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Abstract

The textbook theory of public finance delineates three primary functions of government: 1) to provide for public goods, 2) to provide for an equitable distribution of income, and 3) to stabilize the economy. However, it has become evident with the rise of right-wing populism especially, but not exclusively, in the U.S., that this conceptualization contains a crucial oversight of historic proportions because the gap between the haves and have-nots in a society is not merely a question of equity but also a question of the maintenance of political stability. The January 6, 2021 insurrection against the U.S. Congress by an angry mob made it evident that the distribution of income has bounds beyond which social forces exert such pressure on the political system that the whole edifice of liberal democracy is seriously threatened. Hence, democratic governments must consider income distribution also from the vantage point of sustaining itself.

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Introduction

A classic statement of the pure theory of public finance was formulated circa forty-five years ago by Richard Musgrave (1957). He conceptualized the role of public finance as falling into three primary functions of government: a) to provide for public goods, b) to provide for an equitable distribution of income, and c) to stabilize the economy. In its simplicity, this tripartite division "has been invaluable" and remains the "gold standard" in economics to this day (Mieszkowski 2008).

The present essay concerns a significant and ubiquitous oversight in the discussion of the second of these functions: distribution, for it has become evident in the 21st century that the notion that the distribution of income in a society is a question of equity, fairness, or justice *alone* is no longer tenable. On the contrary, it should be clear by now that in addition to these considerations, the distribution of income has bounds beyond which social forces exert such strain on the socio-economic-political system that the whole edifice of the market economy, founded on liberal democracy, is called seriously into question. In the main, this aspect of the distribution problem eluded the profession until 2016, when the rise of right-wing populism especially but not exclusively in the U.S. laid bare the significance of this oversight of historic proportions. In other words, the government must consider distribution not exclusively from the vantage point of equity but also from the point of view of sustaining itself.

Taxes Became the Boogeyman

Redistribution obviously requires taxes. Yet, in the economist's canon taxes also create deadweight losses. According to Musgrave's understatement: "This concern has now moved to the center of tax theory" (2008, p. 337). In reality, the emphasis on the inefficient attributes of taxation became the dominant ideology and the anti-tax movement became an overwhelming force in popular political culture (Laffer 1981, Gayner 1995). Milton Friedman went as far as to suggest that "[t]he corporate tax should be abolished" (2002, 132) and ridiculed corporate "social conscience" as "preaching pure and unadulterated socialism" (Friedman 1970).

The anti-tax movement became the foundation of Reaganomics, supply-side economics, and the guiding light of subsequent economic policy (Komlos 2019a). These ideas were also supported by textbooks that socialized millions of students, the future voters, into believing that “because taxes distort incentives, they cause markets to allocate resources inefficiently” (Mankiw 2018, 157). The public purpose of taxes was neglected and enabled the mainstream to stamp redistribution as an anti-growth and anti-efficiency policy.

This led to the popularization of seeing redistribution primarily in terms of the efficiency-equity tradeoff: “these two goals conflict…. Although these policies have the benefit of achieving greater equity, they have a cost in terms of reduced efficiency. When the government redistributes income from the rich to the poor, it reduces the reward for working hard, as a result, people work less and produce fewer goods and services. In other words, when the government tries to cut the economic pie into more equal slices, the pie gets smaller” (Mankiw 2018, 5).

In a similar vein, Harvard’s Marty Feldstein, the doyen of tax policy analysis, supported lower taxes for forty years, even the Trump tax cuts (1993, 2017). In publications far too numerous to mention, including in the mass media, he hammered incessantly at the notion that “higher taxes hurt the economy by distorting behavior—reducing work effort, saving, and risk-taking…” and that the deadweight losses of taxes are inefficient, period (Feldstein 2008).[1]

However, the beneficial effects of taxes were seldom (if ever) mentioned, namely, the efficiency gains due to a better educated labor force, the humongous waste of human resources due mediocre public schools, the dead weight losses caused by a mental health crisis, the tremendous gains from public funding of basic research that induced the IT revolution and also transformed medicine, or the productivity gains from public funding of healthcare since a healthier workforce produces more efficiently. None of that ever came up for discussion among the cadre of neoliberals. The focus was on minimizing the deadweight losses and that meant in the U.S. small government and taxes set at the bare minimum. The lower taxes also meant less money for social safety programs which led to increased insecurity and rising stress levels.

Perverse Redistribution

Redistribution had been conceptualized as occurring at a moment in time from the top toward the poor, but a significant redistribution of the economic pie was actually taking place during the previous four decades in exactly the opposite direction from the one envisioned by Musgrave, namely, from the bottom to the top of the income distribution, as the benefits of

[1] In this article he mentioned “dead weight loss” 34 times.

economic growth accrued exclusively to the top quintile and mostly to the top 1% (Stiglitz 2011). By 2019 the wealth of the top 1% reached $26 million per household while the bottom half had practically nothing beyond their household possessions and perhaps their automobile (Board of Governors 2022). Moreover, the bottom eighty percent of the income distribution was losing a significant share of total income. Their annual income would have been $10,300 more per household if their share of the total had remained at the level of 1967 (Table 1).

Insert Table 1. Distribution of Household Income in the U.S., 1967-2019

This redistribution of the share of national income was brought about in the first instance by an immense tax windfall for the superrich, and then by the impersonal forces of globalization, by technological change, as well as by the declining power of labor, by deregulation, by quantitative easing, and by the one-sided bailouts of the financial crises of 2008. How these developments redistributed income in favor of the rich and superrich and how they generated resentment aimed at the institutions of government is beyond the scope of this essay. Suffice it to say, that this complex of issues spawned a humongous literature, almost all of it after the financial crisis (Atkinson, 2015; Autor, et al., 2020; Azar, Marinescu, and Steinbaum, 2022; Bartels, 2016; Bartlett, 2009; Blanchflower, 2019; Boushey, 2019; Buffett, 2011; Burch, 1997; Collier, 2018; Cumbers, 2020; Deaton, 2011; Dorgan, 2006; Farber et al., 2018; Faux, 2012; Formisano, 2015; Foroohar, 2016; Freeland, 2012; Fukuyama, 2014; Gilbert, 2016; Gilens, 2012; Graeber, 2019; Graetz and Shapiro, 2020; Graham, 2017; Hacker and Pierson, 2010, 2016; Hacker et al., 2022; Harvey, 2007, 2015; Hochschild, 2016; Hundt, 2019; Inglehart and Norris, 2017; Jackson, 2021; Kakutani, 2018; Kelly, 2009; Kurbjuweit, 2005; Kwak, 2017; Lessig, 2021; Levinson, 2006a, 2006b, 2007; Levitsky, 2018; Macekura, 2020; Maclean, 2017; Madrick, 2014; Mann and Ornstein, 2012; Marterbauer and Schürz, 2022; May, 2017; Mayer, 2016; Mazzucato, 2020; Milanovic, 2019; Packer, 2020; Page and Gilens, 2017; Paul, 2019; Phillips-Fein, 2010; Pierce and Schott, 2016; Piketty, 2014; Posner, 2009, 2001; Ravenelle, 2019; Ravitch, 2017; Reich, 2018, 2020; Rodrik, 2011; Saez and Zucman, 2019; Sandel, 2018a, 2018b; Scheiber, 2011; Schlozman, Verba, and Brady, 2012; Smith, 2010, 2012; Skidelsky, 2020; Standing, 2014; Stiglitz, 2017, 2019; Taylor, 2020; Temin, 2017; Tirole, 2017; VanderWeele, 2017; Warren, 2007; Wolff, 2017; Wolhandler et al,. 2021; Yeh, Macaluso, and Hershbein, 2022; Zingales, 2012).[2] All these developments actually redistributed the benefits of the economy upward, decreasing the relative income of the bottom eighty percent of the population. By increasing inequality, they generated immense stress on the political system as none of the first four quintiles could keep up with the social norms set primarily by the superrich, fueling the rise of populism (DeMartino 2022; Komlos 2019b). Yet, economists had overlooked completely the political and social implications of this massive income redistribution toward the top (Boushey 2019).

Taking the Stability of the Political System for Granted

In contrast to the views prevalent in classrooms, progressive economists warned early that the economy had taken a wrong turn in 1980 (Ackerman 1984; Galbraith 1982; Modigliani 1988; Palley 1998; Peterson 1988; Prasad 2012; Rothschild 1981; Smithin 1990; Thurow 1983; Tobin 1981; Wilber and Jameson 1990). According to Nobelist Joseph Stiglitz that is when the U.S. had crossed the Rubicon: "President Ronald Reagan began hollowing out the middle class and skewing the benefits of growth to those at the top…" (2016). Harvard economist Benjamin Friedman noted that "the average American family is losing ground, and knows it" (1990). Another observed that "The erosion of middle-class living standards is well documented, and Reagan's tax reform, which brings relief to the very rich, will make it harder than ever for working-class and lower-middle-class taxpayers to make ends meet" (Lasch 1988). "[T]o redistribute income and well-being toward the rich and away from the poor; to redistribute health and education and security toward much the same people who would already have enjoyed them before the second World War…" (Rothschild 1982). Galbraith observed in 1998 that he failed to foresee "the command of income by those in the top income brackets [would be] increasing egregiously. So is the political eloquence and power by which that income is defended" (1958, p.

[2] Sixty percent of the works cited here are from 2016 or thereafter.

viii). However, these early observations and warnings found scant resonance subsequently among academics or in the political arena.

However, by the turn of the 21st century discontent was coalescing to such an extent that the real threat to the entire edifice was becoming more apparent. Even arch-conservative Alan Greenspan recognized prior to the financial crisis of 2008 that the extremely skewed distribution of income in the U.S. was dangerous and if we don't reverse "a quarter century of increases in income inequality, the cultural ties that bind our society could become undone. Disaffection, breakdowns of authority, even large-scale violence could ensue, jeopardizing the civility on which growing economies depend (2007a, 468). In an interview he was more explicit: "[y]ou cannot have the benefits of capitalist market growth without the support of… virtually all of the people, and if you have an increasing sense that the rewards of capitalism are being distributed unjustly the system will not stand" (Greenspan 2007b).

He was by no means alone. Nobel-Prize-winning Princeton economist, Angus Deaton, expressed similar concerns: "If we can only generate good lives for an elite that's about a third of the population, then we have a real problem…if we can't fix this, it really is a crisis of capitalism… it doesn't seem to be working for the people who are not very well educated" (Belline 2018). These sentiments were in line with those of the public. A 2011 survey found that two-thirds of the U.S. population "believe[d] that there are 'very strong' or 'strong' conflicts between the rich and the poor—an increase of 19 percentage points since 2009" (Morin 2012).

However, it was not until the triumph of Trumpism in 2016, that it became perfectly clear that there are limits to inequality beyond which the whole socio-economic-political edifice is vulnerable (Komlos, 2017). Dani Rodrik of Harvard's Kennedy School was among the first prominent economists to see this brazen hiatus in the canon. He reprimanded his colleagues and declared them “partly responsible for Donald Trump’s shocking victory”. After all, economists “have consistently minimized distributional concerns, even though it is now clear that the distributional impact of NAFTA or China’s entry into the World Trade Organization were significant for the most directly affected communities in the United States…. (2016).

Thereafter there was an avalanche of observations recognizing the “sheer awfulness… of the extremes of inequality that have been generated by rent-seeking and upward redistribution…” (Case and Deaton 2020, 262), and the rise of unhappiness (Clifton 2022, Davis 2017, Easterlin 2015). “The economic anxiety and distributional struggles exacerbated by globalization generate a base for populism” (Rodrik 2018, 13). After the January 6th insurrection one-third of Americans thought that violence against the government is justifiable (Anonymous, 2022).

To be sure, the dangerous limit on the Gini coefficient is fuzzy and is obviously a matter of judgment but that has always been true to the distribution problem (Zadeh 1975). Of course, Musgrave and everyone else who followed in this footsteps realized from the very beginning that “…a value judgement of some sort lies at the bottom of any solution to the distribution problem… through a tax transfer plan” (Musgrave 1957, 336). He subsequently suggested that in the realm of distribution, “public finance reaches beyond that safe haven of Pareto optimality and enters the less tractable realm of distributive justice” (Musgrave 2008, 337).

In sum, sustainability of the market economy is being threatened not only by climate change but also by the disaffection of economic agents with the way the laissez-faire market distributs its fruits. The point of this essay is to stress that the distribution concerns of public finance focused primarily on equity and the equity-efficiency tradeoff while completely overlooking the crucial role redistribution plays in the very viability of the economic system.

Although, this was a major oversight, in the mid-twentieth century, when Musgrave's conceptualization gained prominence, such an idea would have been utterly unthinkable, beyond the pale, so to speak. However, after 2016, and increasingly so after January 6, 2021, it should be evident that as far as sustainability of the socio-economic-political system is concerned, it's neither economic growth nor the average income that counts but the size of the post-tax Gini coefficient itself. In short, there is a theoretical limit on the Gini beyond which the stability of democratic capitalism is called into question. That critical issue—the sustainable limit on the Gini coefficient—has not been recognized in the public finance literature, but ignoring it further is no longer an advisable option and must be researched vigorously.

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Table

Table 1. Distribution of Household Income in the U.S., 1967-2019									
	1	2	3	4	5	6	7	8	9
		Percentile				Income			
		of	Percent of Total Income			Hypoth.	Actual	Loss/Gain (52 years)	
Quintile		Population	1967	2019	Change	2019		Dollars	Percent
Poor	1	0-20	4.0	3.1	-0.9	19,700	15,000	-4,400	-29.3
Lower-Middle Class	2	20-40	10.8	8.3	-2.5	53,000	41,000	-12,500	-30.5
Middle Class	3	40-60	17.3	14.1	-3.2	85,000	69,000	-16,300	-23.6
Upper-Middle Class	4	60-80	24.2	22.7	-1.5	119,000	111,000	-8,000	-7.2
Rich	5	80-95	26.4	28.9	+2.5	173,000	189,000	+16,000	+8.2
Ultra Rich	5	Top 5%	17.2	23.0	+5.8	339,000	451,000	+112,000	+24.9
Source:	https://www.census.gov/data/tables/time-series/demo/income-poverty/historical-income-househ								
Note:	Column 9: percent Loss/Gain relative to Actual income in 2019								