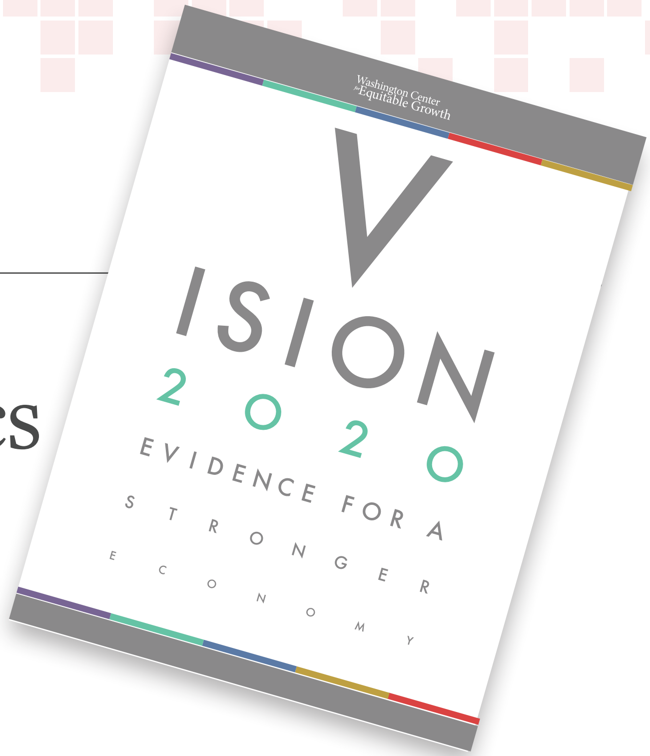
Washington Center *for* Equitable Growth
Evidence for a stronger economy



Tax and macroeconomics

February 2020

Greg Leiserson and Claudia Sahm, **Washington Center for Equitable Growth**

A strong economy operates at its potential and delivers high living standards to the entire population. Monetary, fiscal, and tax policies all help determine the level and distribution of income, wealth, and economic well-being. As the distribution of income and wealth have changed in recent decades—with inequality rising—this trend has implications for the efficacy of policy tools we have now and new ones we need to strengthen the economy.

It is important to construe growth broadly, with consideration to the range of factors that contribute to economic well-being. Broad measures of economic well-being should reflect both the costs and the benefits of output growth. In contrast, Gross Domestic Product—a common measure of growth—largely ignores the costs and focuses only on the benefits.

It is important to understand how policies for the aggregate U.S. economy interact with the large differences across households—referred to as heterogeneity—in income, wealth, and economic well-being. Economic policy should allow the U.S. economy to achieve and remain at its potential. Proposals in the Recession Ready book compiled by the Washington Center for Equitable Growth and the Hamilton Project at The Brookings Institution show several ways to automatically support the economy in a recession. A less severe recession would keep more people employed, and stronger safety net programs, such as Unemployment Insurance, would help those who do lose their jobs.

The essays in this section of the Washington Center for Equitable Growth's latest book *Vision 2020: Evidence for a stronger economy* demonstrate the far-reaching effects of tax and macroeconomic policies in the United States.

A modest tax reform proposal to roll back federal tax policy to 1997

Owen Zidar, **Princeton University** and Eric Zwick, **University of Chicago**

In part due to a number of changes to the tax code, the federal government now collects 3 percent less of Gross Domestic Product in tax revenues than it did two decades ago, yet the nation faces a number of pressing needs for new spending, including on infrastructure, research and development, education, and healthcare. Within the base of taxable income, nearly half of the rise since 1980 in the top 1 percent income share comes from pass-through businesses, which generate more taxable income than traditional C corporations. Therefore, higher tax rates on individual income and on pass-through income represent important steps for taxing substantial amounts of income at the upper steps of the income ladder.

Solutions

Reforms to the individual income tax and estate tax, with particular attention to the tax treatment of pass-through income, would raise revenues by $5 trillion over the next decade and reduce after-tax income inequality. Specifically, policymakers should:

- Return the personal tax rate and bracket structure, adjusted for inflation, to where it was in January 1997. For married couples, taxes would amount to 36 cents instead of 24 cents of their 300,001st dollar. For those making $500,000, marginal rates would increase to 39.6 percent from 35 percent. A tax credit similar to the Making Work Pay tax credit from the 2009 Recovery Act would offset tax increases for low- and middle-class earners in a targeted way.

- Remove the active business income exclusion from the net investment income tax and repeal the recently enacted deduction for people who receive income from pass-through businesses. Also, tax non-publicly listed C corporations at the top personal income tax rate rather than the otherwise applicable corporate rate of 21 percent.

- Return the dividend and capital gains tax rates to their 1997 levels. This change would increase the top federal tax rate to 39.6 percent from 20 percent for the recipients of most taxable dividends. For capital gains, this change would bring maximum long-term capital gains tax rates back to 28 percent from 20 percent today. Also, extend the time horizon for preferential capital gains rates to 10 years to treat more carried-interest compensation as wage income while preserving incentives for long-term investment.

- Unwind the 2001 and 2017 reductions in estate and gift taxation by returning to a 55-percent top rate and setting a $1 million effective exemption. In addition, eliminate the so-called step-up in basis at death, a policy that exempts from income tax any capital gains on assets held by a taxpayer at death. Also, treat charitable contributions and gifts as realization events, meaning that taxes would be due on any unrealized capital gains at that time. Reinvigorating the estate tax should be paired with careful steps to curtail abusive private business valuations.

Good U.S. monetary policy can't fix bad U.S. fiscal policy

John Sabelhaus, **Washington Center for Equitable Growth**

Restrained fiscal policy (government revenues and spending) is holding back the U.S. economy because needed government investments in public goods such as human capital, scientific research, and infrastructure are not happening at the scale required for sustained and broad-based economic growth.

Solutions

Appropriate monetary and fiscal policies in tandem will boost the incomes of the many—not just the values of assets owned by the few—to create the macroeconomic conditions most suitable for sustained and broad-based economic growth.

- To address the excessively low interest rates restricting Federal Reserve actions in the next recession, the federal government needs to invest more, identifying areas where more investment is warranted in human capital, science and technology, and infrastructure to increase productivity growth.

- The federal government needs to rethink spending and tax policy to take account of the fact that a portion of higher income from economic growth is due to public investments, and therefore reasonably subject to greater taxation.

- When economic conditions have deteriorated in the past, the Fed has focused mainly on propping up the financial system—for example, bailing out mortgage lenders but not mortgage borrowers during and after the Great Recession. This needs to change. The Fed needs to make sure the next round of Quantitative Easing or other extraordinary monetary policy actions do not simply rescue those who benefitted from the mistakes that led to problems in the first place.

Fighting the next recession in the United States with law and regulation, not just fiscal and monetary policies

Yair Listokin, **Yale Law School**

In the next recession, the Federal Reserve will be constrained in its ability to reduce interest rates to stimulate investment and consumption and lower unemployment. Fiscal stimulus can offset this monetary policy shortcoming by sparking economic demand, yet partisan gridlock means fiscal stimulus could fall well short of what is needed.

Solutions

Countercyclical regulatory policies to encourage banks to lend, firms to invest, and consumers to spend can increase demand and reduce unemployment during a recession, without the approval of Congress. Specifically, policymakers should take the following steps:

- In general, direct regulators to apply rules that promote spending during recessions and different, more restrictive rules during periods of robust economic growth.
- The next administration should appoint financial regulators more willing to implement countercyclical financial regulation as a means of avoiding lending bubbles during the next boom and stimulating the economy in the next recession.
- Apply the logic of countercyclical regulation to every regulatory regime that affects aggregate demand and unemployment, among them energy, housing, and utility regulation.
- Use permits and mandates as countercyclical regulatory policy tools. For example, make the existence of a recession a factor in whether to approve certain permits that would create jobs. Likewise, make the existence of a recession a factor in determining whether to issue or strengthen mandates in a way that would require additional spending in the economy.
- To sustain profit levels, utility prices tend to rise in a recession, thus decreasing discretionary income and exacerbating downturns. Federal and state regulators should hold utility prices below normal profit levels during economic downturns, and then allow prices, and profits, to rise above normal targets during economic booms.
- Government insurance programs, such as the Federal Housing Administration's mortgage insurance program, should strive for business-cycle-neutral premiums, maintaining or lowering rates during recessions rather than raising them as reserves decline, and raising or maintaining higher rates during boom times, even though reserves might rise above normal levels.
- Establish a coordinating office staffed by a mix of experts in macroeconomics and regulation at the Office of Management and Budget's Office of Information and Regulatory Affairs or the White House National Economic Council to determine how each regulatory regime affects the business cycle, evaluate macroeconomic conditions and the ability of discretionary fiscal and monetary policies to respond to the business cycle, and instruct regulators to implement pre-identified countercyclical regulatory programs accordingly.

https://equitablegrowth.org/vision-2020/

facebook.com/equitablegrowth
@equitablegrowth
equitablegrowth.org/feed
info@equitablegrowth.org

1156 15th St NW Suite 700
Washington DC 20005
202-545-6002