

“Progressive Tax Reform in the Era of Globalization”

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I want to first thank NASI for inviting me to be on this panel to talk about progressive tax reform in the era of globalization. This talk is largely drawn from an article that Jason Furman and I published in the *Harvard Law and Policy Review* this past summer. Obviously, Jason is in the Administration now, and this presentation is entirely my own work and in no way reflects his work in that capacity or the Administration’s views.

I’d like to spend a few minutes laying out some of the factors that I think may converge at this moment to achieve tax reform that not only lowers rates, broadens the base, and reduces complexity, but even more importantly increases progressivity.

I think there are several forces at work that may provide a unique opportunity to forge consensus in support of progressive tax reform. [SLIDE 2] First, there is a broad agreement that our tax code is broken in several respects. As the President’s Advisory Panel on Tax Reform wrote in 2005, “if you were to start from scratch, the current tax code would provide a guide on what to avoid in designing an income tax system.” Of course, reformers disagree about the most pressing problems. Some worry about complexity, others about the extent to which efficiency can be enhanced by reducing taxes on capital income.

In addition to this perennial concern about the tax code's flaws, two emerging external forces may help push us toward a consensus in favor of progressive tax reform.

[SLIDE 3] The first is increasing income disparity. [SLIDE 4] Related to this is the protectionist backlash against globalization. I'll say a bit more about each of these in a minute, but the broad point is that together, rising inequality and protectionism may enable a grand bargain in favor of progressive income tax reform. Those worried about the lack of broadly shared growth should support more progressive tax policy as a way to reduce post-tax levels of income inequality. At the same time, those who favor expanded globalization—including many in the private sector and on the right—may also be coming to recognize that the protectionist backlash against globalization is motivated by the perception that global economic integration is to blame for lost jobs and declining wages.

In other words, trade liberalization is good for the economy, and it's been particularly good for those at the top of the economic ladder, and if they want it to continue, they're going to have to get on board with efforts to make sure that the gains of global economic integration are shared more broadly. I was struck by the possibility that the American business community may be beginning to recognize this reality when the Financial Services Forum released a report about 18 months ago by Grant Aldonas, Robert Lawrence and Matt Slaughter making this very argument: that the most direct and efficient way to stem the protectionist drift was to effect income redistribution through progressive taxation.

These forces for a possible new consensus—broad dissatisfaction with the tax code, rising inequality and protectionist sentiment—may also get a wind in their sails from several political forces at work.

1. First, massive deficits are renewing attention on our long-term fiscal imbalance, which is going to need to be addressed not just on the spending side, but also the revenue side.
2. Second, Democrats control Congress and the White House.
3. Third, the Bush tax cuts will expire, providing a forcing event to think about how the tax code should be reformed.
4. Fourth, the AMT is affecting an increasing number of families.
5. Fifth, policymakers across the ideological spectrum are worried about America's high statutory corporate tax rate.

### Rising inequality

Let me say a few more words about inequality and protectionism and the link between them.

We all know the data. [SLIDE 5] Between 1947 and 1973, productivity growth and median household income roughly grew together. Since 1973, median income has risen much less slowly than productivity and in the last decade has flat-lined. In short, the gains of economic growth have increasingly accrued to those at the very top of the income distribution, resulting in levels of inequality not seen since before World War II. [SLIDE 6] Since 1979, the share of income going to the top 1 percent has risen by more than 8 percentage points

while the share of income going to the bottom 80 percent has fallen by the same amount.

Rising inequality strengthens the case for progressive taxation for several reasons.

1. [SLIDE 7] First, the tax code has become less progressive over time.  
[SLIDE 8] Estimates by Piketty and Saez show that the average federal tax rate for the top 0.1% of households has fallen sharply in the last 45 years, from 60% in 1960 to 34% in 2004. This is actual taxes paid, including individual, corporate, payroll, and estate taxes.
  - a. [SLIDE 9] More than half of the reduction is due to a decline in corporate taxes; a bit over a third to decline in estate taxes, and a tenth to changes in individual and payroll taxes.
  - b. [SLIDE 10] In contrast to this sharp decline for those at the top, the average federal tax rate for families in the middle actually rose—and even after recent reductions remained higher in 2004 at 16.1% than in 1960, when it was 15.9%.
  - c. Expansions in the EITC and other refundable credits have slightly reduced the average tax rate for the poorest families.
  - d. [SLIDE 11] The tax cuts enacted since 2001 have reinforced this long-term trend. *[They have increased taxes for high-income families much more than for the rest. When fully in effect, the tax cuts will have increased the after-tax incomes of the top 1% of the income distribution by 6.8%, but those of the bottom quintile by only half a percent.*
    - i. *This chart also reminds us that when tax cuts are deficit-financed, the distributional effects must take account of how they will be*

*paid for in the future. The light bars here assume that each household pays an equal amount to finance the tax cuts, for example through reduced Medicaid benefits. The cost would then outweigh the benefit for all but the top quintile.]*

2. [SLIDE 12] Rising inequality also strengthens the case for progressive taxation because of the declining marginal utility of income. That is, that a dollar to you and me means more than it does to Bill Gates. Given that progressive taxation is justified by a desire for “equal sacrifice” and by the more fortunate’s greater ability to pay, then to the extent that the share of the nation’s income accruing to those at the top increases, their ability to pay should increase as well.
3. [SLIDE 13] Related to idea that tax code should mitigate inequality. To be sure, some degree of inequality is inevitable—even desirable. After all, it’s the promise of greater rewards based on hard work and skill that has driven Americans to industrious activity and thereby help grow our economy. But at some point the degree of inequality can become so great that it conflicts with America’s promise of opportunity, concentrates power, undermines the democratic capitalist system, and retards social progress, which Harvard economist Benjamin Friedman has explained correlates with broadly-shared prosperity.
4. [SLIDE 14] Progressive tax policy also provides insurance against steep drop in income
5. [SLIDE 15] And serves as an automatic stabilizer to deliver fiscal stimulus in downturns.

In short, all these forces favor more progressive taxation. To be sure, excessively high tax rates can distort economic behavior, which can harm economic

performance. And policymakers need to balance the desire to promote progressivity with an awareness of the effects on the overall economy. But the optimal balance is very different today than it was when the top marginal tax rate exceed 90 or even 70 percent. Extreme supply side arguments that tax cuts are always good for the economy have been shown to be patently false.

### Growing Protectionist Backlash

Let me turn to the relationship between these trends and rising protectionism. Greater economic openness has greatly benefited the U.S. economy—even though it certainly can cause harm to certain workers in certain industries. One study by the Peterson Institute found that trade provided an aggregate benefit to the U.S. economy of \$1 trillion per year.

However, polls show that the American people are growing increasingly protectionist. [SLIDE 16] According to a recent Pew Research Center poll, the share of Americans who believe that free trade is good for their country has plunged from 78 percent in 2002 to 59 percent in 2007. This concern exists on both sides of the aisle. [SLIDE 17] A Wall Street Journal poll a year ago found that Republicans were skeptical of free trade by an almost two-to-one margin (59% versus 32%). Given the recent global downturn and rise in unemployment, these numbers are certainly worse today.

This backlash is perhaps not surprising given the lack of broadly-shared growth. Most people see that global economic integration leads to growth and prosperity, they're just not enjoying any of it. Particularly given the economic literature on happiness—that it's more related to how much people's incomes

grow relative to those around them than it is to the level of growth itself—it's not surprising that people feel like this new global economy isn't working for them and want nothing to do with it.

The perception probably exceeds the reality. Various factors are more responsible for rising inequality and insecurity than trade—including technological change that increasingly rewards skilled workers, institutional changes such as the decline of unions, immigration, and the decline in real value of the minimum wage. Yet those studies were based on data through the early 1990s, and of course the economy has change substantially since then. [SLIDE 18] As Paul Krugman notes in a recent Brookings paper, the dramatic rise in U.S. imports from developing nations suggests that trade may be playing a larger role today.

Regardless whether the reality justifies the perception, the point is that more progressive tax policy can bring about more broadly shared prosperity, and thus temper protectionist sentiment. This link between protectionism and the lack of broadly shared growth may thus provide an opportunity to forge consensus in support of more progressive taxation.

One way to think about it is that economic policies should make everyone better off, and a grand bargain that combines progressive tax reform with pro-globalization policies can move us closer to this ideal. Globalization policies like free trade lead to stronger economic growth and higher standards of living. More progressive taxation can both push back against the real dislocations caused by trade, but even more importantly shore up support for trade liberalization because of the *perception* that trade has caused falling or stagnant

incomes. Instead of being grounded in a specific social welfare function that places a value on a more egalitarian distribution of income, this view of progressive taxation can be thought of as a broad generalization of the economic concept of a “compensated Pareto improvement” or Kaldor-Hicks efficiency.

### How to achieve more progressive taxation

How we achieve progressive tax reform could be the topic of several days of panels all by itself, so let me briefly just make a few observations.

1. [SLIDE 19] First, as it relates to individual income taxes:
  - a. [SLIDE 20] President Obama has pledged to repeal or let expire the 2001 and 2003 tax cuts for the highest earners. This alone would offset roughly one-sixth of the increase in inequality since 1979. At the same time, reform should make taxes more progressive at the bottom, for example by expanding the EITC.
  - b. We also need to make sure there is a robust tax on bequests and gifts, as one-third of the reduction in average tax rate of those at the top came from reduction in estate tax, as noted earlier.
  - c. Finally, we can make our tax code more effective, equitable and efficient by switching from deductions to credits, as has been widely proposed.
2. [SLIDE 21] Second, we need corporate income tax reform. As noted earlier, the erosion of the corporate income tax is the primary reason average tax rates fell so sharply at the top.
  - a. [SLIDE 22] Taxes at the business level are complex, inefficient, and fail to raise the intended revenue. The U.S. has the second highest statutory corporate tax rate in the OECD, but the fourth

lowest corporate tax revenues as a share of GDP thanks to all the generous business tax preferences.

- b. The high statutory corporate tax rate in the United States has been a concern of business leaders and policymakers worried about the competitiveness and profitability of U.S. firms and foreign direct investment. Lower the corporate rate, while broadening the base, may be a way to bring more conservatives around to a tax reform package. Indeed, Ways and Means Chairman Charlie Rangel proposed doing so in his tax reform bill in the last Congress.
  - c. Depending on how it is designed, broadening the base could allow you to lower rates somewhat and still raise revenue.
  - d. This is not the place to go into detail, but just some of the failings of our corporate income tax code that could be addressed by such a reform include: the book-tax income gap, the treatment of foreign source income, and the treatment of different types of investments.
3. [SLIDE 23] Simplification and compliance are also related to progressive tax reform. Complexity hurts progressivity in several ways:
- a. The AMT is perhaps the worst culprit.
  - b. The EITC, child credit, and various education credits are also complicated—so much so that two-thirds of EITC recipients use a paid tax preparer.
  - c. [SLIDE 24] Some steps to simplify include
    - i. Consolidating various subsidies with similar purposes, such as several for higher education.

- ii. Instituting return-free filing
  - iii. Implementing AMT reform.
4. [SLIDE 25] Finally, closing the tax gap would not only raise revenue but also enhance progressivity. A new study by Joel Slemrod and Andrew Johns, for example, confirmed that misreporting of income and tax liabilities is highest among those with very large incomes.
- a. [SLIDE 26] While easy to lament the tax gap, of course, it is notoriously hard to reduce. Still enhanced enforcement and improved reporting and withholding requirements should help.

### Conclusion

[SLIDE 27] I want to conclude with a brief word about where prospects for such reform may stand in today's economy. The stimulus package expands the EITC and provides a Make Work Pay credit, not just to low income individuals but those higher up the income ladder as well. Those are temporary though, at least for now. In terms of raising rates at the top to enhance progressivity, it's unclear whether there's appetite to repeal or simply let expire the tax cuts for high-income individuals—though I think it's clear they're going to go eventually.

In the longer term, we need to get back to some measure of fiscal discipline. The deficit passed from Bush to Obama exceeded \$1 trillion, and that was before stimulus and TARP 2. We're going to need to address our long-run fiscal imbalances, most notably by reducing the growth rate of health spending. And more revenue may also be needed, which may lead to more serious discussion of some sort of VAT, perhaps connected to health care reform. While it won't be sufficient by itself, progressive tax reform is not only justified by the rise in inequality, but can also help raise revenue and, even more importantly, shore up

support for globalization policies that will enhance growth in the long-run, and thus also help our long-term fiscal position.

Thank you very much.