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# Reforming Taxation to Promote Growth and Equity

White Paper by  
Joseph E. Stiglitz  
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## EXECUTIVE SUMMARY

This white paper outlines concrete policy measures that can restore equitable and sustainable economic growth in the United States, in the context of the country's recurring budgetary crises. Effective policies are within our grasp, because these budgetary crises are the result of political and not economic failings. Tax reform in particular offers a path toward both resolving budgetary impasses and making the kinds of public investments that will strengthen the fundamentals of the economy. The most obvious reform is an increase in the top marginal income tax rates – this would both raise needed revenues and soften America's extreme and harmful inequality. But there are also a variety of other effective possible reforms related to corporate taxation, the estate and inheritance tax, environmental taxes, and ensuring that the government gets full value when it sells public assets. This white paper describes the gravity of the economic situation in the United States, but also shows that there is a way out.

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## KEY ARGUMENTS

- The current economic situation in the United States is grave, with extreme inequality, persistently high unemployment, and GDP growth far below potential, to name just a few problems. But the barriers to a solution are political, not economic.
- Reforms to corporate and personal income taxes will be essential in restoring economic vitality. Examples include implementing financial transaction taxes; increasing corporate tax rates while incentivizing investment in the U.S. and closing loopholes; increasing taxes on rent-seeking; reforming estate and inheritance taxes; and making personal income taxes more progressive.
- All reforms must be made with the understanding that deficit reduction in and of itself is not a worthy goal. Rather, taxation must be reformed to help grow the economy, improve distribution, and encourage socially beneficial behavior on the part of firms and individuals.

## Reforming Taxation to Promote Growth and Equity

By Joseph E. Stiglitz, May 28, 2014

### INTRODUCTION

The United States has been reeling from one budgetary crisis to another. But we should be clear that these crises – which have resulted in a government shutdown and a near default on the national debt – are not economic but political. The U.S. is not like Greece, unable to borrow to fund its debt and deficit. Indeed, the U.S. has been borrowing at negative real interest rates. Others are so eager to lend to the U.S. that they are willing to take a loss – get paid back less money, adjusted for inflation, than they lend.

This paper is one of a forthcoming series attempting to outline an agenda for the resolution of the budget impasse, in the context of the very real problems that the country faces. It focuses in particular on various tax reforms. There is broad consensus that some form of tax reform is desirable, and that tax reform could and should play an important role in the resolution of the budgetary impasse. But beyond this, there is no agreement. This paper shows that there are reforms that could simultaneously improve the U.S. debt position – defined in terms of debt sustainability – promote growth, and address some of the other basic challenges facing the country, including its alarming level of inequality. We also show that some of the so-called reforms that conservatives propose would be counterproductive – they could simultaneously reduce growth and economic welfare and increase unemployment and inequality. It would be better to have no reform than these reforms. These proposals are likely to do significant harm to the economy and broader societal goals in the short run, and even more in the long.

The first section provides a brief sketch of the country's current economic situation, analyzing the issues that should be given priority. The second section outlines a set of principles of taxation that should guide us in any tax reform initiative. The next five sections then outline an agenda for raising revenues that are consistent with addressing the challenges posed by the country's current economic situation and are aligned with the principles presented in the second section.

The third section derives, on the basis of these principles, a set of reforms of the corporate income tax system, and the fourth of individual income tax. The remaining three sections discuss alternative ways of raising revenues and reducing the deficit, including reform in the estate and inheritance tax, introducing environmental taxes, and raising revenues by ensuring that the government gets full value when it sells public assets.

We conclude in the final section by attempting to put the debate on deficit reduction in perspective.

### THE CURRENT U.S. ECONOMIC SITUATION

More than five years after the collapse of Lehman Brothers, the economy is still far from fully recovered; not a total surprise, given the severity of the shock. Unemployment remains elevated, at 6.7 percent,<sup>1</sup> but that dismal number masks far greater weaknesses in the labor market. Some 20 million American workers who would like a full-time job still can't get one.<sup>2</sup> Labor force participation is at its lowest level since 1978, when women were

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<sup>1</sup> As of February 2014. See Bureau of Labor Statistics' March 7, 2014 "Employment Situation" report.

<sup>2</sup> This number includes the unemployed, those employed part-time for economic reasons, and those marginally attached to the labor force, as of March 2014.

entering the labor force en masse. If the labor force participation rate were at its average level from 1990-2007, the unemployment rate would be around 11.6 percent.<sup>3</sup>

The weaknesses in the labor market are reflected in low wages and stagnating incomes. That helps explain why 95 percent of the increase in incomes in the three years after the recovery officially began went to the upper 1 percent.<sup>4, 5</sup> For most Americans, there has been no recovery.

Matters are especially bad for those who face long-term unemployment. Some 36 percent of all unemployed Americans have been without a job for 27 weeks or longer, down slightly from the post-recession high of 45 percent, but still 20 percentage points above the level before the Great Recession.<sup>6</sup> The long-term unemployed face increasingly dismal prospects of being reintegrated into the labor force. But we should be clear that the problems of our labor market are not limited to the long-term unemployed. With a high unemployment rate, even those who are freshly unemployed face more competition (more applicants per available job) than they would have before the crisis.<sup>7</sup>

Matters are even worse for our youth, and those in certain demographic groups. Youth unemployment has remained roughly twice that of the population in general. The consequences of persistent youth unemployment can be severe because youth should be a period in an individual's life when his or her human capital increases as a result of job experience, leading to future productivity. Instead, skills are atrophying, with lifelong

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<sup>3</sup> This number is arrived at by counting those individuals not in the labor force, in excess of the "normal" labor force participation rate (its average from 1990-2007, at 66.6 percent versus the current 63.0 percent) as unemployed. Data source: Bureau of Labor Statistics Employment Situation Report for December 2013, available at <http://www.bls.gov/news.release/pdf/empstat.pdf> (accessed January 24, 2014). Some, but only some, of the reduced labor participation is a result of demographics. The economy has never been very good at finding employment opportunities for those in their late 50s and early 60s, or helping these individuals adapt to the changing economy; hence, labor force participation for these groups has always been lower than for others of working age. But we should not take much comfort in knowing that these "market failures" were already present before the crisis, and have simply grown worse, not just because of the crisis, but because the proportion of the population for which the market is failing has increased. Aaronson, Davis, and Hu (2012) conclude that just under half of the post-1999 decline in the U.S. labor force participation rate can be explained by long-running demographic patterns. (Aaronson, Daniel, Jonathan Davis, and Luojia Hu. 2012. "Explaining the Decline in the U.S. Labor Force Participation Rate." FRB Chicago, *Chicago Fed Letter* 296 (March).) Even using this demographic adjustment, we obtain a current effective unemployment rate of 9.2 percent. And even this number does not include those who would like a full-time job and can't get one, so have accepted a part-time job.

<sup>4</sup> Saez (2013) shows that from 2009 to 2012, the top 1 percent incomes grew by 31.4 percent while the bottom 99 percent incomes grew by only 0.4 percent. Hence, the top 1 percent captured 95 percent of the income gains in the first three years of the recovery. Saez, Emmanuel, 2013, "Striking it Richer: The Evolution of Top Incomes in the United States," University of California at Berkeley working paper, available at <http://elsa.berkeley.edu/~saez/saez-USTopincomes-2012.pdf> (accessed February 12, 2013).

<sup>5</sup> This was even worse than what had occurred during the Bush administration. During the Bush years, 65 percent of income growth was captured by the top 1 percent of families. See Thomas Piketty and Emmanuel Saez, "Income Inequality in the United States, 1913-1998," *Quarterly Journal of Economics*, 118(1), 2003, 1-39 (Longer updated version published in A.B. Atkinson and T. Piketty eds., Oxford University Press, 2007), with data updated through 2008, available at <http://emlab.berkeley.edu/users/saez/> (accessed February 12, 2014).

<sup>6</sup> See Bureau of Labor Statistics historical tables, available at <http://www.bls.gov/webapps/legacy/cpsatab12.htm> (accessed February 12, 2014).

<sup>7</sup> In January 2014, there were 2.6 unemployed persons per job opening, down from 6.2 at the end of the recession in 2009, but still much higher than the pre-recession figure of 1.6. Source: Bureau of Labor Statistics, 2014, "Job Openings and Labor Turnover Survey Highlights," January.

consequences: those who go through extended periods of unemployment as young people have significantly lower lifetime incomes.<sup>8</sup>

Those with less education are also facing a particularly hard time. While Americans 25 and over with a bachelor's degree or higher face an unemployment rate of 3.4 percent, the figure for those with only a high school degree is 6.4 percent, and for those without a high school education the unemployment rate is 9.8 percent.<sup>9</sup> Not surprisingly, the incomes of the less-educated are also suffering (as we note below).

These high and persistent levels of unemployment will have long-run effects. A recent study by economists at the Federal Reserve estimated that economic weakness following the Great Recession has reduced the United States' potential growth by some 7 percent, and found that a major contribution to this is persistently high unemployment, especially long-term unemployment.<sup>10</sup>

But as damaging as the Great Recession was, the fact is that for most Americans, the economy wasn't really delivering well beforehand. A few statistics provide some guidance to deliberations about tax reform. Median income in the U.S. is at the level that it was (adjusted for inflation) in 1989,<sup>11</sup> and that of full-time male workers is back to the level of 1972.<sup>12</sup> Median incomes (adjusted for inflation) of men over 25 with only a high school education decreased some 17.1 percent from 1999 to 2012.<sup>13</sup>

Poverty has increased from 11.8 percent in 1999 to 15.0 percent in 2012.<sup>14</sup> Recent years have not only been hard for those at the bottom, there has been a hollowing out of the middle class. Not only has median income declined, the fraction of the population that is "near" the median has decreased. America prided itself on being a middle class society, and the strength of the middle class was viewed as key to the strength of our economy, our democracy, and our society. In economic terms, at least, America is less and less of a middle class society.

While those at the bottom or even the middle have not been participating in America's "success," those at the top have done very well indeed. The upper 1 percent of Americans takes home a staggering 22.5 percent of the country's income.<sup>15</sup>

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<sup>8</sup> See, for example, Bowlus, A. J. and H. Liu (2003). "The Long-Term Effects of Graduating From High School During a Recession: Bad Luck or Forced Opportunity?" CIBC Human Capital and Productivity Project Working Papers, University of Western Ontario; and Kahn, L. B. (2010). "The Long-Term Labor Market Consequences of Graduating from College in a Bad Economy," *Labour Economics*, 17(2): 303-316.]

<sup>9</sup> Bureau of Labor Statistics' "Employment Situation" report for February 2014, available at <http://www.bls.gov/news.release/pdf/empst.pdf> (accessed March 28, 2014).

<sup>10</sup> Reifschneider, D., William L. Wascher, and David Wilcox. 2013, "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy." Paper presented at the IMF's 14th Jacques Polak Annual Research Conference, November, available online at <http://www.imf.org/external/np/res/seminars/2013/arc/pdf/wilcox.pdf> (accessed January 10, 2014).

<sup>11</sup> U.S. Census Historical Income Tables: Households, Table H-6, "Regions—by Median and Mean Income."

<sup>12</sup> U.S. Census Historical Income Tables: People, Table P-36, "Full-Time, Year-Round Workers by Median Income and Sex."

<sup>13</sup> U.S. Census Historical Income Tables: People Table P-16, "Educational Attainment--People 25 Years Old and Over by Median Income and Sex."

<sup>14</sup> Source: Current Population Survey Annual Social and Economic Supplement (CPS ASEC), reports for 2009 and 2012 respectively, available at <https://www.census.gov/hhes/www/poverty/publications/pubs-cps.html> (accessed February 12, 2014).

<sup>15</sup> See income inequality data updated through 2012 on the website of Emmanuel Saez, <http://elsa.berkeley.edu/~saez/>. Tables are an expansion of Piketty and Saez (2003), *Op. cit.*

We have set in motion a vicious cycle. One of the reasons that our economy is not performing is the high level of inequality, which leads to lower growth, a weaker economy,<sup>16</sup> and more instability (as the IMF has recognized).<sup>17</sup> But this weak economic performance has, in turn, contributed to the increase in inequality.<sup>18</sup>

Perhaps the most disturbing aspect of America's outsized inequality is the inequality of opportunity. The American Dream is, in reality, a myth. The U.S. has some of the worst inequality across generations (social mobility) among wealthy nations.<sup>19</sup> The life prospects of a young American are more dependent on the income and education of his parents than in other advanced countries.<sup>20</sup>

Given the enormous increase in inequality that has occurred in the U.S. over the past three decades, any measure that harms those at the bottom should also be unacceptable, and measures that impose undue burdens on the middle class should receive careful scrutiny.

Our economy has been performing well below potential, and the reason for this dismal performance is lack of aggregate demand. Thus, we need to be particularly mindful of the effect of tax reform on aggregate demand in general and employment in particular. While in general taxes take money out of the system, and therefore have a deflationary bias, some taxes have a larger multiplier than others, i.e. lead to a greater reduction in aggregate

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<sup>16</sup> Those at the top of the distribution consume a smaller percentage of their income than those at the bottom, so that aggregate demand will be weak, unless the government undertakes offsetting actions. Before the crisis, weak regulations and low interest rates gave rise to a housing bubble, which offset what would ??????? otherwise have been weak demand; but it was clear that this was not sustainable.

<sup>17</sup> Berg, Andrew G. and Jonathan D. Ostry. 2011. "Inequality and Unsustainable Growth: Two Sides of the Same Coin?" IMF Staff Discussion Note, April 8, 2011.

<sup>18</sup> For a discussion of this two-way relationship between inequality and economic performance (including instability) see J.E. Stiglitz. 2012, *The Price of Inequality: How Today's Divided Society Endangers Our Future*, New York: W.W. Norton, 2012, and J.E. Stiglitz. 2012. "Macroeconomic Fluctuations, Inequality, and Human Development." *Journal of Human Development and Capabilities*. 13(1), pp. 31-58. Reprinted in *Macroeconomics and Human Development*, Deepak Nayyar (ed.), Taylor and Francis, 2013.

<sup>19</sup> The Pew Charitable Trusts' Economic Mobility Project has found that there is a stronger link in the United States between parents' socioeconomic status and their children's outcomes than in any other countries the project investigated, including the UK, France, Germany, Italy, Canada, and Australia. See Economic Mobility Project, 2011, "Does America Promote Mobility As Well As Other Nations?," available at [http://www.economicmobility.org/assets/pdfs/CRITA\\_FINAL.pdf](http://www.economicmobility.org/assets/pdfs/CRITA_FINAL.pdf) (accessed March 28, 2014). The Economic Mobility Project also finds that 43 percent of Americans born into the bottom fifth of income earners remain there as adults, and 70 percent of those born into the bottom two-fifths remain there as adults. See Economic Mobility Project of the Pew Charitable Trusts, 2013, "Moving On Up," available at [http://www.pewstates.org/uploadedFiles/PCS/Content-Level/Pages/Reports/2013/Moving\\_On\\_Up.pdf](http://www.pewstates.org/uploadedFiles/PCS/Content-Level/Pages/Reports/2013/Moving_On_Up.pdf) (accessed March 28, 2014). For a full discussion, see J. E. Stiglitz, *The Price of Inequality*, *op. cit.* and the references cited there. Chetty et al. (2014) have found that income mobility has remained stable in recent decades in the United States, but that it is lower than popular narratives suggest. See Raj Chetty, Nathaniel Hendren, Patrick Kline, Emmanuel Saez, Nicholas Turner, 2014, "Is the United States Still a Land of Opportunity? Recent Trends in Intergenerational Mobility," NBER Working Paper 19844, January, available at [http://www.equality-of-opportunity.org/files/mobility\\_trends.pdf](http://www.equality-of-opportunity.org/files/mobility_trends.pdf) (accessed March 28, 2014); and the website of the Equality of Opportunity Project, <http://www.equality-of-opportunity.org/>. Miles Corak has shown that inequality of outcomes, which is extreme in the United States, also harms mobility, an effect that Alan Krueger has called the "Gatsby Curve." See Miles Corak, 2013, "Income Inequality, Equality of Opportunity, and Intergenerational Mobility," IZA Discussion paper No. 7520, July, available at <http://ftp.iza.org/dp7520.pdf> (accessed March 28, 2014); and Krueger, Alan, 2012, "The Rise and Consequences of Inequality in the United States," speech at the Center for American Progress, Washington D.C. on January 12, available at [http://www.whitehouse.gov/sites/default/files/krueger\\_cap\\_speech\\_final\\_remarks.pdf](http://www.whitehouse.gov/sites/default/files/krueger_cap_speech_final_remarks.pdf) (accessed March 28, 2014).

<sup>20</sup> In an OECD study, the U.S. is ranked 10<sup>th</sup> out of 13 OECD countries studied in social mobility. D'Addio, A. 2007. "Intergenerational Transmission of Disadvantage: Mobility or Immobility Across Generations? A Review of the Evidence for OECD countries." OECD Social, Employment and Migration Working Papers, No. 52. In an IZA study, the U.S. is ranked 8<sup>th</sup> out of 9 developed countries. See Miles Corak, 2006, "Do Poor Children Become Poor Adults? Lessons from a Cross Country Comparison of Generational Earnings Mobility," IZA Discussion Paper No. 1993. Bonn: Institute for the Study of Labor.

demand per dollar of revenue raised. Taxes on the rich and superrich, who save a large fraction of their income, have the least adverse effect on aggregate demand. Taxes on lower income individuals have the most adverse effect on aggregate demand. Thus, increasing the progressivity of the tax system not only improves the distribution of income – reducing the inequality that has come to mark the country – but also stimulates the economy. And doing so is, of course, good for the country as a whole. The higher demand for labor that results is especially beneficial to working class families because unemployment is reduced and wages increase.<sup>21</sup>

There are even some taxes that can more directly stimulate the economy. An increase in the inheritance tax may induce some of the wealthy to consume now, and this will stimulate the economy. A tax on pollution (carbon emissions) has even more benefits. It encourages firms to make carbon-reducing investments, to retrofit their firms to reflect the true costs of the pollution that they generate. A tax on pollution has a triple dividend because it leads to a better environment which can itself lead to stronger economic performance<sup>22</sup> and it raises revenue, even as it reduces the bad externalities spilling over on the rest of us. Moreover, it incentivizes firms to retro-fit, thus encouraging investment that leads to higher output and employment.

It is important to dispel a misunderstanding that one often hears from advocates of lower taxes for the rich and corporations, which contends that the rich are the job producers, and anything that reduces their income will reduce their ability and incentive to create jobs. First, at the current time, it is not lack of funds that is holding back investment. It is not even a weak and dysfunctional financial sector. America's large corporations are sitting on more than \$2 trillion in cash. What is holding back investment, especially by large corporations, is the lack of demand for their products. If there were demand, firms would respond, as they always have, even when tax rates were far, far higher than they are now (as they were until 1980).<sup>23</sup> It is demand that creates jobs, and it is our current system's high level of inequality that accordingly is destroying jobs.<sup>24</sup> Later, we will explain how one can

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<sup>21</sup> Conservatives, of course, dispute this claim. Their main arguments are that (a) the country needs savings, and the rich save more than the rest, and (b) the rich are the job creators. Both contentions are wrong. Right now, as we have explained, the problem with the economy is lack of demand, not a lack of savings – even Bernanke has spoken of a surfeit of savings. Moreover, much of the income of the top arises from rent seeking (wealth appropriation) – and thus impedes growth and efficiency. See J. E. Stiglitz, *The Price of Inequality*, *op. cit.* and Thomas Piketty, Emmanuel Saez, and Stefanie Stantcheva, "Taxing the 1 percent: Why the Top Tax Rate Could Be over 80 percent," *Vox*, December 8, 2011, available at <http://www.voxeu.org/article/taxing-1-why-top-tax-rate-could-be-over-80>. Further, as recent discussions of private equity firms has made clear, some, if not much, of the activity of the rich is associated with job destruction, not job creation; and even when there is job creation, all too often it is overseas, not in the U.S. Later, we explain what is wrong with the idea that the rich are the job creators.

<sup>22</sup> The forthcoming IPCC assessment of the impacts of global warming has provided further evidence of the likely dire consequences to the global economy of not curbing greenhouse gas emissions. While earlier, it was thought that the effects of global warming would be largely felt in the tropics, with the U.S. spared the worse consequences, more recent research has highlighted the effects of global warming in leading to greater weather volatility. (IPCC's Fifth Assessment Report, available at <http://www.ipcc.ch>). What has happened in the U.S. (with unusual hurricanes, droughts, floods, and cold spells) is consistent with these findings.

<sup>23</sup> From 1951 to 1986, the top corporate tax rate ranged from 46 percent to 52.8 percent, peaking in 1968 and 1969. After 1988, the top corporate tax dropped to as low as to 34 percent. Source: Tax Policy Center data, available at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=65> (accessed March 28, 2014), and Bureau of Labor Statistics, *Op. cit.* by the same token, the top individual income tax rate has come down from a high of 92 percent in 1952-1953, and 70 percent or above throughout the 1960s and 1970s, to 39.6 percent today. Tax Policy Center data, available at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=474&Topic2id=30&Topic3id=38> (accessed March 28, 2014). The period of high tax rates corresponds to the period of the country's highest economic growth.

<sup>24</sup> Some conservatives suggest that it is regulatory and tax uncertainty that is holding back the economy. In a democracy, there are always debates about tax and regulatory regimes, and therefore always uncertainty about the regimes that may prevail in the future. There is no evidence that the degree of such uncertainties is greater today than it was in the past. It is worth noting that in those sectors where there is strong demand, these uncertainties have not proved an impediment for investment and increasing employment – reinforcing our conclusion that it is lack of demand that is the dominant factor holding back the economy.



restructure the corporate income tax system in ways that both raise revenue and provide increased incentives for investment.

### **Balanced budget**

There has been much confusion in the public debate about the adverse effects of the deficit, evidenced by the now famous Reinhart-Rogoff debate.<sup>25</sup> There is no (economically and statistically significant) “cliff” above which any adverse effect of debt on growth increases dramatically. While Reinhart and Rogoff’s analysis bolstered the confidence of the deficit hawks in the righteousness of their views, its disproof seems not to have had a symmetrical effect.<sup>26</sup> The clamor for containing the deficit – already shrunk to levels that prevailed during the Reagan administration – continues.<sup>27</sup> With mounting evidence that the pace of the increase in medical costs has been contained, there has been a major turnaround in deficit projections in the future.<sup>28</sup>

But even if we accepted the argument that deficits can be a problem, increasing taxes and government spending simultaneously can stimulate the economy. This is known as the balanced budget multiplier. And if taxes are chosen well (those with small multipliers) and expenditures are correctly targeted (at areas with large multipliers, and even more so, if there are long-run growth effects) the net effect can be quite large. The balanced budget multiplier can reach 2 or more; that is, an increase in spending by 1 percent of GDP matched with a 1 percent

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<sup>25</sup>Reinhart and Rogoff seemed to show that there is a dramatic decline in a country’s growth when a country’s level of public debt exceeds 90 percent of gross domestic product. (Reinhart, Carmen M. and Kenneth S. Rogoff. 2010. “Growth in a Time of Debt.” *American Economic Review*, 100(2): 573-78.) However, Thomas Herndon, Michael Ash, and Robert Pollin later found out that the Reinhart-Rogoff paper had several fundamental flaws, including a basic data problem. See Herndon, Ash, and Pollin, 2013, “Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff,” *Cambridge Journal of Economic* 38(2): 257-279. (The working version of this paper was issued in April 2013.)

<sup>26</sup> Note that the deficiencies in the Rogoff-Reinhart study were apparent well before the famous study referred to in the previous footnote. Their study provided no analysis, for instance of causality: did debt lead to lower growth, or did lower growth lead to more debt, or were there other factors contributing both to lower growth and more debt? The study provided no analysis of the conditions under which debt was particularly adverse, and the conditions under which there would be few adverse effects. For instance, the U.S. debt to GDP ratio exceeded 130 percent after World War II, and yet in the subsequent decades, the U.S. experienced its fastest rate of growth (and growth that was widely shared: both stand in marked contrast to the experiences since 1980). The study did not even pretend to provide a statistical analysis of whether there was a non-linearity in the relationship between debt and growth; it simply asserted it. They have defended their findings in several places, starting shortly after the publication of the study referred to in the previous footnote. Reinhart and Rogoff’s May 5, 2013, “Errata: “Growth in A Time of Debt,” available at [http://www.carmenreinhart.com/user\\_uploads/data/36\\_data.pdf](http://www.carmenreinhart.com/user_uploads/data/36_data.pdf) (accessed March 28, 2014); and op-eds in newspapers such as their April 25, 2013, “Reinhart and Rogoff: Responding to Our Critics,” *The New York Times*, available at <http://www.nytimes.com/2013/04/26/opinion/reinhart-and-rogoff-responding-to-our-critics.html?ref=opinion> (accessed March 28, 2014), minimized the importance of the data errors in their original paper. This defense has done little to assuage critics.

<sup>27</sup> The CBO has estimated the current deficit/GDP ratio as 4.1 percent in 2013, and it is projected to fall to 3.0 percent in fiscal year 2013 (see <http://www.cbo.gov/publication/45069>, accessed March 28, 2014). During the Reagan administration, this number ranged from 2.4 percent to 5.7 percent. Data Source: Bureau of Economic Analysis, (GDP data is from Bureau of Economic Analysis; Deficit data comes from White House, Historical Tables, Tale 1.1).

<sup>28</sup> The annual growth rate of real per capita National Health Expenditures (NHE) fell from 3.9 percent in 2000-2007 to 1.8 percent in 2007-2010. The National Health Expenditure data show that growth in Medicare spending fell from an average of 8.6 percent a year between 2000 and 2005 to an average of 6.7 percent a year between 2006 and 2010. In 2013, Medicare outlays grew at just 2 percent, according to the CBO, the lowest increase since 1999 (see CBO, 2013, *The Budget and Economic Outlook: 2014 to 2024*, available online at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/45010-Outlook2014\\_Feb.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/45010-Outlook2014_Feb.pdf), (accessed March 28, 2014), p. 10). Moreover, CBO’s estimates of Medicare spending as a share of GDP have consistently been revised down over the past five years. For example, the 2018 spending was expected to be 3.4 percent of GDP in the 2008 projection, and in the 2012 projection, this number was revised down to 3 percent. Medicare’s contribution to the deficit over the period 2014-2023 was revised down by \$16 billion in 2014, as compared to the 2013 projections. (Source: “Trends In Health Care Cost Growth And The Role Of The Affordable Care Act,” White House report, November 2013; “The Affordable Care Act and Trends in Health Care Spending,” White House report, 2013.)



increase in tax revenues, can increase GDP by a factor of 2 or more. And beyond that, the growth that results can improve debt sustainability.

## SOME GENERAL PRINCIPLES OF TAXATION

The previous section argued that given the weaknesses in the economy, the design of tax reform needs to be particularly attentive to impacts on aggregate demand. As well, given the enormous increase and high level of inequality, tax reform needs to be particularly attentive to distributive impacts.

Standard textbook treatments emphasize the importance of incentive effects and administrative and compliance costs of taxation. Recent discussions have, however, perhaps given short shrift to two other principles.

### *The Generalized Henry George Principle*

One of the general principles of taxation is that one should tax factors that are inelastic in supply, since there are no adverse supply side effects. Land does not disappear when it is taxed. Henry George, a great progressive of the late nineteenth century, argued, partly on this basis, for a land tax.<sup>29</sup> It is ironic that rather than following this dictum, the U.S. has been, through its preferential treatment of capital gains, doing just the opposite.

But it is not just land that faces a low elasticity of supply. It is the case for other depletable natural resources. Subsidies might encourage the early discovery of a resource, but they do not increase the supply of the resource; instead, that is largely a matter of nature. That is why it also makes sense to tax natural resource rents<sup>30</sup>, from an efficiency point of view, at as close to 100 percent as possible. (Well-designed auctions enable government to capture most of the rents derived from government owned assets.)

### *Generalized Polluter Pay Principle*

The generalized Henry George principle identifies a class of taxes that does not impede economic efficiency. But there is a class of taxes that actually increases economic efficiency: taxes that discourage activities that generate negative externalities. There is a further principle that should guide deliberations, which is it is better to tax bad things (such as pollution) than good things (such as work). The market produces too much of some things (such as toxic mortgages and toxic waste) and too little of others (such as basic research). Taxes can be particularly effective in curbing these negative externalities, and in doing so, yield double dividends. As noted earlier, “corrective” taxes improve the efficiency and stability of the economy and yield revenue.

The most important category of corrective taxes are those on environmental externalities, and within this area, the most important are those associated with carbon emissions, with their impact on global climate change.

It matters less whether those generating the pollution pay a carbon tax or buy emission permits that are auctioned. Either can generate large amounts of money and simultaneously improve economic performance.

### *Financial Transactions Tax and Other Taxes on the Finance Sector*

Environmental externalities are not the only examples of negative externalities in a modern economy. America’s financial sector polluted the entire world with its toxic mortgages. The reckless and predatory lending and other bad behavior of key participants in the financial sector had adverse effects on the American and global economy. Even if the banks were to pay back every dime that they received to those they preyed on, they would not have

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<sup>29</sup> Henry, George. 1879. *Progress and Poverty: An Inquiry into the Cause of Industrial Depressions and of Increase of Want with Increase of Wealth: The Remedy*. More recent research has reinforced the importance of the Henry George principle. See, e.g. R. Arnott and J. E. Stiglitz, “Aggregate Land Rents, Expenditure on Public Goods and Optimal City Size,” *Quarterly Journal of Economics*, 93(4), November 1979, pp. 471-500.

<sup>30</sup> Rents are the term that economists apply to payments to factors of production that are inelastically supplied, which were traditionally land and other natural resources.

come anywhere close to compensating the country for the full costs – now in the trillions of dollars – that they have imposed on others.

Nor is this the first time that the banks have been rescued from their mistaken lending decisions. Bailouts have become a regular feature of the global economy over the last three decades. Repeated bailouts have led to a distorted and inefficient economy. Taxes can be used both to undo these distortions and contribute to deficit reduction. Later in this paper, we provide examples of financial sector taxes that are receiving attention – and enactment – in many countries around the world.

It is reasonable for the financial sector to play a significant role in deficit reduction, because of the large role that it contributed to the current debt crisis around the world, both directly (in the costs of the bailouts), but even more so indirectly, as a result of the extended recession for which it is especially culpable. The recession has been a major cause of the increase in the national debt over the past five years.

## REFORMING THE CORPORATE INCOME TAX SYSTEM

Corporate income taxes have diminished as a major source of revenue, from 39.8 percent in 1943 to 9.9 percent in 2012.<sup>31</sup> The reason is not that corporations have come to play a less important role in our economy, or that corporate profitability has diminished.<sup>32</sup> Rather, it is that corporations have learned how to exploit loopholes in our tax system, have lobbied hard and successfully to increase those loopholes, and have especially taken advantage of globalization to move profits to jurisdictions where they are lightly taxed. Tax arbitrage has become a major and highly profitable activity for firms – an activity with no social returns but high social costs.

These tax avoidance activities have become a concern in countries all over the world. Apple has become the prime example of how a clever firm can use its ingenuity to avoid paying its fair share of taxes by attributing profits to corporations that are essentially stateless, existing only in cyberspace, and which pay taxes to no jurisdiction. What makes these actions by our tech companies so galling is that these companies' profits exist, in no small part, because of basic investments by government, for instance in developing the Internet and the browser. These companies have shown a willingness to take from what the public has provided, but not to give back commensurately.

At the time of the Bush tax cuts for dividends, there was much discussion of the unfairness of “double taxation.” Profits were taxed when they were earned by corporations, and then again when they were paid out to individuals in dividends. There was an awareness, however, that simply taxing individuals on the basis of distributed dividends – and not corporations – would be unfair and distortionary because it would provide incentives for money to remain within corporations, almost regardless of the efficiency with which they could use those funds. Thus, corporations would become an unlimited IRA for the rich.

There was also an awareness that some corporations had managed to avoid paying taxes altogether. Or even if they didn't avoid all taxes, they paid taxes that were a fraction of the “official” tax rate. The problem was not double taxation, but zero taxation. The capital gains of the rich could totally escape taxation through a special

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<sup>31</sup> White House Office of Management and Budget Historical Tables, Table 2.2—Percentage Composition of Receipts by Source: 1934–2018, available at <http://www.whitehouse.gov/omb/budget/historicals> (accessed January 24, 2014).

<sup>32</sup> Corporate profits (before tax) as a percentage of GDP have not been significantly lower in recent years. In fact, this number is 11 percent for 2013, and it was around 7 percent 10 years ago in 2003. It fluctuates between 5 percent to 11 percent in the past 50 years. Data source: corporate profits data are from St. Louis Fed, and GDP data from the Bureau of Economic Analysis.

provision called “step-up of basis at death.”<sup>33</sup> Early in the formulation of the Bush tax cuts, the promoters promised that the special, low rates on dividends would only apply to corporations that were paying taxes. But then in the usual eleventh hour shenanigans before the tax cuts became law, this provision was dropped. Thus, income of tax-avoiding corporations today either escapes taxation, or is taxed at low rates.

We should emphasize that this tax avoidance does not involve a few rogue companies, the black sheep of the corporate world, but is rather a hallmark of America’s corporate icons – GE, Apple, Google, and a host of others.

Making matters worse is the fact that our current tax system encourages multinationals to invest abroad. So long as they don’t repatriate their funds to the U.S., they don’t have to pay any American taxes. If they can find a jurisdiction with no or low taxes, then the tax code has created an unlimited IRA account for corporations.

Investing abroad means creating jobs abroad. With trade liberalization, the goods produced by American multinationals abroad can then be sold in the U.S. So even though the profits of multinationals are in no small measure due to American innovations and American markets, the companies not only escape paying taxes to the U.S., but are encouraged to create jobs and income abroad. One might hope that a sense of loyalty and social responsibility would lead America’s multinationals to act otherwise, but for too many companies, it has not. And, as we have noted, America’s leading companies have set the example for others to follow.

Aware of these criticisms, those in the corporate sector have proposed a set of deals. The intent is clear: to lock in the tax benefits that they received from the Bush Administration, and the hard-won loopholes that have benefited them richly for so many years. They propose a set of “reforms” that would enable them to maintain these low tax payments – or lower them further – in return for some changes that they assert would improve incentives, which might lead to more job creation in the U.S. They recognize that public spiritedness will not induce them to pay their fair share of taxes or to create jobs in the U.S. Only bribes will do that. So they seek to lower the corporate income tax rate and to impose taxation only on production in the U.S.

In the following paragraphs, we propose an alternative set of reforms, which we believe would be simpler, more effective in promoting efficiency, growth, and job creation, and would actually increase revenues. We explain why the reforms proposed by the multinationals are likely to be disappointing, both in creating jobs and in raising revenues. It will be successful in increasing inequality.

### ***Our Corporate Tax Agenda***

Our corporate tax agenda has seven basic elements:

1. Raise the corporate tax rate.
2. But provide generous tax credits for corporations which invest in the U.S. and create jobs here.
3. Eliminate the loopholes that distort the economy, reduce tax revenues, and create enormous inequities.
4. Increase taxes on monopolies and other rent-seeking economic activities.
5. Ensure that multinationals pay their fair share of taxes, and have incentives to invest in America. We will outline several elements of this agenda, including: (i) Tax multinationals on a “formulaic basis” – analogous to the way that corporations are taxed by the states within the U.S., on the basis of their sales, employment and assets within each state; (ii) Adopt a special provision that intellectual property that can be substantially attributed to the U.S. (e.g. as a result of research conducted in the U.S.) be treated as an American asset; and (iii) A minimum tax on global income.
6. Increase taxes on corporations the profits of which are associated with negative externalities.

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<sup>33</sup> Under this provision, an inherited asset is valued at the price at the time of the bequeather’s death, not the value at the time of the original purchase. Thus, as the asset continues to increase in value, the heir will pay capital gains taxes on a smaller increase, calculated from the time of inheritance rather than from the time the asset was originally purchased.

7. Reduce the bias towards leverage by making dividend payments tax deductible, but imposing a withholding tax.

We believe that this agenda will not only eliminate the current distortionary incentive for job creation abroad, but will also go a long way toward leveling the playing field, and indeed toward providing incentives for job creation in the U.S.

We postpone the main discussion of taxes on negative externalities to later in this paper.<sup>34</sup>

### ***Raising Corporate Income Tax Rates While Providing Incentives for Investments and Job Creation in the U.S.***

The implicit assumptions of the advocates of lower corporate tax rates are that low rates induce more investment and that high corporate tax rates disincentivize investment.<sup>35</sup> Both theory and evidence indicate that low corporate tax rates fail to induce investment, but that one can design a corporate income tax that will promote investment and employment creation in the U.S. Such a tax system will require higher tax rates on corporations that do not invest, accompanied by lower taxes on those that do. It is the difference in taxation between those who do and those who do not invest and create jobs that provides the incentives for investment and job creation.

It is understandable that corporations put forward self-serving arguments for lowering the corporate income tax. The reason that the corporate tax does not in fact discourage investment is that, at the margin, most firms finance investment by borrowing. But since interest is tax deductible, the marginal cost of investment is reduced by the same proportion that the marginal return to investment is reduced. There is in fact no distortion. Indeed, with current depreciation allowances, the returns to investment are reduced less than in proportion to the cost of capital, so net investment is encouraged.<sup>36</sup>

But the current tax system does create a distortion: it encourages the creation of jobs abroad by multinational firms. Below, we discuss more fully how our system of taxation of international corporations needs to be reformed. Here, we focus on a single provision: the fact that profits of multinational American firms are not taxed until they are repatriated to the U.S. This means that if they are kept abroad, profits escape taxation. But that in turn means keeping money abroad is giving multinationals a privilege analogous to having an unlimited IRA account: as long as they keep their money abroad, they can avoid paying taxes. This is especially attractive since there are some tax-avoiding jurisdictions, such as Ireland, that are competing in a race to the bottom by offering low tax rates, so much so that money kept abroad can almost escape taxation.<sup>37</sup>

But the consequences are not just a matter of fairness. There is a distortion in the allocation of investment, one that is particularly costly to the U.S. If corporations invest abroad, they can postpone paying their taxes, but if they invest in the U.S., and use pre-existing profits to do so, they must bring those profits back to the U.S. and pay taxes. Thus, investing and job creation abroad become more attractive than investing in the U.S., even in circumstances when, apart from this tax preference, America would be the better place to invest.

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<sup>34</sup> Some of the reforms in the individual income tax, e.g. concerning taxation of capital gains, discussed below are equally applicable to the corporation income tax.

<sup>35</sup> There is another argument that we address below: higher tax rates in the U.S. induce firms to locate elsewhere.

<sup>36</sup> The analytic argument is by now well-established. See, e.g. J. E. Stiglitz. "Taxation, Corporate Financial Policy and the Cost of Capital." *Journal of Public Economics*, 2, February 1973, pp. 1-34. (Subsequently published in *Modern Public Finance*, 1, International Library of Critical Writings in Economics, No. 15., A. Atkinson (ed.), Elgar, 1991, pp. 96-129.) and J. E. Stiglitz, "The Corporation Tax," *Journal of Public Economics*, 5, April-May 1976, pp. 303-311. More recent analyses have shown how the lower taxation of dividends may actually lead to reduced investment. See A. Korinek and J. E. Stiglitz. 2009. "Dividend Taxation and Intertemporal Tax Arbitrage." *Journal of Public Economics*, 93(2009), pp. 142-159.

<sup>37</sup> In Ireland, the corporate tax is as low as 12.5 percent.

There is an easy solution to this: eliminating the provision that allows the postponement of taxes, while retaining provisions that give companies a full tax credit for taxes paid abroad. With this provision, companies would not face the problem of double taxation. (We discuss below the appropriate way of determining the overall tax liability.)

Many in the corporate sector seek another reform: to tax corporations only on the economic activity that occurs in the U.S., an approach that many other countries take. This would lead to an even more distorted allocation of capital because it would encourage the movement of businesses to jurisdictions with the lowest taxes, exacerbating the race to the bottom noted above.

Such a “reform” would be especially disadvantageous to the U.S. In Europe and around the world, it is common for goods produced abroad to face a V.A.T. or sales tax, so at least there is a contribution to the country from the sale of these goods inside the country. The incentives for moving abroad to avoid taxes are mitigated, because there is a rebate on the tax for exports. But there is no national American sales tax, no V.A.T., and many states impose no sales taxes.

### ***Reduced Spending on Corporate Welfare***

Welfare payments provide assistance to poor individuals in need. But in the U.S., we give large amounts of money to rich corporations that can hardly be viewed as needy. Such payments – mainly hidden in our corporate tax system – have come to be called corporate welfare. (The losses in government revenue arising from these special provisions are referred to as “tax expenditures.” It is as if the government collected the taxes, and then paid the money out to the corporations. The outcomes – both in terms of corporate after-tax profits and in terms of government revenues – would be the same. But embedding these gifts to the corporation inside the tax code has two benefits to the corporations: The expenditures are less transparent, less subject to scrutiny. And the payments automatically go up, say as the level of the “preferred” activity increases. With conventional expenditures, as opposed to tax expenditures, there would have to be annual votes. In this sense, corporate welfare tax expenditures are a kind of corporate entitlement.)

Corporate welfare consists of the billions – over a decade, tens and perhaps hundreds of billions – of dollars to enrich the coffers of corporations, sometimes to protect them from adverse situations (as in the massive bailout of the banking system, sometimes directly, as in the current crisis, sometimes indirectly, through the IMF) and other times to “promote” particular industries.<sup>38</sup> The net beneficiaries of corporate welfare are, by and large, wealthy Americans – and increasingly wealthy foreigners (since foreigners are large owners of American corporations). But these expenditures distort our economy. There is a deadweight loss arising from this corporate welfare; that is, the value of the benefits to the recipients is less than the value of the losses to the Treasury. Both for reasons of equity and efficiency, the elimination – or at least the reduction – of corporate welfare should be at the center of tax reform.

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<sup>38</sup> DeHaven (2012) shows that corporate welfare in the federal budget costs almost \$100 billion a year, and this is about 50 percent more than what the government spends on traditional social welfare programs. (Tad DeHaven, “Corporate Welfare in the Federal Budget.” CATO Institute, 2012.)

One category of corporate welfare/tax expenditures<sup>39</sup> in particular deserves attention.

*Subsidies to producers of fossil fuels* distort the economy and are bad for the environment. We should, in fact, be taxing the production of fossil fuels (as we note further below). This is consistent with the general principle enunciated earlier: it is better to tax bad things than good things.

Defenders of these hidden subsidies to polluters say that eliminating this (and other forms of) corporate welfare will reduce GDP and employment. We explained earlier how such taxes raise revenue at the same time that they increase economic efficiency. We also explained how they can actually increase employment, as firms try to retrofit their capital stock to reflect the new economic realities. In doing so, they also increase GDP.<sup>40</sup>

But the two most important responses to such justifications for corporate welfare are that the maintenance of full employment should be the overall responsibility of monetary and macro-policy, and that were the government to eliminate the corporate welfare provisions and spend the increased revenue on “high multiplier” expenditures (such as domestic investment), employment and output would increase, both now, and in the future.

### **Financial Sector Taxes**

The previous section argued for the elimination of preferential treatment of a wide range of companies. At the same time, there are some sectors that should face higher taxes – in particular, the financial sector. There are good reasons that there should be a special set of taxes imposed on the financial sector. First, as we noted earlier, the recession caused by the misdeeds of the financial sector is a major cause of the current high level of national indebtedness. Secondly, also as we noted, there is an important role for “corrective” taxation – taxes that simultaneously raise revenue and provide incentives for firms not to, for instance, impose externalities on others. The financial sector has, in fact, imposed huge costs on the rest of the economy.

But in spite of the evidence that it has imposed large costs on the rest of the economy, the financial sector has been particularly successful in escaping taxation. We suggest a number of financial sector taxes that would, we believe, actually increase the likelihood that the financial sector more efficiently performs the key social functions that it should perform.

These should not be viewed as mutually exclusive alternatives, but rather a set of taxes that works together. Several of these taxes correct distortions in the financial sector. Ideally, all these taxes should be imposed. Even

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<sup>39</sup> One of the most egregious forms of direct corporate welfare expenditures is for agriculture. Subsidies to agriculture and agro-business are bad for the environment, go disproportionately to those who are better off, hurt the poor in developing countries, and have been a major impediment to global trade agreements that (at least those in the business community contend) might bring significant benefits to American businesses. As in other areas, subsidies are often defended on the grounds that they help a particularly deserving group of Americans. When agricultural programs first began, farmers were, on average, poorer than other Americans, and hence targeting them for assistance might have made some sense. Even then, there is a question of why poor farmers are more deserving of assistance than other poor Americans. Today, though, most of the money goes to corporations (“agro-business”) and Americans who are better off than average, often much better off. Again, as in other areas, if there is a compelling case that poor farmers need more protection than other poor Americans – a case that has not been made – there are easy fixes, e.g. by limiting the benefits to those whose income is below \$100,000, and limiting payments to, for example, at most \$100,000 per farm. (From 1995 to 2012, the top 1 percent of farms received 26 percent of farming subsidies; the top 10 percent of farms received 77 percent of farming subsidies. Data source: Environmental Working Group Farm Subsidy Database.)

<sup>40</sup> The benefits to correctly measured GDP – taking into account the costs of pollution and environmental degradation – are even larger. When there are large externalities, then GDP provides a particularly bad measure of economic performance, and one should be careful about equating changes in GDP with changes in wellbeing. See the report of the International Commission on the Measurement of Economic Performance and Social Welfare, available as J. E. Stiglitz (chair), J. Fitoussi and A. Sen *Mismeasuring Our Lives: Why GDP Doesn't Add Up*. New York: The New Press, 2010

at very low rates, they could raise substantial revenues and simultaneously increase the overall efficiency of the economy.

#### *Bonus tax*

In the wake of the financial crisis of 2008, there was probably nothing that did more to provoke the sense of injustice than the huge bonuses paid out to those responsible for the crisis, even as the banks that these individuals managed were being bailed out by taxpayers who bore the brunt of the costs of the banks' misdeeds. The pre-crisis justification for the bonuses was bankers' supposedly outstanding performance, but this rationale was undermined when they were still paid even as banks experienced massive losses. Huge payments by the banks to their officials also are one of the sources of growing inequality in our society. Moreover, the structure of the bonuses contributes to shortsighted behavior and excessive risk taking.

A well-designed bonus tax could thus encourage incentive structures that align behavior of those in the financial sector with the long-term interests of society (thereby increasing overall efficiency), contribute to a broader sense of societal fairness, and simultaneously contribute to deficit reduction. Indeed, the U.S. is one of the few countries that rescued its banks without attempting to address these issues.<sup>41</sup>

#### *Financial Transactions Tax*

For a quarter century, it has been recognized that short-term financial transactions may contribute to economic volatility without enhancing long-term economic performance.<sup>42</sup> They were at the center of the global financial crisis at the end of the last century. In recent years, partly because of that crisis and partly because of the current Great Recession, this notion has received widespread support, within academia and within civil society. With the acceptance of that perspective has come increasing support for a financial transaction tax. Such a tax, even at an extremely low rate, would raise considerable revenue, and there is little evidence that it would have any adverse effect on long-term productivity – on the contrary, it is likely to enhance it.<sup>43, 44</sup>

#### *Bank Rescue Fund*

As we have noted, banks have had to be rescued time and time again. It is unlikely that the Dodd-Frank Wall Street Reform and Consumer Protection Act will suffice to prevent the occurrence of another crisis, especially

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<sup>41</sup> A major mistake of the Clinton Administration was to have an exemption on the tax imposed on excessive corporate pay for performance-related compensation. This encouraged stock market bonuses, whether the stock market increases were a result of the managers' actions, e.g. bonuses that were paid when the stock market went up, for instance as a result of lower interest rates (obviously not a consequence of the managers' actions). Indeed, this provision encouraged the kind of creative (and deceptive) accounting that has marked the U.S. economy over the past two decades. See J. E. Stiglitz. 2003. *The Roaring Nineties*. New York: W.W. Norton & Company, especially chapters 5 and 6.

<sup>42</sup> Stiglitz, J. E. "Using Tax Policy to Curb Speculative Short-Term Trading," *Journal of Financial Services Research*, 3(2/3), December 1989, pp. 101-115. Reprinted in *The Selected Works of Joseph E. Stiglitz, Volume II: Information and Economic Analysis: Applications to Capital, Labor, and Product Markets*, Oxford: Oxford University Press, 2013, pp. 85-98.

<sup>43</sup> There is by now a large literature in support of such a tax, and several European leaders have now endorsed one version or another of such a tax. See, for example, Avinash Persaud. 2012. "The Economic Consequences of the EU Proposal for a Financial Transaction Tax," published by Intelligence Capital, available at <http://www.stampoutpoverty.org/wp-content/uploads/2012/10/The-Economic-Consequences-of-the-EU-Proposal-for-a-Financial-Transaction-Tax-3.pdf> (accessed February 14, 2014).

<sup>44</sup> Not only do such short-term transactions increase volatility, they lead firms to focus excessively on the short term. Such "short-termism" has become a marked feature of the American economy, contributing to the current crisis, and shifting attention away from the longer term investments that are essential for long term productivity increases and growth.



because nothing was done about too-big-to-fail banks.<sup>45</sup> Among economists, there is a broad agreement that the repeated bailouts have led to a problem of moral hazard, with excessive risk taking and an excessively large financial sector. Moreover, too-big-to-fail banks are able to get access to capital at lower interest rates and grow at the expense of competitors, not because they are more efficient, but because of implicit public subsidy. Because of their presumption of being “too big to fail” the largest banks have a competitive advantage over others.<sup>46</sup>

The Obama administration at one point talked about a tax based on leverage and size, designed to discourage excessive leverage and size. A tax based on the size of the bank (at least for the very largest banks) would help level the playing field, increasing efficiency within the financial sector itself. This is an example of “corrective” taxation – using the tax system to avoid behavior that could (and in the past has) imposed high costs on the rest of society.

A corrective tax would also help address some of the other problems posed by our mega-banks, including that they appear to be not only too big to fail, but too big to be managed,<sup>47</sup> and too big to be held accountable.<sup>48, 49</sup> The problem of bank concentration has become worse in the aftermath of the crisis, as the Federal Reserve encouraged bank consolidation.<sup>50</sup> Increased concentration means that the too-big-to-fail problem has become worse – making it even more desirable to impose the kinds of taxes described in this section. But it also means that it is easier for banks to engage in oligopolistic and collusive practices. Banks’ oligopolistic powers are exercised in a multiplicity of ways, e.g. in foreign transaction fees, which now run 3 percent, a number that seems highly inconsistent with trading in a market with homogeneous commodities.<sup>51</sup>

#### *Electronic Payment System (EPS) Fees*

Modern technology has allowed the creation of an efficient electronic payments system. It should cost almost nothing to transfer money from an individual’s bank account to the merchant’s bank account when a purchase is made. Yet the credit card companies charge large fees, as much as .6 to 2.4 percent.<sup>52</sup> These fees act as a tax on every transaction, but a tax that goes not to the public coffer but to enrich the credit card companies, including

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<sup>45</sup> For an excellent discussion of the problems confronting the financial sector, see Mervyn King, governor of the Bank of England, “Banking: From Bagehot to Basel, and Back Again,” The Second Bagehot Lecture, Buttonwood Gathering, New York City, October 25, 2010, available at <http://www.bis.org/review/r101028a.pdf> (accessed February 14, 2014). See also a 2009 speech by King, in which he criticized banks being too big to fail: “Speech given by Mervyn King, Governor of the Bank of England at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion House,” available at <http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2009/speech394.pdf> (accessed March 28, 2014).

<sup>46</sup> These too-big-to-fail banks not only have a competitive advantage in accessing debt at lower interest rates, they have an advantage in attracting low cost deposits. Depositors feel more secure putting money in a bank that will almost surely be protected. See Dean Baker and Travis McArthur. 2009. “The Value of the ‘Too Big to Fail’ Big Bank Subsidy,” Center for Economic and Policy Research, September.

<sup>47</sup> See, e.g. Group of Thirty, 2009 *Financial Reform: A Framework for Financial Stability*, January 15, 2009, available at <http://fic.wharton.upenn.edu/fic/Policy%20page/G30Report.pdf> (accessed February 28, 2014).

<sup>48</sup> This has been seen most vividly as the Justice Department has refused to fully prosecute very large banks that have engaged in a variety of egregious practices, including violating sanctions and lying in signing court affidavits. See, e.g. J. E. Stiglitz, *Freefall: America, Free Markets, and the Sinking of the World Economy*, New York: WW Norton, 2010.

<sup>49</sup> It is important to recognize that the reforms discussed here go only a little way in resolving the problems with our banking system, e.g. they do not address the problems of too interconnected to fail or too correlated to fail.

<sup>50</sup> In 2007, the top 5 banks held 36 percent of all the deposits, this number increased to 44 percent in 2013. Source: FDIC, Summary of Deposits.

<sup>51</sup> There is even concern that this increased concentration, especially in mortgages, has undermined the effectiveness of monetary policy, as lower long-term interest rates did not get fully reflected in lower mortgage rates.

<sup>52</sup> See Terri Bradford and Fumiko Hayashi, April 2008, “Interchange fees in the United States and abroad” Federal Reserve Bank of Kansas City. <http://www.kansascityfed.org/Publicat/PSR/Briefings/PSR-BriefingApr08.pdf> (accessed November 23, 2010).

the banks. Other countries have curtailed the anti-competitive practices, but given the need for deficit reduction, an alternative is to redirect the revenues from credit cards to public purpose, by, for example, setting the fees at 1.5 percent, with 50 basis points going to the card companies, and the rest dedicated to deficit reduction. This is an example of an efficiency-enhancing deficit reducing reform – consumers and merchants would be better off, transaction costs would be lowered, and so too would the deficit.<sup>53</sup>

### ***Taxes on Monopolies and Other Rent-Based Enterprises***

One of the advantages of taxing monopolies and other rent-based enterprise “profits” at a higher (“surtax”) level is the absence of adverse supply responses. Indeed, if the response to taxing rent seeking activities is to decrease the quantity of such activities, the efficiency of the economy may actually be enhanced.

While in some cases it may be difficult to ascertain the extent to which there are monopoly profits, in some sectors (such as telecom and cable TV) the magnitudes and associated distortions are large.<sup>54</sup>

### ***Ensuring that Multinationals Pay Their Fair Share of Taxes and Have Incentives to Invest in America***

Earlier, we explained that the current system, in which many multinationals do not pay their fair share of taxes, also is an expensive system for the American economy: we lose not just tax revenues but also jobs. In the following two subsections, we discuss two ways by which this problem can be addressed.

#### *Replace the transfer price system with the formulaic approach, taxing firms on their global income in a fair and comprehensive way*

In spite of the recent assertions of the Supreme Court, corporations are not people. One of the ways that they differ from people is that where they reside can be nothing but a legal fiction. We can tell where an individual resides – an individual is a resident of the State of New York if she sleeps 50 percent of nights in New York. But a corporation can set up an office in the Cayman Islands, claim that as its home, even if little or none of its business is conducted there, and even if it has few if any employees there. Our leading technology companies have shown that they can be as innovative in tax avoidance as they have been in producing new products.

The current system cannot work in a world of globalization. The current system is based on trying to infer the value of what is produced within any given jurisdiction. Firms are asked to assess what they would have received for the goods that they produced in a particular place, if they had sold the products in an arm’s-length transaction – even if there are not markets anywhere for the half-finished goods that may be shipped from one jurisdiction to another.

The states recognized the hopelessness of the transfer price system in the economically integrated U.S. as goods repeatedly move across state boundaries in the process of production. State taxes use a formula that takes into account the fraction of the company’s sales, employees, and capital that occurs within any given jurisdiction. (Even here, tax avoidance is possible, but the scope appears markedly lower than under the transfer price system.)

But as globalization has progressed, the same problems are arising internationally. A formulaic approach, well-tested within the U.S. among state governments, is the obvious answer.

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<sup>53</sup> A major responsibility of the Federal Reserve should be the creation of an efficient (electronics) payments system. It has clearly failed to do so. Sadly, even when the Durbin Amendment to Dodd-Frank mandated that the Federal Reserve impose restrictions on interchange rates on debit cards (a provision that did not extend to credit cards), the Federal Reserve failed to do so adequately, continuing to allow charges that were well in excess of costs, so much so that Judge Richard Leon rejected the proposed Federal Reserve regulations. (NACS v. Board of Governors of the Federal Reserve System, 11-cv-02075, U.S. District Court, District of Columbia, Washington.)

<sup>54</sup> As a matter of economic policy, it would, of course, be preferable to attempt to create a more competitive market place, rather than to tax the monopoly/oligopolistic rents.

### *Intellectual Property*

Corporations whose profits are strongly related to intellectual property have been particularly effective in tax avoidance, partly because it is relatively easy to claim that the intellectual property was created in, or resides in, a low tax jurisdiction. This is so even when the intellectual property depends heavily on basic research paid for by American taxpayers. As we noted earlier, technology firms, whose very existence depends on the Internet, which itself only exists as a result of government investments in research and development, have become emblematic of this kind of “corporate irresponsibility.” In the implementation of the formulaic approach described above, we need to adopt a special provision that intellectual property that can be substantially attributed to the U.S. (e.g. as a result of research conducted in the U.S.) be treated as an American asset. That is, we may need to implement a formulaic approach to intellectual property: if the research on which it is based was largely conducted in the U.S., it should be considered largely an American asset.

### *A Minimum Tax on Global Corporate Income*

An alternative (or perhaps complementary) scheme would impose a minimum tax on global corporate income of 15 or 20 percent, with a credit, of course, given for taxes paid in other jurisdictions. This would reduce, if not eliminate, the incentive to move to low tax jurisdictions.

### ***Reduce the Bias Towards Leverage by Making Dividend Payments Tax Deductible, But Imposing a Withholding Tax***

One of the distortions associated with the current tax regime is that it encourages excessive leverage, which can, in turn, contribute to excessive volatility. Firms that raise capital through debt can deduct the interest they pay, but this is not true for the dividends that firms pay to those who contribute equity. This bias would be eliminated if dividends were tax deductible.<sup>55</sup> But many of the recipients of the dividends would, under the current regime, then succeed in avoiding all taxes on this income, by taking advantage of various provisions in the tax code. Hence we propose that there be a 40 percent withholding tax.<sup>56</sup> Upper income Americans who actually pay taxes on dividends received would then get a full credit for these taxes that have been withheld. There would then be no double taxation – there would be an effective integration of the individual and corporate income tax.

## **REFORMING THE INDIVIDUAL INCOME TAX SYSTEM**

Just as we suggested that there was a reform agenda for the corporate sector that would simultaneously address our nation’s problems, increase efficiency, stimulate investment, and improve equity, we have a similar five point agenda for the individual income tax.

Our individual tax agenda has five basic elements:

1. Increase the progressivity of the tax system.
2. Create a “fair” tax system, in which speculation and the returns to capital are taxed at as high a rate as work.
3. Reduce “loopholes” for the rich.
4. Broaden the tax base, but in ways that do not reduce progressivity.
5. Use taxes to improve the efficiency of the economic system, by taxing activities that give rise to negative externalities. This point is linked to the imposition of corrective taxes (as discussed earlier in this paper), which can play an especially important role in addressing environmental externalities, and is discussed in section 5.

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<sup>55</sup> Indeed, there would be a reverse bias, because of preferential treatment of capital gains. In the next section, we argue that this preferential treatment should be eliminated.

<sup>56</sup> The tax would not be refundable, but, as we note below, taxpayers receiving dividends would be given credit for the taxes collected at the corporate level.

### ***Progressive Increases in Taxation***

There is a general principle in economics that there is no such thing as a free lunch. To the extent that we can, however, improve the efficiency of tax and expenditure programs, there is a free lunch: we can achieve the objectives of the programs and reduce expenditures. The reality, however, is that efficiency-enhancing measures are unlikely to suffice, by themselves. That means that there will likely have to be increases in taxes. Someone has to pay. The question is, who?

Fortunately, the unfortunate changes in the distribution of income in the U.S. provide a simple and easy answer: most of the increase should come from those who have done so well by the U.S. in the last quarter century, the top 1 percent, who as we have noted, now garner for themselves 20 percent or more of the total national pie.

A small increase in the tax rate on them – 5 percent of their income – would generate, over 10 years, revenues equal to between \$1 and \$1.5 trillion. Currently, most of these individuals pay effective tax rates that are far below the “official” rates, because of their ability to take advantage of tax preferences and loopholes. Eliminating these tax preferences and loopholes would go a long way towards achieving announced goals of reducing the deficit.

Let’s take as an example someone earning \$1 million a year. She would have to contribute an extra \$50,000. Just as a matter of illustration, assuming that she is currently paying an effective tax rate of 20 percent<sup>57</sup>, she would still have \$750,000 to get by.<sup>58</sup> It should be evident that such a small change in the tax system, while raising considerable revenues, would not impose severe hardship.

### ***A Simplified Individual Income Tax Combined with a VAT***

A key characteristic of a good tax system is that administrative and compliance costs be low relative to the amount raised. Large fractions of Americans – those with low and moderate incomes – are asked to fill out income tax forms. The costs (including anxiety) imposed on them are not commensurate with the revenues raised. A simple reform would significantly lower costs of tax administration. A standard exemption of, for example, \$100,000 would release large numbers of citizens from the burden of filling out tax forms, and simultaneously eliminate for these individuals the distortions associated with the specific provisions of the current tax system, which provide special treatment to some categories of spending. The loss in revenue would be made up by a comprehensive VAT, levied at a low rate of 5 percent, for example (or an even more comprehensive GDP tax, levied at a still lower rate).<sup>59</sup>

### ***“The Fair Tax”***

One proposal that has been widely discussed is to tax all forms of income the same, i.e. eliminate the preferential treatment of dividends and capital gains, the benefits of which go disproportionately to upper income Americans.

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<sup>57</sup> A 2013 IRS report shows that the effective tax rate was 23.4% for the top 1 percent and 20.6% for the top 5 percent in 2010; these numbers have dropped from 27.6% and 23.9% from 2001. See Table 5 in “Individual Income Tax Rates and Shares, 2010,” available at <http://www.irs.gov/pub/irs-soi/13inwinbulratesshare.pdf> (accessed March 29, 2014). Note that the effective tax rate is markedly lower than the “legislated” tax rate.

<sup>58</sup> It is worth noting that the tax compromise agreed to at the beginning of 2013 was, from every perspective, less than ideal. The temporary payroll tax cut was eliminated as was the temporary reduction in taxes on those with incomes over \$400,000. But the temporary reduction in taxes on those with incomes between \$250,000 to \$400,000 was retained. Had these temporary tax cuts be terminated instead of the temporary payroll taxes, the economy would have enjoyed more fiscal stimulus. By choosing the “break point,” one could obtain both more tax revenues and more stimulus than under the tax reforms that were adopted.

<sup>59</sup> A VAT is not a progressive tax; and since the rich spend a larger fraction of their income overseas, it is even regressive. But our proposal entails joining a VAT with the EITC and a progressive income tax. The entire tax structure would be progressive – with the reforms we propose, substantially more progressive than the current system.

The preferential treatment afforded to dividends and capital gains is another example of tax provisions where the official rationale has little to do with the actual effects. The argument has been put forward that the U.S. should encourage savings. But the savings of most Americans (through their pension funds and 401(k) programs) already receive preferential treatment. When taxes on capital gains and dividends were lowered, the benefits were extended to investments made prior to the enactment. These tax benefits were simply windfall gains. Tax revenues were reduced, without any concomitant increases in investment.

In the end, the special treatment did not have the benefits promised. Instead of household savings increasing, after the enactment of the Bush tax cuts, the savings rate plummeted to new lows.

There is, moreover, no justification for taxing those who work hard to earn a living at a higher rate than those who derive their income from speculation.

The complexity of our tax system (compared to what would be the case in a “fair tax” system in which all sources of income are treated the same) leads individuals to expend enormous resources to convert income into forms that are tax-preferred. This distortion in our economy, like other distortions, reduces efficiency and growth.

The encouragement of speculation has further adverse effects: the resulting excesses in risk taking contribute to economic volatility.

A related but particularly obnoxious provision of the tax code allows those in private equity firms to treat the income they receive as if it were capital gains and thus taxed at a much lower rate. This is called the carried interest provision. The “trick” is to give the private equity managers shares in the companies that they are restructuring, so that their compensation largely takes the form of an increase in the value of their shares. But the managers of the private equity firms are simply providing a service – helping to restructure firms. In some cases, it can be a valuable service. In some cases, it may consist of a financial restructuring, allowing the private equity firms to take out money now, leaving a burden of debt that the firm cannot bear, leading in turn to bankruptcies and job losses down the line. But whether one views the service provided as one having positive or negative social value, there is no reason that the provision of this service should be taxed at a lower rate than other managerial services. There is no reason that these managers should be able to avoid taxation, operating through the Cayman Islands and/or taking advantage of the favorable treatment of capital gains.

The preferential tax treatment of capital gains and dividends is perhaps the single most regressive distortion in the individual income tax system. As the Congressional Budget Office observed, “the preferential tax rates on dividends and capital gains provide almost no benefits to households in the bottom four quintiles but provide notable benefits to households in the top quintile – amounting to 1.7 percent of after-tax income in 2013.”<sup>60</sup> Even more striking is the fact that 68 percent of the benefits of this preferential treatment go to the top 1 percent of the population.

The budgetary cost of this single provision in 2013 was \$161 billion, and is estimated over the next decade (2014 to 2023) to cost \$1.34 trillion. Simply eliminating this provision would go a long way – more than a third – of meeting the deficit reduction target of \$4 trillion. When combined with other aspects of preferential treatment, discussed below, more than half of the deficit reduction target of \$4 trillion would easily be reached.

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<sup>60</sup> See Congressional Budget Office, 2013, *The Distribution of Major Tax Expenditures in the Individual Income Tax System*, May, p.31, available at [http://cbo.gov/sites/default/files/cbofiles/attachments/TaxExpenditures\\_One-Column.pdf](http://cbo.gov/sites/default/files/cbofiles/attachments/TaxExpenditures_One-Column.pdf) (accessed March 28, 2014).

### *Step-up of Basis at Death*

A peculiar feature of our tax code is that if an asset is passed on to one's heirs at death, the capital gains earned during the individual's lifetime goes entirely untaxed. Over 10 years, the cost of this single, seemingly obscure provision that is of benefit mostly to those at the very top – 49 percent of the benefits go to the top 5 percent – is more than \$600 billion.

### *Tax Deferral*

Capital gains receive still a further benefit, which is particularly valuable in periods when interest rates are high: the tax is imposed only upon realization. This provision gives rise, moreover, to a significant distortion, known as the locked in effect – individuals are reluctant to sell an asset because if they do so, they have to pay a tax. The locked in effect is, of course, greatly enhanced by the step-up of basis at death provision discussed above, because if individuals hold on long enough, the tax can be avoided entirely. Like the other tax provisions related to capital, the benefits overwhelming accrue to those at the very top.

There are a number of ways of imposing taxes as capital gains accrue, especially in the case of marketed assets, such as stocks. For these assets, we could use mark-to-market accounting (as we already do in much of the economy). For non-marketed assets, we could impute earnings as if the capital gains accrued smoothly over the holding period. Individuals could be encouraged to report on an annual basis their estimated capital gains, and upon the sale of the asset, it would be an easy matter (given current technology) to calculate whether there has been an under or overpayment.

### ***Eliminating Loopholes for the Rich***

The preferential rates for speculation (capital gains) and dividends is only one of the reasons that the rich pay such a small share of their income in taxes. A recent IRS report shows that the rich saw their share of all national income rise and their effective federal income tax rate fall in recent years. In 2010, the top 1 percent (the 1.35 million families with adjusted gross income above \$369,691), reported 18.87 percent of all Adjusted Gross Income (AGI), up from 17.21 percent in 2009. Meanwhile their average tax bill (as a percentage of AGI) fell to 23.39 percent in 2010, from 24.05 percent in 2009. The IRS report also shows that in 2010, 10,666 families reporting AGI of more than \$10 million realized 5.5 percent of the nation's taxable income, but as high as 41 percent of all long-term capital gains and corporate dividends, which are taxed at very preferential rates.<sup>61</sup> One of the other reasons that they pay taxes at a relatively low rate is that they can avail themselves of a variety of loopholes in the tax law. Rich taxpayers don't keep their money in the Cayman Islands because the sunshine there leads to higher returns. Quite the opposite: the money is there to be kept in the shadows. They are willing to bear the slight cost and inconvenience of having their money parked off shore for the opportunities of tax avoidance, opportunities that the jurisdiction's lack of transparency enhances.

There is no reason that money can be managed better a few hundred miles off the shore of the U.S. than in the world's most efficient money center, New York. The offshore tax havens were deliberately created to enhance the opportunities for tax avoidance and "regulatory arbitrage." They are a privilege accessible only to the rich, who can afford the tax lawyers who know how to avail their clients of these tax avoidance opportunities.

There is no economic reason that tax havens should exist. There is no reason that this financial activity should not occur in the U.S. We could stop these tax havens overnight – just as we stopped the use of secretive banking centers to curtail their use in funneling money to terrorists. We should do so for other reasons, too. Offshore tax havens facilitate corruption, drug and other illegal and illicit activities, and money laundering.

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<sup>61</sup> Dungan, Adrian, and Michael Parisi. 2013. "Individual Income Tax Rates and Shares, 2010." *IRS*. At the time, they were taxed at a rate of 15 percent. They are still taxed at very preferential rates – only 20 percent, just over half of the rate imposed on ordinary income at the top.

At various times, we have worked hard to circumscribe tax avoidance and to close loopholes. But it has been a constant battle, with new loopholes opening up as old ones get closed.

Some ways that the rich avoid taxes are, however, longstanding, such as the tax exemption of interest on municipal bonds, for which the reductions in tax liabilities for the rich exceed, by a considerable margin, the reduction of interest costs for the municipalities. They are ways of making the municipalities better off, raising revenues, and increasing the fairness of the tax system.<sup>62</sup>

These and other special provisions of individual income tax significantly reduce the taxes paid at the top. The Congressional Budget Office estimates that more than half of the benefits of the ten major “tax expenditures” – a euphemism for tax breaks – go to the richest 20 percent of American households, and 17 percent go to households in the top 1 percent alone. Just 13 percent of the benefits go to the middle 20 percent of Americans (the middle quintile), and only 18 percent go to the bottom 40 percent. A huge proportion of American tax breaks simply funnel money to the rich.<sup>63</sup>

### ***Broadening the Tax Base and Middle Class Tax Expenditures***

A major item on the agenda of most economists has been to broaden the tax base, allowing the lowering of tax rates. The argument is that distortions are associated with marginal tax rates, that base broadening would allow a lowering of the marginal tax rate, and the special provisions (exemptions, preferential tax treatment) which riddle the tax code and distort the economy.

Such reforms have to be carefully done if they are not to have large distributional consequences and impose large transition costs.

Most importantly, to the extent that these tax deductions are middle class deductions, these reforms should not be seen as a way of raising tax revenues. Changes in our economy discussed in Section 1 have led to the middle class being hard pressed. Tax reforms should not worsen their plight. Middle class Americans have to be compensated, with at least an offsetting reduction in tax rates. In short, while these tax reforms – broadening the base to allow a lowering of the rates for middle class taxpayers – may be desirable from both perspectives of efficiency and horizontal equity, they should not be viewed as part of the solution to the nation’s deficit problem. The only part of base broadening that should be viewed as such entails curtailing tax expenditures for upper income Americans – part of the agenda of increasing progressivity of the tax code.

### ***Elimination of Tax Deductibility of Mortgage Payments***

In the long run, eliminating tax distortions related to mortgage payments makes enormous sense. Tax deductions for mortgage payments encourages excessive consumption of housing, and in particular, it encourages excess leverage. There are two problems in the elimination of the subsidy. The timing couldn’t be worse because even the announcement of the future elimination of mortgage subsidies would lead to reductions in house prices. But even if the government decided to proceed with the elimination, one can’t ignore the distributional consequences.<sup>64</sup>

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<sup>62</sup> For instance, providing a tax credit at a given rate, say 28 percent, for the purchase of municipal bonds would have much the same effect on the costs of capital to municipalities, but would reduce some of the current inequities.

<sup>63</sup> See CBO, May 2013. “The Distribution of Major Tax Expenditures in the Individual Income Tax System,” Op. Cit.

<sup>64</sup> Federal tax expenditures on housing heavily favor wealthier households. A 2013 CBO report finds that people with top 20 percent income take 73 percent of the total tax deduction on mortgage interest; the top 1 percent alone takes 15 percent of tax deduction on mortgage interest. CBO, May 2013, Ibid. For a compelling analysis, see also Center for Budget and Policy Priorities, 2013 “Mortgage Interest Deduction Is Ripe for Reform,” June 25, available at <http://www.cbpp.org/cms/?fa=view&id=3948> (accessed March 28, 2014).



There are two reforms that would reduce the inefficiencies and inequities associated with these tax benefits. The first is to convert the deductibility into a tax credit, and to impose an upper limit on the tax credit. Putting an upper limit on the tax credit would have the further advantage of eliminating the distortionary aspect of the preferential tax treatment for upper income Americans.

The second reform is to convert the mortgage deduction – which encourages leverage – into an “equity subsidy,” e.g. for first time homebuyers. This would reduce the adverse impact that would arise from a complete elimination of preferential treatment for housing, but would eliminate one of the worse aspects of the current program, its encouragement of debt.

There is a debate about whether there are positive externalities associated with home ownership. There is some research that suggests that homeowners are more engaged in the community and that the children of homeowners do better in school.<sup>65</sup> To the extent that this evidence is viewed as compelling, it provides a rationale for government to encourage homeownership. But this is distinct from encouraging leverage, which is what our tax system does now. One can encourage ownership – real ownership – without encouraging indebtedness.

#### *Tax Exemption of Employer-Provided Health Insurance*

This encourages excessive spending on health insurance, which in turn can lead to excessive spending on medical care. But this provision simultaneously provides important and hard-won protections for many Americans, which is especially important given the high costs of health care. The country has just been through an exhaustive debate on health care reform. This may not be the appropriate time to reopen that discussion (beyond the elimination of the one major source of corporate welfare, the peculiar programs which in effect result in huge excess payments to the drug companies). But if this tax benefit is reduced or eliminated, given its importance, some middle class compensatory tax adjustment should again be made.

#### *Savings Subsidies*

The definition of tax expenditures depends, of course, on one’s reference point. If one takes as one’s “base” a fair tax in which all forms of income are treated the same, then the special treatment of savings, dividends and capital gains is clearly one of the most significant categories of tax expenditures, justified (by its advocates) by the virtue of encouraging savings or investment. The evidence that these special provisions lead to higher levels of national savings is weak. Even if the interest elasticity of savings were positive, the question is whether the increase in private savings is large enough to offset reduced tax revenues, which lead to negative public savings.<sup>66</sup>

IRA accounts and preferential treatment of pensions constitute an important source of middle class tax expenditures, but the incidence of these and other tax expenditures allegedly directed at encouraging savings is regressive and increasingly so, as the inequality of wealth is even greater than the inequality in income. The elimination of these tax preferences for upper income Americans could contribute significantly to national debt reduction, and probably to an increase in national savings. At the very least, these tax deductions should be converted into cashable tax credits – ensuring that those at the bottom of the income distribution get at least a chance at getting their “fair share” of the benefits, and that those at the top don’t get more than their fair share.

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<sup>65</sup> See, for example, Richard Green and Michelle White. 1997. “Measuring the Benefits of Homeowning: Effects on Children.” *Journal of Urban Economics*, 41, 441-461. Haurin, Donald R., Toby L. Parcel, and R. Jean Haurin. 2003. “Does Homeownership Affect Child Outcomes?” *Real Estate Economics* 30 (4): 635-666. Dietz, Robert D., and Donald R. Haurin. 2003. “The Social and Private Micro-Level Consequences of Homeownership,” *Journal of Urban Economics* 54 (3): 401-450.

<sup>66</sup> Moreover, the link between savings and domestic investment is even weaker: those at the top who put their savings in the Cayman Islands may not invest these savings within the United States.

There are other inequities associated with the current arrangements. If your employer doesn't offer a 401K or equivalent, then you face a sharp limit on how much you can save for your retirement with any tax benefit. There is no good rationale for this form of differentiation.

## ENVIRONMENT TAXES<sup>67</sup>

We noted earlier that it is better to tax bad things than good things. Such taxes simultaneously increase economic efficiency and raise revenue - they provide a double dividend. The most important category of these taxes are those on polluting activities.

Some states have already adopted taxes that have double dividends, such as the bottle recycling tax. The most important potential source of environmental tax revenues perhaps is a tax on carbon, which would discourage the emission of carbon dioxide and other greenhouse gases that contribute to climate change. The potential revenue from an environmental tax, at the "optimal" level, corresponding to (estimates of) the social cost of pollution are enormous.

## INHERITANCE AND ESTATE TAXES

It has increasingly been noted that America is becoming a plutocracy - not the land of opportunity that it perhaps once was, and that it likes to think of itself as still being. (Earlier, we described the high level to which inequality has grown in the U.S. and how America has one of the lowest levels of equality of opportunity among the advanced countries.) Tax policy, in particular inheritance and estate taxes, can be used to help prevent (or reduce the extent of) the perpetuation of inequality.

Today is a particularly opportune time to impose such taxes. Not only do inheritance and estate taxes reduce inequality and its perpetuation, they may actually induce more consumption and stimulate the economy. Rich individuals who would have saved to pass on their wealth to future generations - helping to create a new American plutocracy - may be induced to consume at least some of this wealth.

Critics of the estate tax suggest that it is unfair. It constitutes (they claim) double taxation. After all, the income that was the basis of the creation of the estate was taxed once. Moreover, some suggest it is unfair because death is not a matter of choice. Finally, it is asserted that it is particularly unfair to small businesses, which, to pay the tax, may have to sell assets, inhibiting their operations and costing jobs.

Each of these arguments is questionable. In many cases, the problem is not double taxation, but zero taxation. Capital gains are not taxed until the gains are realized (that is, the asset is sold). But then the provision we noted earlier called step up of basis of death means that when the asset is passed on to one's heirs, they pay a tax only on the capital gain from the time they inherited the asset. The previous capital gain goes entirely untaxed. And because clever lawyers can convert ordinary income into capital gains, even taxes on ordinary income can be avoided by this route.

Moreover, there are easy ways of avoiding the alleged stress imposed on small businesses. First of all, the high level of exemption (currently \$10 million for a married couple) means that few small businesses are actually

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<sup>67</sup> There is considerable uncertainty about the incidence of these environmental/energy taxes. In general, the poor avail themselves more of public transport systems, do not have large, gas guzzling cars (though they are more likely to have older, less efficient cars), and have smaller homes (even if per square foot they are less efficient), and thus it would seem that the poor spend (directly or indirectly) a smaller fraction of their income on energy than the rich. But because there are some poor who have old, inefficient cars, some would suffer disproportionately (though *in equilibrium*, the price they would have to pay for their used cars would fall commensurately.)

affected. Provisions allowing the stretching out of taxes due over a period of 14 years ensure that no viable business should ever face a severe cash constraint of the kind that would force cutbacks of the kind hypothesized. Perhaps not surprisingly, critics of the tax have not provided evidence of significant effects.

## **OTHER EFFICIENT WAYS OF RAISING REVENUES**

There are other ways of raising revenues that enhance (or do not subtract much from) economic efficiency and growth while supporting other national goals. We go back to the principles enunciated earlier: taxing inelastically supplied resources, taxing rents, and taxing activities that generate negative externalities can raise revenue while possibly even increasing social welfare. But there are other efficient ways of raising revenues: selling or managing public natural resources and other assets in ways that maximize government revenues are key examples.

### ***Better Auctioning/Management of Government Owned Natural Resources and Other Assets***

The government owns large amounts of natural resources and is responsible for managing other natural resources (such as fisheries) and assets (such as the electromagnetic spectrum). Efficient auctioning of the rights to use these resources (assets) and/or the management of these resources can lead to greater efficiency (ensuring that they are used by those generating the highest social returns) and greater revenues. As we have learned from the sale of the spectrum, the amounts at issue are significant. Yet the government continues to dispose of many of these assets in a less than optimal way. While cell phone companies pay for the use of spectrum, broadcasters are often not charged.

Rights to extract some natural resources are still given away in a manner similar to that used in the nineteenth century. Even when there is an auction, the auction is not well-designed, and the terms of the lease contract are far from optimal. Auctioning off fishing rights has the potential to not only raise revenues, but reduce the risk of over-fishing.

## **CONCLUSION: PUTTING IT ALL TOGETHER**

The agenda that we have put forward could significantly increase revenue, reduce inequalities, promote growth and economic efficiency - contrary to some of the reforms that are being proposed by others, which would do just the opposite.

To see a conservative rough order of magnitude of the revenues that could be raised by even a few of these reforms, assume a 40 percent comprehensive tax on those with the highest 25 percent of our nation's income (roughly the top 1 percent), a 20 percent tax on the next 25 percent of our nation's income, and a 5 percent VAT, levied on the 80 percent of national income that is not investment. These taxes would raise revenues equal to 19 percent of national income. Corporate profits are roughly 11 percent of national income, so a combination of tax rates and investment incentives that imposed a tax of 15 percent on that income (less than half of the current "official" tax rate) would raise 1.6 percent of national income. Finally, it is estimated that if we imposed a carbon tax or auctioned carbon emission rights reflecting even a conservative estimate of the social costs of carbon emissions, we would raise revenues that are in excess of 5 percent of national income. Putting these numbers together, this program alone could raise about 26 percent of national income - at the same time that it stimulated output today and improved growth, efficiency, and equity.

Deficit reduction is not an end in itself. It is supposed to be a means to an end, to more sustainable, equitable growth, in which the interests of future generations are fully taken into account. If, to achieve deficit reduction, we sacrifice current investment, we may actually be undermining future generations.

Clearly, there are some forms of spending that contribute more to future growth and the well-being of future generations than others. A future-oriented fiscal policy needs to restructure spending to increase spending that contributes to social good at the expense of other categories of spending. But in assessing which categories of

spending fall within this ambit, one needs to take a broad perspective, taking into account weaknesses in the current economic situation and what contributes to long term sustainable and equitable economic growth. Thus, there is a compelling case that inequality, in the magnitude and form that it has taken in the U.S., weakens growth. If this is so, expenditures which ameliorate this inequality are growth enhancing.

As noted earlier, persistent high unemployment contributes significantly to weakening future growth prospects, and youth unemployment is especially pernicious in this regard. Thus, policies that promote output and employment today also contribute to future growth – particularly if they lead to more investment. Thus, austerity measures that take the form of cutbacks in spending on infrastructure, technology, or education not only weaken the economy today, but weaken it in the future, both directly (through the obvious impacts, for example, on the capital stock) but also indirectly, through the diminution in human capital that arises out of employment or educational experience.

In this paper, we have not detailed how government spending might be restructured to be more growth-and-future oriented, but rather have focused on how we can raise revenues in ways that are consistent with our long term goals and needs – in ways that can actually strengthen growth now and in the future. Before ending, however, we want to make two critical points.

First, the demand for raising revenues arises largely out of a concern for the deficit and debt. Mindless “deficit fetishism” is likely to be counterproductive. It will weaken the economy and prove counterproductive to raising revenues because the main reason that we are in our current fiscal position is the weak economy. The weak economy caused the deficit, not the other way around. As President Franklin D. Roosevelt put it forcefully long ago, in the context of the Great Depression:

If the national income continues to decline, then the Government cannot run without going into the red. The only way to keep the Government out of the red is to keep the people out of the red. And so we had to balance the budget of the American people before we could balance the budget of the national Government.<sup>68</sup>

As he reflected on the period of the Hoover Administration that had preceded his administration, Roosevelt observed:

In those dark days, between us and a balanced budget stood millions of needy Americans, denied the promise of a decent American life.

To balance our budget in 1933 or 1934 or 1935 would have been a crime against the American people.

When Americans suffered, we refused to pass by on the other side. Humanity came first...

But it was not just a matter of humanity. President Roosevelt realized, intuitively, that what mattered was not just the country’s liabilities, but also its assets – one needed to look at the country’s balance sheet, just as one would do in assessing any corporation.

President Hoover’s Administration increased the national debt in the net amount of over three billion dollars in three Depression years, and there was little to show for it. My Administration has increased the national debt in the net amount of about eight billion dollars and there is much to show for it.

Put that figure of eight billions out here on the scoreboard, and let me tell you where the dollars went.

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<sup>68</sup> Franklin D. Roosevelt, 1936, “Address at Forbes Field, Pittsburgh, PA,” October 1.

Over a billion and a half went for payment of the World War Veterans' Bonus this year instead of in 1945. That payment is now out of the way, and is no longer a future obligation of the Government.

As for the other six and a half billions of the deficit we did not just spend money; we spent it for something. America got something for what we spent - conservation of human resources through C.C.C. camps and through work relief; conservation of natural resources of water, soil and forest; billions for security and a better life. While many who criticize today were selling America short, we were investing in the future of America.

I ask you the simple question: Has it not been a sounder investment for us during these past three years to spend eight billion dollars for American industry, American farms, American homes and the care of American citizens?

President Roosevelt understood that if the American economy was stronger, then there would be no burden associated with the debt. It would, in a sense, be self-liquidating. As he put it:

...And now a word as to this foolish fear about the crushing load the debt will impose upon your children and mine. This debt is not going to be paid by oppressive taxation on future generations. It is not going to be paid by taking away the hard-won savings of the present generation.

It is going to be paid out of an increased national income and increased individual incomes produced by increasing national prosperity...

Finally, we note that for those who have developed a deficit fetishism, and feel uncomfortable with any increase in indebtedness - even if the increase in the liability side of the country's balance sheet is matched by an increase in the asset side - there is a way to increase employment today, growth tomorrow, and simultaneously prevent an increase in the deficit today and reduce the deficit and debt tomorrow: an old, long established principle, the balanced budget multiplier, referred to earlier in this paper.

An increase in government spending today matched by an increase in taxes will stimulate the economy, and especially so if the taxes and spending are appropriately designed, i.e. where the tax increase is associated with a low (or negative) multiplier and the expenditure increase is associated with a high multiplier. For instance, the multiplier associated with the estate tax is, as noted above, probably negative. The multiplier associated with an increase in capital gains taxes on the rich is probably small. The multiplier associated with an increase in domestic spending on education or technology is very high, especially in a period of high and persistent unemployment such as today.<sup>69</sup>

The bottom line is simple: As we have repeatedly said, tax reform is not an end in itself. Nor is the object of tax reform just to raise more money to reduce the deficit. The objective of tax reform is to create a more efficient tax system, which simultaneously advances a variety of societal goals: higher employment and growth, a better distribution of income, and less environmental degradation.

Some of the reforms being advocated by corporations and special interests would do none of these things; they risk making matters worse, and at the same time lowering revenue. Among the bad ideas now being discussed

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<sup>69</sup> For example, Auerbach and Gorodnichenko (2013), Baum et al (2012) find that GDP multipliers of government purchases are larger in recessions than in expansions. (Auerbach, Alan and Yuriy Gorodnichenko, 2013. "Fiscal Multipliers in Recession and Expansion." In *Fiscal Policy After the Financial Crisis*, edited by Alberto Alesian and Francesco Giavazzi, pp. 63-98. University of Chicago Press. Baum, Anja, Marcos Poplawski-Ribeiro, and Anke Weber, 2012. "Fiscal Multipliers and the State of the Economy." Unpublished paper, IMF.)

are lowering corporate income and estate taxes and lowering the top marginal tax rates for individuals. There are other base broadening measures, which if done carefully in ways that do not reduce progressivity and are sensitive to our current economic situation should be given consideration.

But there are a large number of reforms that move in exactly the opposite direction to the regressive tax changes being advocated by the right. They include higher corporate income taxes on firms that do not invest in America, accompanied by lower taxes on those that do.<sup>70</sup> We should impose higher taxes on firms that spoil the environment accompanied by lower taxes on those that improve and preserve it. We should have higher taxes on speculators, accompanied perhaps by lower taxes on those that work for a living as well as higher taxes on the financial institutions that have wreaked such havoc to our economy – not to punish them for their past misdeeds, but to ensure that in the future our economy becomes less distorted and there is less of a risk of calling upon taxpayers for another multi-trillion dollar bailout.

We can reform our tax system in ways that will strengthen the economy today, address current economic and social problems, and strengthen our economy for the future. The economic agenda is clear. The question is, will the vested interests which have played such a large role in creating the current distorted system continue to prevail? Do we have the political will to create a tax system that is fair and serves the interests of all Americans?

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<sup>70</sup> Interestingly, more than three quarters of a century ago, President Roosevelt raised similar questions, as he noted money that had been leaving the U.S. during the seeming golden years that preceded the Great Depression:

During that period...billions came out of American pockets and were sent abroad – to foreign countries where the money was used for increasing foreign armaments, for building foreign factories to compete with us, for building foreign dwellings, swimming pools, and slaughter houses, for giving employment to the foreign unemployed – foreign boondoggling, if you will.

Those dollars, billions of them, were just as good American money – just as hard-earned – just as much the reward of our thrift – as the dollars we have spent during these three years at home giving work to the unemployed...

## APPENDIX: SPECIFIC TAX PROPOSALS

### Corporate Tax Reform

- Raise corporate income tax rates while providing incentives for investments and job creation in the U.S.
- Reduce spending on corporate welfare
- Impose a special set of financial sector taxes, including the bonus tax, the financial transactions tax, the bank rescue fund, and electronic payment system fees
- Impose taxes on monopolies and other rent-based enterprises
- Ensure that multinationals pay their fair share of taxes and have incentives to invest in America by replacing the transfer price system with the formulaic approach and taxing firms on their global income
- Reduce the bias towards leverage by making dividend payments tax deductible but imposing a withholding tax

### Individual Tax Reform

- Institute a progressive tax increase
- Institute a simplified individual income tax (e.g. a \$100,000 standard exemption) combined with a value-added tax, levied at a low rate
- Implement the fair tax, with which we eliminate the preferential treatment of dividends and capital gains
- Eliminate the step-up of basis at death
- Eliminate capital gains tax deferral, e.g. using mark-to-market accounting
- Eliminate loopholes for the rich, e.g. the tax exemption of interest on municipal bonds
- Broaden the tax base by curtailing tax expenditures for top incomes
- Gradually eliminate tax deductibility of mortgage payments by converting the deductibility into a tax credit (with an upper limit) and/or into an equity subsidy for first time homebuyers
- Reduce or eliminate the tax exemption of employer-provided health insurance, but balance it with a middle class compensatory tax adjustment
- Eliminate savings subsidies as tax expenditures

### Other Taxes and Ways of Raising Revenues

- Impose environment taxes, including a tax on carbon
- Impose inheritance and estate taxes
- Improve management of government owned natural and other resources, including better auctioning