out of compliance with these goals. But the out-of-pocket compliance costs of these sorts of programs, particularly in the case of mandated positive action, are similar in effect to a tax on the objects of the mandate. That is, just as with an explicit tax, affected actors in the private sector are compelled to part with cash, but in the case of regulations the money goes to pay for specific goods (handicap-accessible bathrooms, for example) whose acquisition is overseen by the taxpayer.

Different forms of regulation and taxation thus constitute a continuum of possible government interventions; often, one can substitute for the other, particularly in the commercial sphere. In such cases, it is accurate to see regulation as simply a different form of taxation (or for that matter, the other way around). But even when regulation and taxation are close substitutes, they do not receive identical treatment in government accounts. Our standard metrics for describing what government does (taxes collected, deficits incurred, government spending as a percentage of gross domestic product) do not track the cost of regulating one activity, or prohibiting another.

This fundamental difference in "salience"—in the visibility of government's hand on the marketplace or our individual lives—can sometimes lead to distorted decisions, when for example government chooses the low salience instrument (regulation) to accomplish a task more logically handled by the higher salience one (taxing). The difference in salience also means that it theoretically is difficult to make comparisons across radically different societies. A highly regulated low-taxed country may suffer more "deadweight loss"—the distortions in individuals' behavior induced by government intervention—than would be true of a higher-taxed country with more functional markets. In practice, however, the developed economies of the world are not so different in their choice of governmental instruments as to make such comparisons inaccurate.

NATIONAL WELFARE IS NOT NATIONAL INCOME

Years ago, in the midst of the Mexican sovereign debt crisis, James Carville famously remarked that in his next life he wanted to come back as the Bond Market. The Bond Market is remorseless, almost insatiable, and ultimately unbeatable, as the slow motion train wreck of euro sovereign borrowers in 2012 reminded us. From Ireland to Portugal to Greece to Spain to Italy, the market turns to prey on the weakest of the herd of borrowers, until its demands are satisfied, or no more blood can be drained from the borrower's corpse.

It sometimes seems as if in our public discourse we share a similar attitude toward another institution, which we describe as the Economy. We do this when we measure every policy proposal almost entirely in terms of its alleged contribution to the Economy, usually framed in terms of aggregate gross domestic product (GDP). GDP essentially totes up the value of all the goods and services we produce in explicitly transactional settings in the United States. Even within the domain of work, narrowly construed, GDP captures only a fraction of our real work contributions: work within the household, for example, is ignored.

To measure every policy by its alleged effects on GDP is a sophomoric understanding of the human condition and the role of government. What we should care about is our aggregate welfare, which is not the same thing at all. "Welfare" incorporates all the instances of happiness, well-being, satisfaction, contentment, or similar concepts that together add up to what we would describe as an authentic and good life.[4] It is exactly what the framers of our Constitution had in mind when they provided (Article I, Section 8) that the Congress had the power "to lay and collect taxes . . . to provide for . . . the general welfare of the United States."

This use of "welfare" is commonplace in modern economics and the social sciences generally, but it is very different from how the term is used in ordinary conversations, where it connotes a program designed to help the poor, usually in a derogatory sense. Of course the welfare of individuals in poverty is enhanced by "welfare" programs, but the use of the word in the second context confuses matters. Such programs more neutrally are "income support" programs, when viewed from the perspective of their objectives, or "means-tested" programs, when viewed from the perspective of their eligibility criteria.

The logical error of conflating a nation's GDP with its welfare is endemic. Consider, for example, the famous economist Milton Friedman, whose popular work emphasized the theme that capitalism and freedom were joined at the hip.[5] In Friedman's construct, unalloyed capitalism supported the cause of personal freedom, and near-absolute personal freedom in turn was the foundation of successful capitalist systems: to interfere with one was to jeopardize the other. This worldview leaves little room for government to articulate any shared values beyond those required to host laissez-faire economic tournaments.

Thus, Friedman was mystified by the existence of national parks: "If the public wants this kind of activity enough to pay for it, private enterprises will have every incentive to provide such parks. And, of course, there are many private enterprises of this nature now in existence. I cannot myself conjure up any . . . [reasons] that would justify governmental activity in this area."[6] Putting to one side the factual error—there are no private enterprises in the business of offering customers privately owned million-acre authentic mountain wildernesses—Friedman's argument boiled down to the claim that, because he did not understand the value of wilderness or the symbolic pull of the national parks as an expression of national pride, no such values could possibly exist.

Yet millions of annual visitors—four million a year at Yosemite alone—not to mention calendars and coffee table books, point otherwise: many Americans take solace in our common ownership of some of the world's most beautiful terrain, and enjoy the thought that we collectively maintain places where the wild things really are. We accept an apparent economic efficiency cost (a small increase in taxes, which means a constraint on our individual freedom to spend our money exclusively on our private pleasures), in order to fund a portion of the cost of these great commonly owned resources that are open to all of us. We pay for the rest through user fees, but we keep those fees to a reasonable level, and use the tax system to pay the remainder, precisely to ensure that access is within the reach of most Americans.

National parks are an example of how national welfare and national product do not always perfectly overlap. And we reach agreement that national parks or other instances of government spending beyond the narrowest possible police functions "promote the happiness of the society" through the mediation of the political system, which is the forum in which consensus is forged and national values are articulated.

As a more recent example, Britons in 2012 enjoyed not only the usual clutch of holidays, but also the Olympics and the Queen's Diamond Jubilee (conveniently organized to offer workers a four-day weekend). One business organization responded by urging that this sort of frivolity should cease, as it was sure to cut into Great Britain's 2012 GDP. *Financial Times* columnist John Kay nicely skewered this sort of thinking:

> One could analyse these effects indefinitely, but the only thing to be gained from the exercise would be insight into the conventions of national accounting. Measuring output is of interest only as a step on the road towards measuring something else. . . . After all, we could raise GDP further by cancelling Christmas (though we would lose the expenditure on unwanted gifts), taking shorter vacations (though think of the impact on easyJet), and by working till we drop from exhaustion. But why would we want to? The idea that there is something called "the economy," which is separable from the welfare of society and its citizens, is silly. There isn't. What really matters is whether the holiday, and the celebration, makes [*sic*] us better off. That question answers itself without need of economic statistics.[7]

Throughout the study of fiscal policy, our metrics, like GDP, often come to frame our thinking: because hunger in America, for example, reduces national incomes in ways not visible from casual inspection of GDP data, and because the misery that follows from poverty is wholly ignored, we tend to give short shrift to these fundamental issues of welfare, unless they are recast in econometric terms.

The country of Bhutan recognized this framing problem, and at one point in time replaced GDP as its official measure of its year-to-year development with GHP—its gross happiness product (although recently it has returned to more conventional measurement norms).[8] This is an adorable conceit, but one perhaps not terribly practical when applied to the United States, which accounts for about one-fourth of the world's income. The idea behind this book therefore is not to urge the abandonment of GDP as a policy tool, but to invite meditation on the underlying assumptions behind metrics like GDP, and the limits they impose on our public discourse.

WHAT DOES GDP ACTUALLY MEASURE?

Deep in the bowels of every business is an accounting system, and at the foundation of that accounting system is the general ledger. The general ledger is the place where all of a firm's transactions are recorded (technically, recorded twice, in double entry bookkeeping). From the general ledger the firm's accountants distill more abstracted (and more useful) pictures of the firm's wealth at a point in time (the balance sheet) or its income over a period of time (the income statement).

The closest analogy that the country as a whole has to a general ledger are the dozens of accounts that together comprise the National Income and Product Accounts, or NIPAs.[9] The NIPAs are produced by the Bureau of Economic Analysis (a division of the Commerce Department). The NIPAs' star attraction for economic analysis and political wrangling is the calculation of GDP.

The NIPAs are complemented by the Federal Reserve Board's Flow of Funds Reports. These reports can be understood as tracking the flows of money from households, businesses, and governments with money to save or invest to other households, businesses, and governments in need of financing. The Flow of Funds Reports are the only government reports that give a comprehensive picture of the assets and liabilities of households, including net worth.

The two sets of data are now closely integrated, so that but for the accident of which government entity produces which, the NIPAs and the Flow of Funds Reports can be viewed as one comprehensive record of the value added by the economy and the modes of financing of investments in a specific time period.[10]

The federal government produces a great many other datasets beyond the NIPAs and Flow of Funds Reports that are relevant to understanding how we as a country are doing. The Bureau of Labor Statistics compiles employment data; the Census Bureau collects useful personal information through the census, and also publishes statistical compilations of median incomes and the like; the IRS Statistics of Information Division publishes aggregated data drawn from the 140 million tax returns filed every year (so that you can look up how many tax returns claimed a charitable contribution deduction, or the minimum income required for admission onto the list of the 400 highest-income taxpayers for a year); and so on. I sometimes suspect that the best reason to get a PhD in public finance economics is because somewhere along the line someone must hand you the secret handbook telling you which agency collects which data, under which name.

Notwithstanding this torrent of useful information, GDP is the right place to start, because it figures so prominently in all our thinking about our economic health. It turns out that GDP is a more exotic concept than most people realize, and does not even purport to measure what most of us think it does.

GDP does not measure income, in the same sense that the tax code or an accountant uses the term, nor does it measure the country's wealth, or even its change in wealth. And GDP certainly does not directly compete with Bhutan's former calculation of gross national happiness as a measure of our collective welfare, in any complete sense.[11]

There are many equivalent ways of describing what GDP does measure. GDP can be said to measure the total "value added" over a specified period of time by the visible market economy of the United States—the dollar value of all goods and services created in the United States for sale to final customers (that is, ignoring business-to-business intermediate sales). Another way of phrasing matters that may resonate with readers accustomed to corporate income statements is that GDP measures the sum of all compensation income for labor performed in the United States, plus what business people might recognize as a sort of mega-EBITDA—that is, the earnings of all US businesses, after compensation and other costs of earning that income, but before taking into account interest or other financing expenses, depreciation (the allowance for the wear and tear on the machines and structures used to produce goods for sale), and any tax costs. The first way of phrasing things looks to the value of production, the second to the gross income earned from producing everything.

The two formulations are conceptually equivalent. The value added through production must translate into income for someone as soon as the production is reduced to cash—either the workers who provide their labor or the owners of businesses. So by definition, aggregate gross incomes of labor and business must equal the value of aggregate gross production.

GDP has some of the same flavor in an eighteenth-century insight called Say's Law (after Jean-Baptiste Say), but Say (or at least followers of Say) took matters one step further. Say asserted that production creates its own demand—that once value is created, and labor or business owners realize income, then they must do something with that income, and the only two things that you can do with your income is to spend the money on current consumption or to invest it (ultimately in more means of production). So, said Say, creating value creates income, which creates demand, because that's all you can do with your income—you demand other stuff with it. In other words, build it, and they will come. Say's Law is the great-grandparent of supply-side economic logic.

At its logical extreme, Say's Law (or perhaps Say's Lore) argues that there can be no such thing as depressions or massive recessions, which we know do occur. John Maynard Keynes's contribution was to create a logical story as to why production does not always create its own demand, and why in fact demand is sometimes needed to prod the supply side along. Keynes's core prescription basically was that, since the private sector under-demands things in recessions, government should pick up the slack by borrowing and spending (demanding goods and services) until the economy recovers its equilibrium, at which point the government's borrowings can be paid down.

The national accounts from which GDP is drawn properly are agnostic on whether supply (production) creates demand, or vice versa, or whether the answer varies as economies, like spinning tops, sometimes list this way, and then the other. All that the national accounts do is to assert that aggregate gross incomes must equal aggregate value added, without inserting any kind of causality arrow into the picture.

It is worth teasing apart the limitations implied in the definition of GDP. First, as its name reminds us, GDP is a measure of *gross* value added in a period. This means that GDP ignores depreciation—the wear and tear or obsolescence over the same period of the existing "capital stock," which is to say the aggregate amount invested in greasy machinery, buildings, and important intangible assets like computer software, all of which are used to create the added value. Part of the gross domestic product needs to be set aside to replenish this erosion in investment, to get an accurate picture of how much value we actually have created in a period.

Think of the economy for a minute as a single farmer. If the farmer were to eat his seed corn in 2012, GDP would record that consumption as a boost to GDP in 2012. Of course, come 2013, the farmer would starve. The Bureau of Economic Analysis also tracks *net* domestic product (unimaginatively called NDP), which does set aside an amount each year to fund the seed corn for the future, but for whatever reason it has never been the headliner that GDP is.

Second, GDP is a measure of the productivity of economic activities that take place within the United States, regardless of who owns the income-producing assets. A US business owned by a mysterious Lichtenstein trust adds to the GDP of the United States, even if all the profits are distributed to Lichtenstein. And conversely, a German beer company owned entirely by US persons, who earn enormous returns on their investment, contributes nothing to GDP. When people talk about GDP they often really have in mind gross national product, which measures the value added by investments owned by US persons, wherever situated in the world, and excludes US-generated income streams that are owned by foreigners.

Third, GDP is firmly based in the market economy. It ignores illegal businesses, but more important, it ignores all the value created by human beings in the private sphere of their lives—housework, child care, or do-it-yourself projects done for yourself or for your family, rather than for money. (Economists describe this arbitrary demarcation as defining the "production boundary.") This leads to the old joke, no doubt still considered riotously funny at the Bureau of Economic Analysis, about the economics professor who wrecked the economy by marrying his housekeeper: what had been commercial activity (providing housekeeping services for compensation) moved over to the private sphere, and thereby disappeared from view for GDP purposes. The statisticians recorded a drop in GDP when all that had transpired was an increase in married couples.

In reality, the exclusion of the private sphere of human activity from official GDP statistics is no joke, and materially understates the sum total of value added during our waking hours. This limitation is widely understood, and attempts have been made from time to time to quantify it (including attempting to set a value on leisure itself), but obviously precise data on the value added by all the homeowners of America through their assembly of IKEA furniture is hard to come by.

Bureau of Economic Analysis professionals have recently published a fascinating study of the size of this extra-market economy.[12] The study concludes that in

2010 "nonmarket services"—basically, things we do in the private spheres of our lives that we could hire someone else to do (child care, housework, etc.)—had a value of roughly $3.8 trillion, against an official GDP for the year of just under $15 trillion. If included in the official accounts, these nonmarket services therefore would have increased GDP by 26 percent.

The same paper also determined that the value of nonmarket services for the family was a much larger percentage of official GDP in 1965, accounting for some 39 percent of official GDP. The value of nonmarket services as a percentage of GDP has gone down over the last 45 years because women in particular have entered the workforce in increasing numbers. As they did so, they crossed the production boundary and became visible in the official statistics.

But to the extent that families now have to pay outsiders for services that a stay-at-home spouse previously would have performed, crossing the production boundary means that the official data double count our incomes. If the second wage earner in a family earns $30,000 per year (ignoring taxes for simplicity), and the family spends $20,000 of that on services that the second wage earner would have performed for free in the private sphere of the couple's lives, the family really is ahead $10,000 in monetary value (ignoring other satisfactions that come from a career and the like). But GDP data record all $30,000 as a component of GDP—along with the $20,000 of services provided by others to the family.

Our official GDP data thus have behaved like the old joke about the professor, except in reverse: it is as if the professor got divorced and started paying his ex-wife to be his housekeeper. The double counting means that a measurable portion of the growth of incomes of Americans in the official data over the last 45 years just reflected a change in visibility, by virtue of crossing the production boundary—which means that in this respect we have overstated our actual economic growth by some 0.2 percent per year from 1965 to 2010.

GDP does incorporate the private sphere of our lives in one important respect, which is homeownership. The Bureau of Economic Analysis statisticians accept the problems inherent in excluding the private sphere (the production boundary) as a necessary evil, but they work very hard to avoid such artificial results where they can. Housing is the largest class of investment assets in the United States, and so measuring the annual value added by investments in housing is extremely important to our national statistics.

If you rent your home, things fit easily into the standard metrics. Your rent is an annual consumption expense—it is one of the ways you spend your money on yourself for the year in question. And on the other side, your landlord is running a business, and the rental income (net of maintenance and other business costs) shows up as part of total value added by the market economy.

But what if you own your own home? Then you suddenly have retreated to the private side of the production boundary, and if nothing more were done, the contribution of your investment in your home to annual value added would disappear beneath the surface of the GDP ocean.

To keep renters and homeowners on the same footing, the Bureau of Economic Analysis adopts a rule that makes a great deal of sense to economists, and almost none at all to generation after generation of first-year tax law students, where the concept (called imputed income in that context) is discussed at length. The statisticians pretend that a homeowner is in the business of renting her home to herself. They therefore create a hypothetical income statement, showing the rent that the homeowner (wearing her tenant hat) hypothetically paid to herself (wearing her landlord hat). They further treat expenses of earning that hypothetical rental income just like other business expenses. Now a homeowner shows up in the national accounts as both a renter and a landlord, simultaneously.[13]

The Bureau of Economic Analysis collects data on rental rates around the country, and uses that data to estimate (to impute, in their lingo) the hypothetical rental values of all the owner-occupied homes in America, but obviously those values assume a gigantic market that does not really exist. Moreover, as housing prices soared in the early 2000s, the statisticians assumed that rental values for owner-occupied homes would go *down* as a percentage of market value, because landlords would expect to capture a large part of their economic return in the form of capital gains. In turn, as explained below, capital gains are ignored in calculating GDP. But when housing prices collapsed in the Great Recession, that same logic would suggest that imputed rental values as a percentage of market value must go up, to give homeowners, wearing their hypothetical landlord hats, a better return on their investment. One therefore should expect to see owner-occupied housing making a larger contribution to GDP just at the time that homeowners were mired in economic despair.

So GDP overstates our annual increment to national well-being in the sense that by definition it does not reflect an allowance for setting aside next year's seed corn, measures domestic value added rather than value added by assets controlled by Americans, understates our total productivity to the extent that it ignores the private sphere of our lives, including that portion that we could plausibly hire others to do for us, and adds to GDP a large number of market transactions that do not actually exist, in the case of owner-occupied housing. And of course GDP does not purport to value any of the other things that give our lives meaning, like the time I spend cycling rather than teaching.

GDP also does not measure our annual income in another critically important respect, because it completely ignores capital gains and losses. The idea is that GDP measures the annual value added by the economy—the product created in the year—or alternatively the income generated *by that production*. Capital gains are not part of the engine of production; they simply represent someone cashing in on a change in price for an existing asset, but that asset will continue to produce the same added value in the hands of the new owner. And on the downside, capital losses (whether realized or unrealized) also are ignored, even though they represent an immediate loss in wealth. Viewed more abstractly, in economic theory, an increase in value for a productive asset logically represents a discounting to today of all the future income the asset is expected to generate; since GDP measures value added this year, including capital gains effectively would mix expected future incomes with current incomes. (Here is a place where the Federal Reserve's Flow of Funds Report complements the GDP data nicely.)

Of course, the things that money can buy, including money derived from capital gains, do end up in GDP, if those things are produced in the United States. So depending on consumption patterns, capital gains do indirectly feed into GDP. But things get very complicated very quickly if you want to tease apart how much GDP growth is a real (permanent) increase in productivity, and how much is just a temporary run-up in consumption goods purchases fueled by an asset bubble. This is highly relevant, because the United States has endured two great asset bubbles in the last 15 years—the Internet boom of the late 1990s and the housing bubble of the mid-2000s. So one can fairly ask, how much of GDP growth in the 1990s was a permanent uptick in productivity of the economy, and how much the side effect of an asset bubble flooding Americans with newfound (and in many cases very temporary) wealth?

You can see the difference between GDP and income, as we ordinarily use the latter term, if you ponder for a minute the consequence of an uptick in automobile accidents in light of the treatment of capital gains and losses, as well as the characterization of personal purchases of cars and other consumer durables as a form of immediate consumption. Any normal person would conclude that a rash of car crashes must lower GDP, because all those expensive cars have been destroyed, but a special sort of person, typically found only at the Bureau of Economic Analysis, would say no—more accidents mean more GDP, at least assuming that the occupants of all those cars return to the workforce promptly. The cars themselves already have been accounted for as consumption, or alternatively can be viewed as constructively sold for a large capital loss, and meanwhile the ambulance services and other healthcare professionals are busier than ever, generating more production (in this case, in the form of services rather than tangible things). As explained by the authors of a study analyzing the international standards to which our government accounts now adhere, "It may seem strange that GDP rises if there are more road accidents.... On the contrary, one would intuitively like to see GDP diminishing in such circumstances. But this would be to confuse a measure of output (GDP) with a measure of welfare, which GDP is not. At most, GDP is a measure of the contribution of production to welfare. There are a great number of other dimensions to welfare that GDP does not claim to measure."[14]

GDP includes the value added by government as well. The treatment of government in the national accounts gets complex, but basically the idea is that transfer payments, including social security payments, are recorded as neutral (neither creating nor destroying value, just moving money around), and government spending on "free goods," like roads, defense, public schools, or the whole range of government services (air traffic controllers, Food and Drug Administration oversight of pharmaceuticals) is recorded as adding value. Most of the data are determined by actual or estimated market value, but here even the best statisticians give up, and record government spending on free goods as creating value equal to the cost expended on them.

So those readers who worship at the shrine of GDP should remember that the data take government spending at face value. If you really believe that government spending is the same as taking money and burning it, then our GDP is substantially lower than the numbers you read in the newspaper.

Finally, GDP itself is not an entirely static concept. In July 2013, for example, the Bureau of Economic Analysis changed how it measured GDP in some important respects, for example by treating the cost of research and development as an investment in an asset, rather than a current expense. The result was to increase the 2013 GDP of the United States by about 3 percent—an amount equal in size to the economy of Belgium.[15] More directly relevant to this book, because the revisions did not change actual tax collections, the revisions had the effect of reducing the amount of federal tax collections as a percentage of GDP—itself the most common metric used in Congress when debating the overall size of the tax system. The difference moved the needle substantially—reducing tax collections as a percentage of GDP by about 0.5 percent per year, for all years covered by the new methodology.

Notwithstanding this uncommonly large revision to its methodology, the calculation of GDP is sufficiently uncontroversial and objective that observers from across the political spectrum rarely debate the accuracy of the resulting figure. It is GDP's *meaning* that should be the topic of more discussion.

ALTERNATIVE WELFARE MEASURES

To summarize, GDP and similar metrics are poor surrogate measures of welfare.[16] First, GDP excludes all interactions that take place outside the marketplace. So, for example, performing one's own household work is not measured by GDP. GDP tells us nothing about whether the drivers of middle class financial survival over the last generation—the arrival of women in great numbers into the workplace, and the improvement in the wages they receive—are viewed within every family as welfare-enhancing, or as a stern financial necessity that constrains their innate preferences.

From the other direction, market transactions that respond to degradations in welfare nonetheless are included in GDP, simply because they are market transactions. For example, if crime increases, and as a result more police are hired, or individuals spend more on house alarm systems, these "defensive" expenditures increase GDP, while at the same time signaling developments that are problematic for welfare.[17]

Finally, measures like GDP per capita make no effort to reflect issues of inequality or poverty. A nation in which most of us are groundskeepers to plutocrats may not be a society whose welfare is as high as a nation of shopkeepers with lower aggregate GDP.

These are not simply academic observations. Because it is ubiquitous, easily described in news reports, comparable across different countries and relatively uncontroversial in its measurement, GDP tends to frame our sense of progress. This gives rise to the phenomenon of framing fiscal policy discourse in terms of a GDP Olympics with other countries. The results are false political conflicts, as between "growth" and "the environment," or the obfuscation of important social issues, as when statistics about per capita GDP crowd out questions surrounding the distribution of that national income. It may be that we are what we eat, but to a surprising extent our society is what we measure of it.

Social scientists have struggled to address the problem of our excessive reliance on GDP as a surrogate for welfare. One approach has been to measure "happiness" directly, principally through surveys. Proponents argue that empirical research methodologies are sophisticated enough to make the survey results reliable and meaningful, but others strongly disagree, either as to the reliability of surveys or as to their relevance to real-world policymaking.[18] There also are issues of cross-country comparability: Are the dour Swiss as able to admit to their own happiness as are the fun-loving Portuguese?

Another approach is to develop broader measures of welfare within the constraints of more traditional data collection methods. The best-known example of this is the Index of Sustainable Economic Welfare (ISEW), but the fact that most readers have never heard of the ISEW tells you all that you need to know about its general acceptance in the professional econometric community, much less in mainstream news outlets.[19] Like happiness surveys, the ISEW has been robustly criticized as relying too heavily on subjective inputs to be a reliable complement to GDP.

The point to take away from all this is that our collective welfare, which is the reason we band together to act together through the medium of government—and the good we want to maximize to have happy, meaningful lives—by design is not captured in GDP. Moreover, even if you construe welfare in the narrowest possible market economy sense, GDP is quite different from income, which presumably is what people think it is trying to measure. But because no better metric is at hand, we fall back on it.

As a society, we should care about more than winning a GDP Olympics: there are other values that define us as a unique society. To be sure, we care about the GDP Olympics more than we imagine our counterparts in France to care—that is one of our defining characteristics—but even so there is more to us as Americans than that. To say this is not to deny economics, but rather to recognize that we measure national product because it is easy to do so, when what we really mean to focus on is the broader concept of our welfare.

Every reader of this book already has fully formed ethical judgments, and my advocacy in support of particular moral imperatives will not change many minds. I therefore adopt throughout this book a morally indefensible but nonetheless realistic focus exclusively on national rather than global welfare, and on welfare consequences that ultimately have measurable productivity implications.[20]

Since this is a book about *national* fiscal policy, and since government spending comes from taxes we impose only on ourselves, my focus on national welfare viewed through the filter of measurable productivity has at least some practical justification. In light of the sorry state of our own awareness of our obligations to each other inside the United States, we should be so lucky as to have the occasion to revisit this narrow focus at some future date, when our fiscal soul is less in peril of utter extinguishment.

EQUALITY OF OPPORTUNITY

It is a commonplace of political disputations to argue that all that we can fairly ask of government is equality of opportunity—that our government does not exist to guarantee equality of outcomes. This may be right: government cannot make the homely handsome, and in the end fortune plays favorites for reasons opaque to us. Nonetheless, government in fact can do a great deal to give real substance to the phrase "equality of opportunity." Government does so when it militates against the worst outcomes, and creates a more secure platform from which those not clever enough to have chosen wealthy parents can nonetheless achieve their full potential. Social insurance, broadly construed, is one instrument for doing so. And government investment is the other.

The data here cry out to be heard. When we fairly listen to what the data are saying, and what careful research has demonstrated, we understand that those who blow their horns the loudest to define fiscal policy in terms of equality of opportunity do not really mean it.

If they did, they would, for example, insist on the highest possible investment in public education for children from low-income households, but the United States turns out to be one of the few developed countries in the world that spends less on educating the children of the poor than it does on the children of the rich (see chapter 3). Education is the essential foundation of opportunity, but no matter how you slice it, there is no equality of opportunity in our educational system today.

Similarly, an important recent research paper showed that poverty impedes cognitive function.[21] That is, poverty, by itself, leads to people behaving as if their IQ were 13 points lower, because of the amount of mental energy constantly channeled into coping with that poverty. In effect, the brain turns out to have limited bandwidth, and poverty permanently absorbs a substantial fraction of it, beyond measures of the consequences of stress and the like.[22] There is a reason, after all, why one adjective invariably linked to "poverty" is "grinding." Of course, some individuals overcome this and every other handicap. Kobe Bryant, slowed by a nagging injury, still outplays me on the basketball court. But that does not mean that a society that accepts widespread poverty as normal is one in which equality of opportunity is genuinely honored.

Consider one more example. According to research published by Save the Children Fund, malnourishment during the first 1,000 days of a child's development (from conception through the child's second birthday) leads to irreversible cognitive impairment. MRI scans show cerebral atrophy—a shrinking of brain—due to protein deficiency, and micronutrient deficiencies inhibit myelination, a critical brain development process that enables complex brain processes.[23] As a result, compared to adequately nourished children, victims of early malnourishment are 19 percent less likely to be able to read a simple sentence at age eight, even after controlling for differences in background and schooling. What is more, the young victims of malnourishment suffer from other follow-on effects, such as lethargy and smaller stature, which can lead to lower parental investment in their development.

These consequences persevere over time, with economic as well as personal consequences. Save the Children Fund's report finds that early childhood malnutrition reduces a person's lifetime earnings capacity by roughly 20 percent—globally, a productivity shortfall of around $125 billion a year when today's malnourished youngsters have been absorbed into the workforce in 2030. "By improving cognitive abilities, health, physical strength and stature," the report concludes, "good nutrition in the early years can lead to greater wages in adulthood."[24]

Save the Children Fund's principal focus in its report was on very young children in the world's poorest countries, but malnutrition haunts the United States as well. The Johns Hopkins Children's Center estimates that one percent of American children (around 760,000 in number) suffer from malnutrition. The US Department of Agriculture found that in 2012, 14.5 percent of all American households, comprising 49 million individuals, suffered from food insecurity at some point during the year, and 5.7 percent of households—17 million Americans—endured "very low food security."[25]

The United States in fact is the world's great outlier in ensuring that its own citizens receive adequate nutrition. Despite living in by far the richest large country in the world, US households saw food security issues at levels associated with Indonesia or Greece (which has about one-half the GDP per capita as does the United States).[26]

As a result of the pervasiveness of food insecurity in America, the Center for American Progress in 2011 calculated that the annual *economic* cost of hunger in America amounted to at least "$167.5 billion due to the combination of lost economic productivity per year, more expensive public education because of the rising costs of poor education outcomes, avoidable healthcare costs, and the cost of charity to keep families fed."[27] Just as poverty affects cognitive ability, so too the food insecurity that accompanies poverty has its own measurable productivity costs.

Federal government programs like Head Start's breakfast component and the Supplemental Nutrition Assistance Program (what used to be called food stamps) are a response to problems of childhood and adult hunger in America, but of course the data summarized here reflect the facts on the ground after taking into account the modest ameliorative effects of all such programs. Chapters 7 and 11 look more at the state of federal income security programs, including these. But to put food stamps in particular into context, here is what it means in practice in contemporary America to rely on the $5 or less per person per day that food stamps provide:

> As a self-described "true Southern man"—and reluctant recipient of food stamps—Dustin Rigsby, a struggling mechanic, hunts deer, doves and squirrels to help feed his family. He shops for grocery bargains, cooks budget-stretching stews and limits himself to one meal a day.
>
> Tarnisha Adams, who left her job skinning hogs at a slaughterhouse when she became ill with cancer, gets $352 a month in food stamps for herself and three college-age sons. She buys discount meat and canned vegetables, cheaper than fresh. Like Mr. Rigsby, she eats once a day—"if I eat," she said.[28]

We leave a cancer victim to feed a family of four on less than $12 per day in food stamp assistance, and a working man to supplement his family's calories by hunting squirrels. Hard-working Americans now are reduced to selling their own hair, breast milk, or eggs to make ends meet.[29] And in return, a member of Congress calls this government program an act of theft from him and other affluent American taxpayers. Yet at the same time, this Congressman apparently believes that the millions of dollars in federal agricultural subsidies that he has pocketed are the just deserts of the virtuous, paid to him by the gods, rather than by his fellow Americans through their tax burdens.[30]

Is eradicating malnutrition in the United States a moral imperative? Of course it is, but what more can usefully be said along those lines? Instead, the idea behind this book is to sneak moral objectives in the back door, by emphasizing the *economic* case for collective action. In other words, I try to meet on their own terms those who dismiss government interventions as naïve or as “class warfare,” and to demonstrate that the fundamental idea of equality of marketplace opportunity—the essence of what Milton Friedman and his ilk have assumed to be the case—in fact is systematically dishonored in America today.

Thus, the example of infant and early childhood malnutrition can be presented as an investment opportunity as well as a moral plight. This is what Save the Children Fund was doing when it emphasized the loss in future earnings power of children who have suffered cognitive impairment from malnutrition, or what the Center for American Progress meant by toting up the productivity costs of hunger in America. Each institution sees little point in the current political environment in appealing solely to ethical impulses—nor is it necessary so to limit the reasons for government intervention. The economic case for government spending to afford children born into poverty genuine equality of opportunity through education, or to address early childhood malnutrition or adult hunger—the case for collective investment in an area where private markets necessarily must fail—basically makes itself.

For argument’s sake, resist for a moment the urge to dismiss every inconvenient study as redistributionist propaganda, and accept that the studies summarized above are at least roughly accurate and relevant to some cases in the United States. These studies show that poverty, if left uncorrected, slices 13 IQ points off a poor person’s human potential, and malnutrition leads to stunted human development that in turn reduces the productivity—the income—of each of its victims by thousands of dollars a year.

A capitalist offered the opportunity to invest a few hundred dollars today in a machine that will yield thousands of dollars in profits for years to come would jump at the opportunity. But of course there is no market in human lives, nor should there be, and capitalists therefore cannot invest directly in the most productive and important generators of income in American society—its citizens (at least when those citizens are not yet in the workforce). In the absence of such a market, we as a nation are doomed to leave on the table the returns we collectively could reap by investing in the proper nutrition of our most vulnerable citizens—unless we acknowledge that government exists as the mechanism to enable all of us collectively to make just such investments. Government here complements private markets by offering forms of insurance and making completely sensible investments in areas that private markets do not and should not reach.

All that is required is to appreciate that the poorest Americans are still Americans—that we are part of one large community, one society. If that fact