Heather Boushey, Executive Director and Chief Economist, Washington Center for Equitable Growth, testifying before the U.S. Senate Committee on Finance on "Fairness in Taxation."

Taxation and Fairness in an Era of High Inequality

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Introduction

I would like to thank Chairman Hatch, Ranking Member Wyden, and the rest of the Committee for inviting me here today to testify.

My name is Heather Boushey and I am Executive Director and Chief Economist of the Washington Center for Equitable Growth. The center is a new project devoted to understanding what grows our economy, with a particular emphasis on understanding whether and how rising levels of economic inequality affect economic growth and stability.

I'm honored to be here today to discuss a very important topic: the relationship between fairness and taxation. Over the past several decades, economic inequality, on a variety of measures, has increased in the United States. The benefits of economic growth have flowed primarily to households and individuals at the top of the income and wealth ladders. We need to keep this fact in mind when we consider taxation and fairness in the years ahead.

There are three major conclusions from my testimony:

- As inequality has increased, the tax code has not kept pace with this change. The tax code does less to reduce inequality than it did in the late 1970s
- Efforts to reduce inequality are not in tension with economic growth. A variety of research shows that steps taken to reduce inequality do not significantly hinder economic growth
- There are policy options that can make the tax code more progressive that will have broad benefits for everyone

The rest of my testimony will focus on documenting the rise in inequality, reviewing the academic research on the effects of taxation, and some thoughts about where policy should go forward.

The rise of inequality

Inequality, at least in the popular conversation about it, is talked about like it is a single phenomenon. Even the most widely used measure of inequality, the Gini coefficient, treats it as such. If the coefficient rises, we know that inequality has gone up. But what we don't know is how exactly inequality has increased.

In short, the story of the past four decades when it comes to inequality is a rapid rise in incomes and wealth for those at the top, slower growth for the middle compared to earlier time periods, and stagnation, if not outright declines, for incomes at the bottom of the ladder.

According to data from Paris School of Economics professor Thomas Piketty and University of California-Berkeley economist Emmanuel Saez, the average pre-tax income of the top 1 percent grew by 178 percent from 1979 to 2012. Correspondingly, the top 1 percent's share of pre-tax income has increased from 8 percent to 19 percent over the same time period.[1]

At the same time, inequality of wealth has been rising as well. According to research by Saez and London School of Economics professor Gabriel Zucman, the share of wealth going to top 0.1 percent of households has increased to 22 percent in 2012 from roughly 7 percent in 1979. That's a 3-times increase in the share of wealth held by the top 10 percent of the top 1 percent. The reason for this rise? The rich have a much higher savings rate than the rest of population and the increase income inequality appears to be calcifying into wealth inequality as the rich save their incomes.[2]

According to data from the Congressional Budget Office, the pre-tax, pre-transfer income of the median U.S. household grew by an average of 0.9 percent a year from 1979 to 2007, the last year before the Great Recession. That growth rate is considerably slower than the 4.7 percent a year for the average income of the top 1 percent of households.[3]

For those at the bottom, the reductions in poverty over the past several decades have been driven almost entirely by tax-and-transfer programs.[4] This means that our anti-poverty programs are working to reduce material hardship. Whether they have reduced it enough is another question. But this research also raises concerns about how the labor market is working for those at the bottom of the ladder.

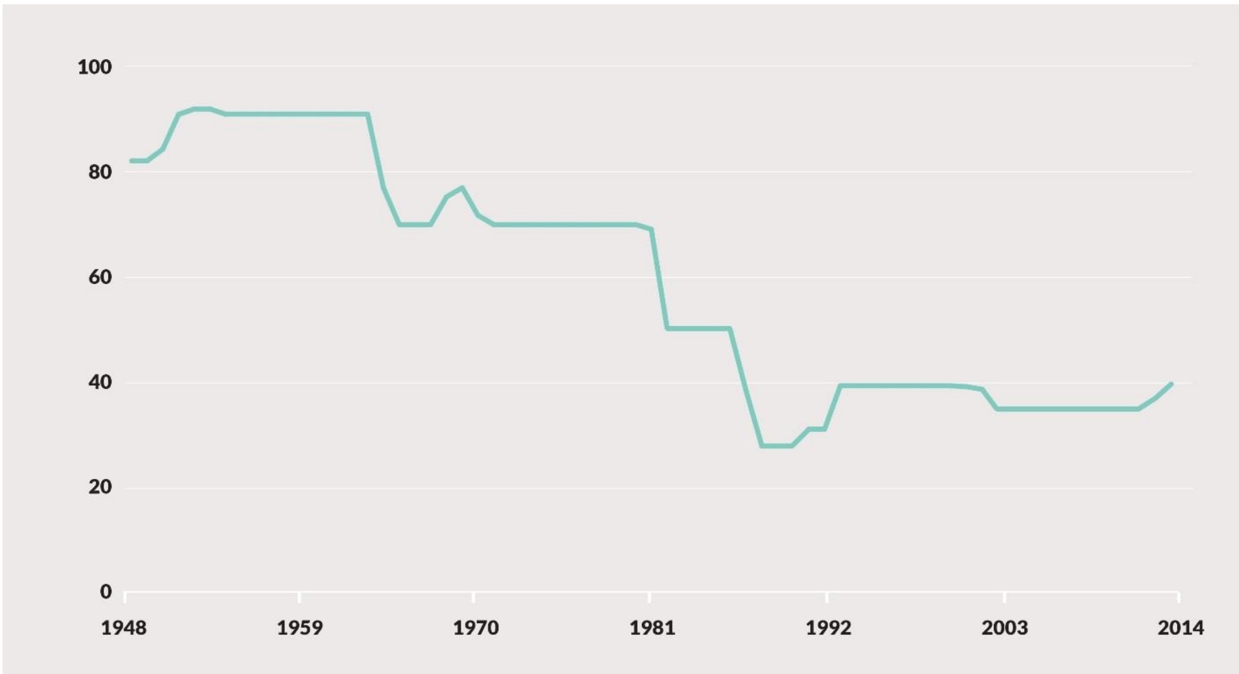
Another shift toward inequality has been the shift of income from labor income (salaries and wages) toward capital (business income and capital gains). This shift matters for inequality because the distribution of capital income is far more unequal than the distribution of labor income. Households at the bottom and the middle of the income ladder rely much more on labor as a source of income than capital.[5] And capital income is concentrated much more at the top of the income ladder.

As these shifts in inequality occurred, the federal tax system was doing less to reduce inequality, though the federal tax system is still progressive. A quick look at Figure 1 below shows how much the top marginal tax rate for labor income has been declining since the early 1980s.

Figure 1

Evolution of the Top Marginal Tax Rate for Ordinary Income

From 1948 to 2014



Source: U.S. Internal Revenue Service, SOI Tax Stats - Historical Data Tables, Table 23. U.S. Individual Income Tax: Personal Exemptions and Lowest and Highest Bracket Tax Rates, and Tax Base for Regular Tax.

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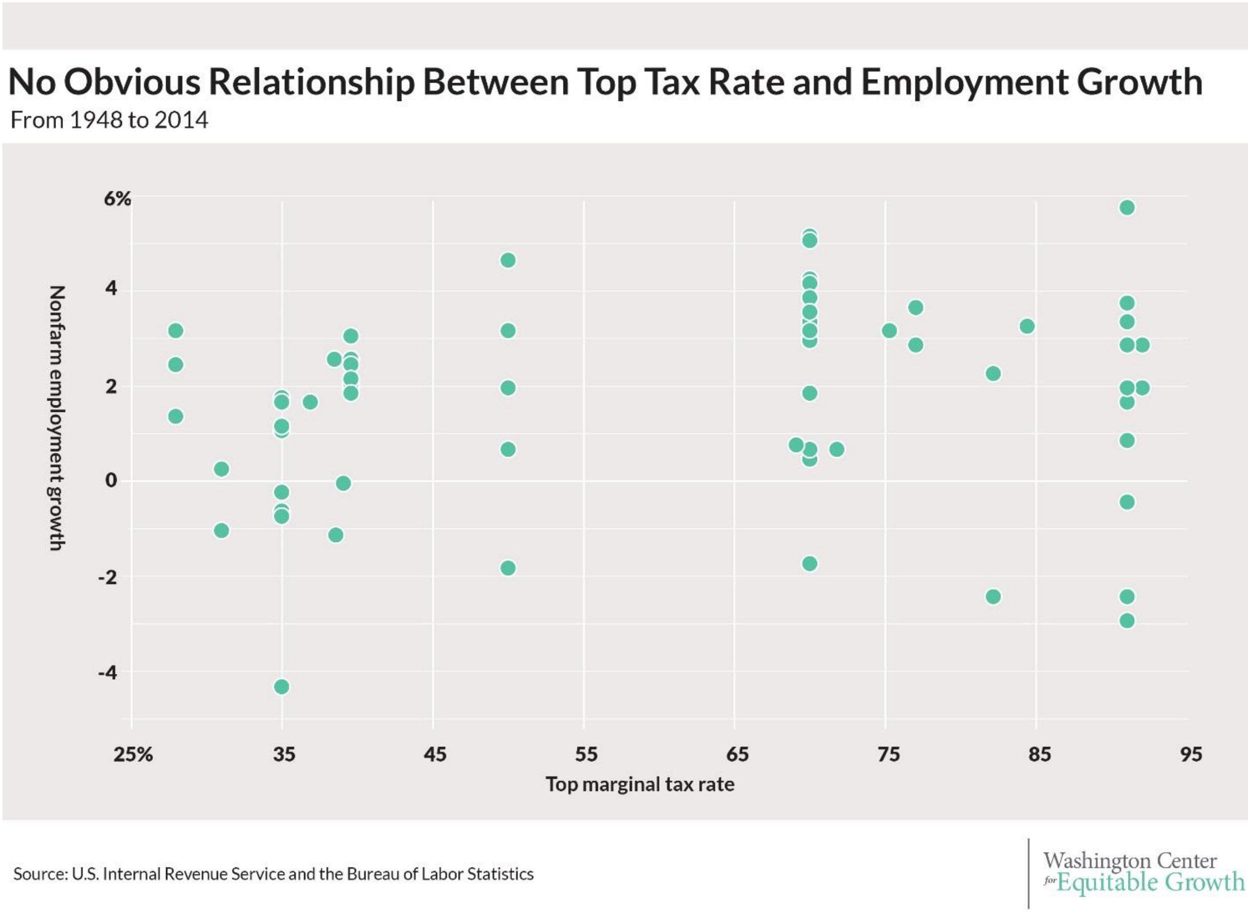
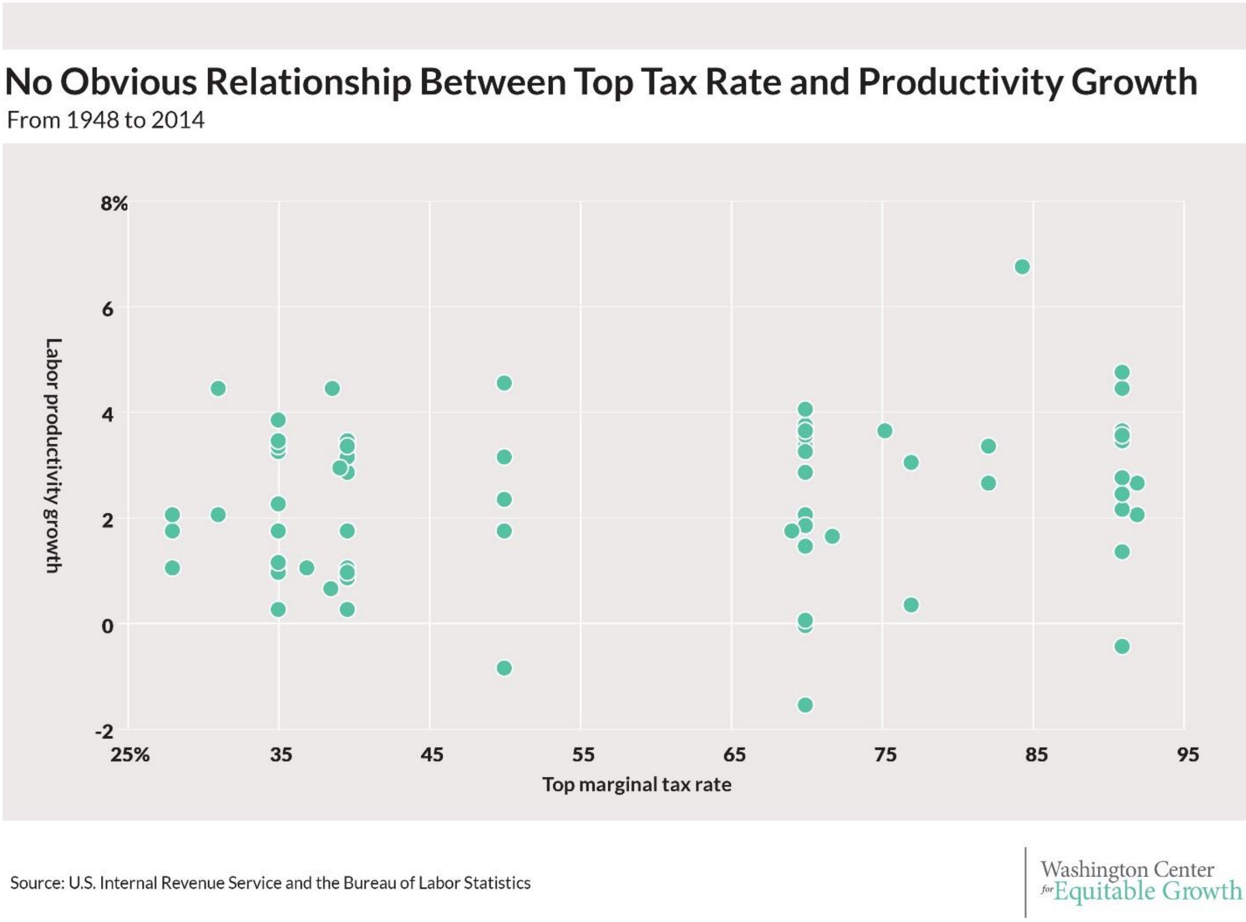
However as the top rate has decreased, the improved economic performance that we might expect given the conventional wisdom doesn't show up in the data. Figure 2 shows no discernible relationship between employment growth and the level of the top marginal tax rate. If cutting taxes resulted in stronger employment growth then there would be a discernible pattern in the years between 1948 and 2014, represented by a green dot in Figure 2. There is no pattern.

Figure 2



The lack of any obvious relationship isn't the case for just employment growth. Figure 3 below shows that there is no clear correlation between the growth in labor productivity, one of the key sources of long-run economic growth, and the top marginal tax rate.

Figure 3



A more in-depth treatment of the relationship between tax rates and macroeconomic growth can be found in a 2012 Congressional Research Service report by Thomas Hungerford.[6]

Now it's true that the federal income tax has become slightly more progressive by some measures. But more tax revenue has come from payroll taxes, which have become less progressive. And those at the top of the distribution are paying a large share of federal income taxation. According to Congressional Budget Office data, the top 1 percent of earners had 14.2 percent of federal tax liabilities in 1979. By 2011, that share increased to 24 percent.[7]

Yet over that same time period, the top 1 percent's share of pre-tax income increased from 8.9 percent to 14.6 percent.[8] So if progressivity is measured by the distribution of taxes paid, then progressivity has gone up. But that measure doesn't account for the rising inequality in the distribution of income. The result of inequality increasing as the tax system does less to reduce inequality (as a CBO report points out) is that the inequality of incomes after taxation has increased more than the inequality of income before taxation.[9]

Why should we care about the rise in inequality? There's an emerging consensus in economic research that high levels of inequality can threaten economic growth. My colleague Carter C. Price and I went through the research literature on the relationship between inequality and growth and found that research points toward a negative relationship.[10] As inequality goes up, economic growth tends to go down. A recent paper by researchers at the International Monetary Fund further finds that redistribution does not necessarily hamper growth.[11] The exact reason for this apparent relationship is unclear and my organization was founded to help better understand it. But the evidence as it stands is cause to seriously grapple with the negative effects of inequality.

Academic research on taxation

Given the rise in inequality, what can tax policy do about this trend? One potential concern about taxation is that in an effort to reduce inequality, it can reduce economic growth and cause more problems than were already there. An increase in labor taxation might cause some workers to work less or an increase in capital taxation might cause a reduction in savings, both of which are important for economic growth.

These assumptions are widely held by policymakers and economics commentators. And to a certain extent they are true. But the level of taxation at which these problems would occur is much higher than usually expected.

On the subject of income taxation, a body of new research shows that labor income taxes for those at the top of the income ladder have no adverse effect on economic growth. A paper by Nobel Laureate Peter Diamond and UC-Berkeley economist Emmanuel Saez reviewed the research literature on income taxation and finds that progressive taxation is well-supported by the research.

When it comes specifically to top rates, another paper by Saez along with Thomas Piketty and Harvard University's Stefanie Stantcheva look at the underlying forces that determine what the optimal level of taxation could be. After accounting for a variety of factors, the three economists find that the top marginal rate could be as high as 83 percent without affecting economic growth.[12] I wouldn't take this paper as evidence that the United States could increase its top income rate to such a level. Rather, the result is instructive that tax rates could be significantly higher without major adverse effects.

Research also shows that reducing certain tax expenditures wouldn't negatively affect the economy either. Research that shows tax incentives are often ineffective at incentivizing behavior. The tax code may provide a tax break for a certain behavior on the belief that this economic incentive will dramatically change behavior, but some work casts doubt on how much behavior is changed by these kind of incentives. Take, for example, Harvard economist Raj Chetty's work on retirement savings decisions. He and his co-authors look at millions of data points on changes in retirement savings after a change in tax policy in Denmark. What they found is that 85 percent of workers were non-responsive to changes in tax incentives and savings rates didn't decline.[13] Of course, this result isn't perfectly applicable to the U.S. situation. But its results are suggestive and should be considered in the U.S. policy situation.

New research also challenges the idea that capital taxation will invariably result in lower savings and consequently lower economic growth. Recent work that shows the long-held belief that capital income shouldn't be taxed at all is flawed. A paper by Piketty and Saez shows the flaws with the famous Chamley-Judd assumptions.[14] Chamley-Judd assumptions imply that savers have infinitely long-time horizons when thinking about saving for the future. If I care about the returns on my savings very, very far in the future, then a tax on savings would end up compounding to a point where the burden is immense. Taxing capital in this situation would drastically reduce savings. But Piketty and Saez show that this assumption doesn't hold up under scrutiny. And a recent paper by Ludwig Straub and Ivàn Werning of the Massachusetts Institute of Technology show that the zero taxation result doesn't even hold up within the Chamley-Judd framework.[15]

There is also the assumption that reducing capital taxation will induce corporations into investing more. The reduction in taxation supposedly will increase the return to investment. But research by the University of California-Berkeley's Danny Yagan finds that the 2003 dividend tax cut didn't have any effect on investment or employee compensation. Yagan compares the investment behavior of public companies, which would were affected by the tax cut, with the behavior of privately held companies. What he found was that the public companies, which should have invested more due to the tax cut, didn't invest more than similar privately held companies.[16]

Another possible form of capital taxation is increased taxation of bequests and inheritances. A 2013 *Econometrica* article by Piketty and Saez argues that the optimal tax rate for inheritances for the United States may be as high as 60 percent. And that the rate would be even higher for those at the very top. In their paper a high inheritance tax is optimal if those bequeathing wealth are relatively unaffected by taxation, inheritances are very unequally distributed and society favors work over inheritance. And the United States fits this description, hence the high level of taxation found in their paper.[17]

With this knowledge, what can we say about tax policy moving forward?

Possible policy steps

So we know that inequality has risen in the United States over the past several decades. At the same time we have learned from research that there is more room to make the tax code more progressive to help reduce inequality. There are quite a few policies that could move the tax code in that direction.

There are many examples of changes that would be consistent with the literature. Two that are on the table right now would be eliminating the "stepped-up basis" for taxation of bequests and expanding the Child Tax Credit and making it permanent. A rather large loophole currently exists when it comes to the taxation of capital gains. When a person inherits, say, a large amount of stock holdings from a parent, the inheritor is only taxed on the gains made after they inherit the stocks.[18] So if a parent bought a stock at $1 and it appreciates to $99 before the child receives the stock, then the child would only be taxed on the gains over $99. So the capital gains that occurred over the lifetime on that asset since it was first purchased aren't taxed as income.

If we are concerned about the possibility of families passing along large estates to children and the potential damages that could have on the vitality of the economy, this seems like a loophole we should close. There are a variety of other ideas for taxation in this area, including eliminating the carried interest loophole, whereby hedge fund managers do not pay the ordinary income tax. David Kamin, a professor at New York University School of Law, outlines a menu of options for taxing the wealth of the very wealthy, including transfer taxes, raising the ordinary income tax rates or limiting deductions and exclusions.[19]

But we can also do a variety of things at the low end of the income laddee. One example is the Child Tax Credit, which provides workers with children a tax credit of up to $1,000 per child in hopes of offsetting the costs of raising a child. The tax credit is currently partially refundable for a set percentage of income (15 percent) over a set threshold (currently $3,000). The value of the tax credit has been increased and the threshold decreased, both temporarily, in recent years.[20] I recommend making these reforms permanent. Given the rising costs of child care and the incredibly important role of children and the development of their future talents for the future growth of the economy, giving parents more funds to help raise children makes sense.[21]

Conclusion

The past four decades have been a period of high and rising inequality in the United States. Tax policy has an important role to play in the policy response to this major shift in our economy. It cannot, and should not, be policymakers' sole response. But changes are needed.

Our economy currently isn't creating prosperity that is broadly shared. And it hasn't for a while. Today's hearing is an important contribution to the conversation about how to get our economy on a track to creating shared prosperity for all Americans.

Endnotes

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