

# Progressive Tax Reform in the Era of Globalization: Building Consensus for More Broadly Shared Prosperity

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It has been more than two decades since lawmakers last achieved meaningful bipartisan tax reform to lower tax rates and broaden the tax base. That reform effort was fueled by deep public dissatisfaction with the tax code's complexity, loopholes, perceived unfairness, and high statutory tax rates, combined with the government's desire to raise more revenue. In 1984, for example, an influential report by Robert McIntyre at Citizens for Tax Justice found that 128 out of 250 large and profitable companies paid no federal income taxes in at least one year between 1981 and 1983, and a Treasury Department study the following year showed that about 30,000 taxpayers with earnings exceeding \$250,000 paid less than 5% of their income in taxes.<sup>1</sup> Such studies provided momentum to close loopholes and enhance equity in the tax code.

Two decades later, there is a broad consensus once again that the federal tax code is in need of serious reform. There is broad agreement about what *not* to do. As the President's Advisory Panel on Tax Reform wrote in 2005, "[i]f you were to start from scratch, the current tax code would provide a guide on what to avoid in designing an income tax system."<sup>2</sup> But there is less agreement on what should be done. Some reformers are motivated by the internal illogic of the tax code, the growth of complexity since 1986, and the continued frustration of taxpayers with the process of filing taxes.<sup>3</sup> Other reformers are motivated by the belief that efficiency will be

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<sup>1</sup> JEFFREY H. BURNBAUM & ALAN S. MURRAY, *SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM* 10–12 (1987).

<sup>2</sup> REPORT OF THE PRESIDENT'S ADVISORY COUNCIL ON TAX REFORM, *SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM* 1 (2005), available at <http://www.taxreformpanel.gov/final-report/>.

<sup>3</sup> See, e.g., MICHAEL J. GRAETZ, *THE DECLINE (AND FALL?) OF THE INCOME TAX* 7–8 (1997).

enhanced by reducing or eliminating the taxes on capital income.<sup>4</sup> While internal considerations like simplicity and efficiency are important, two emerging strains of tax reform are motivated by *external* factors.

The most important of these factors is increasing income disparity. Although the United States has enjoyed strong macroeconomic performance in recent years, much of the gain from that growth has accrued to those at the very top.<sup>5</sup> At the same time, however, the tax code has become less progressive. Not surprisingly, polls show a majority of Americans feel the economy is not working for them and worry that their children will not enjoy a higher standard of living than they do.<sup>6</sup> The lack of broad-based economic growth helps explain why a growing number of people across the ideological spectrum are rejecting further efforts at global economic integration, such as trade liberalization, which they perceive as responsible for lost jobs and declining wages in the United States.<sup>7</sup> While this perception is exaggerated, there is nonetheless growing evidence that trade and globalization increasingly contribute to inequality.<sup>8</sup>

This potential protectionist backlash is a serious threat to America's economic well-being—not to mention that of other countries, particularly developing ones—since open economies enjoy higher growth rates.<sup>9</sup> To avoid such a backlash and sustain support for globalization, its supporters must advocate much more forcefully for policy reforms to make sure that America's prosperity is more broadly shared than has been the case in recent years. Tax policy is a relatively efficient, immediate, well-targeted, and scaleable policy tool to help spread the gains of global economic integration more broadly.<sup>10</sup> A cornerstone of such an effort should be progressive income tax reform.

The second external factor motivating tax reform is the increased dissatisfaction with health insurance, pensions, and myriad social problems

<sup>4</sup> See, e.g., R. Glenn Hubbard, *Capital Income Taxation in Tax Reform: Implications for Analysis of Distribution and Efficiency*, in UNITED STATES TAX REFORM IN THE 21ST CENTURY 89, 89–90 (George R. Zodrow & Peter Mieszkowski eds., 2002).

<sup>5</sup> See *infra* notes 31–32 and accompanying text.

<sup>6</sup> See, e.g., CELINDA LAKE, LAKE RESEARCH PARTNERS, THE AMERICAN DREAM SURVEY: ANXIETY, ANGER AND RESTORING THE DREAM 7–8 (2007), available at [http://www.changetowin.org/fileadmin/pdf/American\\_Dream\\_presentation\\_Celinda\\_Lake\\_040407.pdf](http://www.changetowin.org/fileadmin/pdf/American_Dream_presentation_Celinda_Lake_040407.pdf); Dennis Jacobs, *Americans Worried About Their Standard of Living*, GALLUP, Feb. 22, 2008, <http://www.gallup.com/poll/104497/Americans-Worried-About-Their-Standard-Living.aspx>.

<sup>7</sup> In a January 2008 survey, for example, nearly two-thirds of respondents agreed that “[i]nternational trade is bad for the U.S. because it results in the loss of jobs and lower wages.” Fortune Magazine Survey: Recession Near, or Already Here, <http://money.cnn.com/magazines/fortune/electionpoll/2008/pollresults.html> (last visited Mar. 17, 2008).

<sup>8</sup> See Paul Krugman, *Trade and Wages, Reconsidered* 3–4 (paper presented at the Brookings Panel on Economic Activity, Feb. 2008), available at <http://www.princeton.edu/~pkrugman/pk-bpea-draft.pdf>; Paul Krugman, *Trade and Inequality, Revisited*, VOX, June 15, 2007, <http://www.voxeu.org/index.php?qN%de/261>. But see ROBERT Z. LAWRENCE, *BLUE-COLLAR BLUES: IS TRADE TO BLAME FOR RISING US INCOME INEQUALITY?* 9–10 (2008) (concluding that the rapid growth of imports from developing countries has not, in fact, been a source of rising inequality).

<sup>9</sup> See *infra* notes 51, 55–56 and accompanying text.

<sup>10</sup> See *infra* note 83 and accompanying text.

ranging from education to housing prices to climate change. The tax code today impacts these and many other economic and social activities, either as part of the problem or as part of the solution. Traditional tax reform dogma emphasized getting all social programs out of the tax code, making them in effect the problem of any government agency other than the Internal Revenue Service. But against this view, an emerging view holds that these problems are inextricably bound up in the tax code, either for political or substantive reasons, so tax reform should be motivated as much by achieving social efficiency in these different areas as it is by achieving classic economic efficiency. Collectively, then, three forces—the traditional recognition that our tax code is deeply flawed, the desire by those who have benefited from them to continue globalization policies, and a concern over the economic insecurities faced by a growing share of the American population—provide a unique opportunity to forge an agreement in support of progressive tax reform. Such reform could distribute tax burdens more equitably based on ability to pay while also achieving much needed simplicity. In that way, more progressive taxation, even if effected in a revenue-neutral way, can achieve more broadly shared prosperity and shore up support for growth-enhancing trade policies.

Certainly, tax reform should at the least be revenue-neutral and not worsen our fiscal deficit, which now amounts to nearly seven percent of U.S. gross domestic product (GDP).<sup>11</sup> The deficit not only is a threat to economic growth and unsustainable, but it also is regressive in two respects. First, the single largest source of fiscal deterioration since 2001 has been the tax cuts enacted since then that overwhelmingly benefited those at the top of the income distribution.<sup>12</sup> Second, to the extent the fiscal gap is ultimately paid for through spending reductions elsewhere, the impact will be severely regressive, with the large majority of the bottom eighty percent of households witnessing reductions in their after-tax incomes.<sup>13</sup> Ideally, progressive tax reform might help close our fiscal gap since, as a matter of sound economic policy and political reality, this gap cannot be closed through spending cuts or revenue increases alone. In reality, however, both tax reform—which inevitably creates winners and losers—and deficit reduction—which is largely about allocating the losses—are politically difficult. Attempting both of them at once may be too much for the political system. But at the very least, progress in one dimension should not come at the expense of progress in the other.

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<sup>11</sup> CONGRESSIONAL BUDGET OFFICE, LONG-RUN BUDGET OUTLOOK 5 tbl.1-2 (2007), available at <http://www.cbo.gov/ftpdocs/88xx/doc8877/12-13-LTBO.pdf>.

<sup>12</sup> Between January 2001 and March 2007, 40% of the change in the projected unified budget baseline is attributable to the Bush tax cuts, 31% to defense and homeland security outlays, 22% to other outlays, and 7% to economic and technical projection errors. Alan J. Auerbach, Jason Furman & William F. Gale, *Still Crazy After All These Years: Understanding the Budget Outlook*, 115 TAX NOTES 765, 767 (2007).

<sup>13</sup> *The Effect of the 2001-06 Tax Cuts on After-Tax Incomes: Hearing on Fair and Equitable Tax Policy for America's Working Families Before the H. Comm. on Ways & Means*, 110th Cong. 2 (2007) (statement of Jason Furman, Director, The Hamilton Project).

A broad coalition built around these three forces—the need for tax reform, the lack of broad-based growth, and rising economic insecurity—can also take advantage of political events. The tax cuts enacted starting in 2001 are expiring in 2010. The Alternative Minimum Tax (AMT) is affecting an increasing number of families. Policymakers and analysts across the political spectrum are increasingly concerned about America's high corporate tax rate. Health reform and climate change are rising to the top of the agenda. At the same time, political leaders want to push forward with globalization but are concerned about the rising populist backlash against it. This convergence of political forces provides a potentially unique opportunity to build broad agreement on achieving progressive tax reform.

Part I of this Essay reviews the traditional case for progressivity in the tax code, putting it in the context of the recent trend toward increasing income inequality. This Part also rejects the view that modestly more progressive rates will seriously harm economic performance by blunting incentives to work, save, and invest. Part II suggests a broader motivation that goes beyond concerns about inequality per se, instead appealing to the widely accepted notion that economic policies should be favored when they make everyone better off. A combination of progressive tax reform and pro-globalization policies can move us closer to this ideal. This is not just a theoretical argument. Evidence shows that globalization policies like free trade lead to stronger economic growth and higher standards of living, but there are worrisome signs of an increasing protectionist backlash. We argue that this backlash stems in part from real economic dislocations caused by trade, but far more from the government's failure to ensure that the fruits of strong economic growth are broadly shared. Falling or stagnant incomes, likely due largely to factors *other than* trade, have led to this protectionist drift. A disproportionate share of blame is attributed to trade in part because of its highly visible manifestations. A firm's decision to outsource jobs to China or India is easier to see than the rising returns to skill from technological change, which most economists agree is a key cause of wage stagnation and rising inequality.<sup>14</sup> Those who seek enhanced economic security for American families and those who seek greater globalization should come together in support of progressive tax policy to achieve more broadly shared prosperity. Part III compares the relative merits of alternative proposals to secure more broad-based economic growth and explains why progressive income tax reform is a more promising approach. Part IV then offers a set of specific recommendations to effect progressive income tax reform. Part V concludes.

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<sup>14</sup> For an extensive review of the literature, see David Card & John E. DiNardo, *Skill-Biased Technological Change and Rising Wage Inequality: Some Problems and Puzzles*, 20 J. LAB. ECON. 733, 734 (2002).

## I. THE TRADITIONAL CASE FOR GREATER PROGRESSIVITY

The most fundamental purpose of the tax code is to raise the money the government needs to pay for the level of spending it has chosen to undertake. As N. Gregory Mankiw, the former chairman of President George W. Bush's Council of Economic Advisors, wrote, "[e]veryone hates taxes, but the government needs to fund its operations . . . ."<sup>15</sup> In this sense, government spending is actually a better indicator of the ultimate tax burden than is revenue collected at any given point in time—which is what Nobel Laureate in Economics Milton Friedman meant when he said, "[t]o spend is to tax."<sup>16</sup> To the extent government funds spending with borrowing, as it has done in recent years (primarily as a result of the tax cuts enacted starting in 2001)<sup>17</sup>, it has merely deferred the taxes that future generations will have to pay. Although a familiar argument views income tax cuts, which will nearly always be regressive,<sup>18</sup> as a way of "starving the beast," there is no evidence that large deficits actually force spending restraint.<sup>19</sup> Indeed, recent history suggests an opposite dynamic may be at work, in which fiscal recklessness shatters an ethic of responsibility and restraint, facilitating sizable increases in government spending.

*The Rationale for Progressive Taxation*

In raising government revenue, there is broad support for the notion that our tax system should be progressive. Several reasons are usually cited. First, income is declining in marginal utility. In other words, if we wish to ask for "equal sacrifice" from each individual in sharing the tax burden, we should have progressive rates since those with higher incomes have greater "ability to pay" (that is, an extra dollar to Bill Gates means less than it does to someone in poverty). It was in that spirit that Adam Smith declared, in his first canon of taxation in *The Wealth of Nations*, that "the subjects of

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<sup>15</sup> N. Gregory Mankiw, *Repeat After Me*, WALL ST. J., Jan. 3, 2006, at A24.

<sup>16</sup> J. Bradford DeLong, *Right from the Start? What Milton Friedman Can Teach Progressives*, 4 DEMOCRACY: A JOURNAL OF IDEAS 108, 111 (2007).

<sup>17</sup> Auerbach, Furman & Gale, *supra* note 12.

<sup>18</sup> Any tax cuts that do include expansions in refundable credits, such as the EITC, are necessarily regressive because the bottom 60% of households pay less than 1% of total income taxes. These households do pay substantial payroll taxes, however, representing 15% of total federal taxes. This makes the federal tax system moderately progressive, since the bottom 60% receives 27% of total income. But with state and local taxes included, the overall tax burden is barely progressive. Furthermore, the federal programs funded by income taxes tend to be progressive, so income tax cuts that lead to reductions in spending in areas such as education, health care, or food stamps will be that much more regressive.

<sup>19</sup> Christina Romer & David Romer, *Do Tax Cuts Starve the Beast? The Effect of Tax Changes on Government Spending* 1 (Nat'l Bureau of Econ. Research, Working Paper No.13548, 2007), available at <http://www.nber.org/papers/w13548>.

every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.”<sup>20</sup>

Second, and related to the concept of “ability to pay,” is the idea that the tax code should be used to mitigate inequality. In 1938, economist Henry Simons wrote, “[t]he case for drastic progression in taxation must be rested on the case against inequality.”<sup>21</sup> To be sure, some degree of inequality is inevitable, and likely even desirable. Indeed, it is the possibility of greater rewards based on hard work and skill that has long driven Americans to industrious activity and entrepreneurship, thereby driving our nation’s economic growth. But at some point, the degree of inequality can become so great that it can become harmful for several reasons. Although the free market is the best organizing principle for promoting economic growth, as former Federal Reserve Chairman Alan Greenspan put it, “income inequality is where the capitalist system is most vulnerable. You can’t have the capitalist system if an increasing number of people think it is unjust.”<sup>22</sup> This concern over the sustainability of a vastly skewed income distribution was echoed long ago by Aristotle, who warned that “when there is no middle class, and the poor greatly exceed in number, troubles arise, and the state soon comes to an end.”<sup>23</sup> Extreme inequality also concentrates power, which can undermine democracy and America’s promise of equal opportunity. The wealthy can buy a head start for their children, political influence, and other forms of economic and social power.<sup>24</sup> In addition, Harvard economist Benjamin Friedman explained that when economic growth benefits the few rather than the many, social progress outside of strictly economic gains is hindered, specifically “greater opportunity, tolerance of diversity, social mobility, commitment to fairness, and dedication to democracy.”<sup>25</sup> Finally, there are more abstract arguments concerning morality, fairness, and even aesthetics—as

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<sup>20</sup> ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 825 (R.H. Campbell & A.S. Skinner eds., Liberty Classics 1981) (1776); see also NICHOLAS KALDOR, AN EXPENDITURE TAX 26 (1955) (“Taxation according to ability to pay for the last hundred years or more has been a universally accepted postulate, not only amongst political and economic writers, but amongst the public at large.”). But see H.C. SIMONS, PERSONAL INCOME TAXATION 54–58 (1938) (rejecting Mill’s formulation of the ability to pay principle for assuming that all individuals have similar and independent income-utility functions).

<sup>21</sup> SIMONS, *supra* note 20, at 18.

<sup>22</sup> Martin Crutsinger, *Greenspan Talk Doesn’t Roil Markets*, ASSOCIATED PRESS, Mar. 13, 2007, available at <http://www.washingtonpost.com/wp-dyn/content/article/2007/03/13/AR2007031300744.html>.

<sup>23</sup> ARISTOTLE, POLITICS 94 (Kessinger 2004).

<sup>24</sup> See Christopher D. Carroll, *Why Do the Rich Save So Much?*, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 463, 470–73 (Joel B. Slemrod ed., 2000). Carroll provides several entertaining quotes regarding the relationship between money and power from titans of the Gilded Age: “Money is the measuring rod of power” (Howard Hughes); “If you give away the surplus, you give away the control” (Cornelius Vanderbilt, explaining why he did not want to give away his wealth); “The ultimate gift of colossal wealth, at least for the founder of the richest families, was power” (James Stillman). *Id.* at 478.

<sup>25</sup> BENJAMIN M. FRIEDMAN, THE MORAL CONSEQUENCES OF ECONOMIC GROWTH 4 (2005).

economist Henry Simons put it, there is something “unlovely” about extreme inequality.<sup>26</sup>

The third rationale for progressive taxation is that it can serve as a form of insurance by mitigating the impact of steep drops in income through the imposition of proportionally lower rates on lower incomes.<sup>27</sup> According to the Congressional Budget Office (CBO), between 2002 and 2003 about one in five workers saw his earnings fall by 25% and about one in seven saw his earnings fall by more than 50% (although household income was significantly less volatile).<sup>28</sup> Faced with the possibility of an expected drop or rise in income, a person behind a Rawlsian veil of ignorance would likely agree to share a larger percentage of income if he were prosperous and a smaller share if not.<sup>29</sup> This logic extends beyond the individuals most affected by the income shift. A more progressive tax code also functions as a more effective “automatic stabilizer,” delivering fiscal stimulus when the economy starts to turn down.<sup>30</sup>

### *The Trend Toward Increased Income Inequality*

Based on these justifications for progressive taxation, rising inequality should strengthen the case for progressivity. If progressive taxation is justified by a desire for “equal sacrifice” and the wealthy’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. And, indeed, America has experienced a large increase in income inequality in recent decades. The changes have been particularly pronounced at the very top of the income distribution. In 1979, the earliest year for which comprehensive data from the Congressional Budget Office are available, the before-tax income of the most affluent 1% of the U.S. population already equaled that of the bottom 26%. That share has risen continuously, reaching 48% in 2005.<sup>31</sup> To provide some perspective on the scale of the income shift

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<sup>26</sup> SIMONS, *supra* note 20, at 18–19; *see also* Walter J. Blum & Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, 19 U. CHI. L. REV. 417, 488–90 (1952) (making the “uneasy” case for progressive taxation for its “ethical or aesthetic” effects on income and wealth inequality).

<sup>27</sup> *See Economic Volatility: Hearing on Economic Challenges Facing Middle Class Families Before the H. Comm. on Ways & Means*, 110th Cong. 10 (2007) (statement of Peter Orszag, Director, Congressional Budget Office); Jonathan Eaton & Harvey S. Rosen, *Labor Supply, Uncertainty, and Efficient Taxation*, 14 J. PUB. ECON. 365, 366–67 (1980); Hal R. Varian, *Redistributive Taxation as Social Insurance*, 14 J. PUB. ECON. 49, 49–52 (1980).

<sup>28</sup> CONGRESSIONAL BUDGET OFFICE, TRENDS IN EARNINGS VARIABILITY OVER THE PAST 20 YEARS 1–2 (2007), available at <http://www.cbo.gov/ftpdocs/80xx/doc8007/04-17-EarningsVariability.pdf>; Congressional Budget Office Director’s Blog, <http://cboblog.cbo.gov/?p=54> (Jan. 7, 2008, 17:54 EST).

<sup>29</sup> *See generally* JOHN RAWLS, A THEORY OF JUSTICE (1971).

<sup>30</sup> *See infra* note 41 and accompanying text.

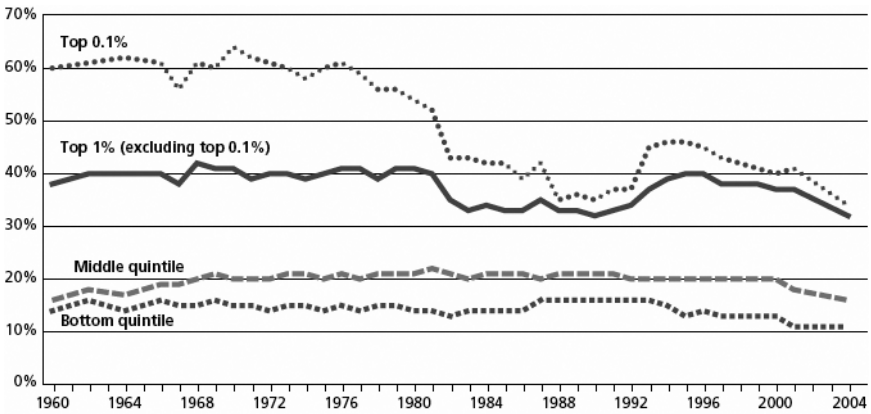
<sup>31</sup> Authors’ calculations based on CONGRESSIONAL BUDGET OFFICE, SUPPLEMENTAL TABLE 1A, EFFECTIVE FEDERAL TAX RATES, 1979–2004 (2006), available at <http://www.cbo.gov/ftpdocs/77xx/doc7718/SupplementalTables.xls>, and THOMAS PIKETTY & EMMANUEL SAEZ, INCOME INEQUALITY IN THE UNITED STATES, 1913–2005, TABLE A3: TOP FRACTILES INCOME

that has occurred, consider that to offset fully the income shift in 2005 would have required transferring \$884 billion from the top 1% of households to the bottom 80%—the equivalent of nearly \$800,000 from every household in the top 1% and \$10,000 to each household in the bottom 80%.<sup>32</sup> No one would suggest this is feasible or even desirable, but it provides a useful benchmark for gauging the magnitude of the public policy interventions that would be necessary to address inequality on this scale.

### *The Trend Toward Less Progressive Taxation*

At the same time that pre-tax income inequality has worsened, the tax system has been doing less to push back against that increase in inequality because the tax system itself has become less progressive. According to estimates by Thomas Piketty and Emmanuel Saez, the average federal tax rate—actual taxes paid, including individual, corporate, payroll, and estate taxes, as a share of income—for the top 0.1% of households (families making over \$1.3 million in 2005) has fallen sharply in the last 45 years, from 60% in 1960 to 34% in 2004. This decline is far greater than that enjoyed by the rest of the top 1% of income earners (from 38% to 32%; see Figure 1).

FIGURE 1: AVERAGE FEDERAL TAX RATES FOR SELECTED INCOME GROUPS, 1960–2004<sup>33</sup>



Source: Piketty and Saez (2007a).

SHARES (INCLUDING CAPITAL GAINS) (2007), available at <http://elsa.berkeley.edu/~saez/TabFig2005prel.xls>.

<sup>32</sup> Authors' estimates based on CONGRESSIONAL BUDGET OFFICE, APPENDIX TABLES, available at [http://www.cbo.gov/ftpdocs/88xx/doc8885/Appendix\\_tables\\_toc.xls](http://www.cbo.gov/ftpdocs/88xx/doc8885/Appendix_tables_toc.xls).

<sup>33</sup> Thomas Piketty & Emmanuel Saez, *How Progressive is the U.S. Federal Tax System? A Historical and International Perspective*, 21 J. ECON. PERSP. 3, 13 (2007).



More than half of the reduction in the average tax rate for the top 0.1% of households is due to a decline in corporate taxes (Table 1); their share of GDP has fallen from an average of 4% in the 1960s to an average of 2% in the 2000s. More than one-third of the change is due to a reduction in estate taxes (and the Piketty-Saez estimates do not include most of the scheduled reduction and eventual repeal of the estate tax enacted as part of the 2001 tax cut). Less than 10% is due to the reduction in combined individual income and payroll taxes, and this reduction is entirely the result of the recent tax cuts.

	<b>Change from 1960 to 2004 (percentage points)</b>	<b>Contribution to total change (percent)</b>
Individual income and payroll taxes	-2.7	10%
Corporate taxes	-14.0	53%
Estate taxes	-9.6	37%
All federal taxes	-26.4	100%

In contrast to the sharp fall in average tax rates for families at the top, the average federal tax rate for families in the middle income quintile rose over the same period and, even after the recent reductions, remained at 16.1% in 2004, slightly higher than the 15.9% rate in 1960 (Figure 1). Expansions in the Earned Income Tax Credit (EITC) and other refundable credits have slightly reduced the average tax rate for the poorest families.<sup>35</sup>

Some of these dramatic tax changes have been acts of commission, particularly the reductions in taxes passed in this decade. But other changes are due to acts of omission, as policymakers have failed to reform the tax code to keep up with the rapid pace of change from globalization and an increasingly sophisticated financial system. Both of these phenomena have made it easier for corporations to avoid paying taxes, thus contributing to the halving in corporate taxes as a share of GDP since the 1960s.<sup>36</sup> Financial innovation also makes it easier to take advantage of the highly variable tax treatment of economically identical forms of income and of different investments, includ-

<sup>34</sup> *Id.* at 11–12.

<sup>35</sup> The EITC, a refundable tax credit for low-income workers, was first passed in 1975 and then expanded significantly in tax reform acts of 1986, 1990, 1993, and 2001. These acts boosted the phase-in rate to \$0.40 of tax benefit for each dollar earned up to \$12,060, with a maximum credit of \$4,824, for a household with two or more children.

<sup>36</sup> KIMBERLY A. CLAUSING, THE AMERICAN JOBS CREATION ACT OF 2004: CREATING JOBS FOR ACCOUNTANTS AND LAWYERS 3 (2004), available at [http://www.urban.org/uploadedPDF/311122\\_AmericanJobsAct.pdf](http://www.urban.org/uploadedPDF/311122_AmericanJobsAct.pdf).

ing tax-exempt investments. For example, the large differential between tax rates on income and tax rates on capital gains and dividends encourages financial engineering that allows some taxpayers to re-label labor compensation or interest as capital gains or dividends in order to take advantage of the dramatically lower rates.<sup>37</sup> Although occasional attempts have been made to patch the tax system, the underlying principles of the income tax were developed more than ninety years ago, long before most derivatives and other sophisticated financial instruments were dreamed of.<sup>38</sup>

The tax cuts enacted in and since 2001 have reinforced this long-term trend, increasing after-tax incomes for high-income families substantially 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 20% by only 0.5%. The middle 20% will have received only a 2.3% income boost on average (Figure 2). As a result, the tax cuts increased the after-tax income share of the top 1% of families by nearly 1%.

Moreover, these estimates are incomplete, because they do not take into account the unknown distributional effects of the future tax increases or spending cuts that will be required to pay for these tax cuts.<sup>39</sup> If we assume that each household will pay an equal amount to finance the tax cuts, for example through reduced Medicare benefits, the cost would outweigh any benefits of the tax cuts for all but the top 20% of households (see Figure 2). If instead, low-income families end up bearing a disproportionate share of the burden, through cuts in programs such as Medicaid and food stamps, the result would be even more regressive. This form of analysis recognizes that deficits themselves are effectively a future tax falling in an as yet undetermined manner.

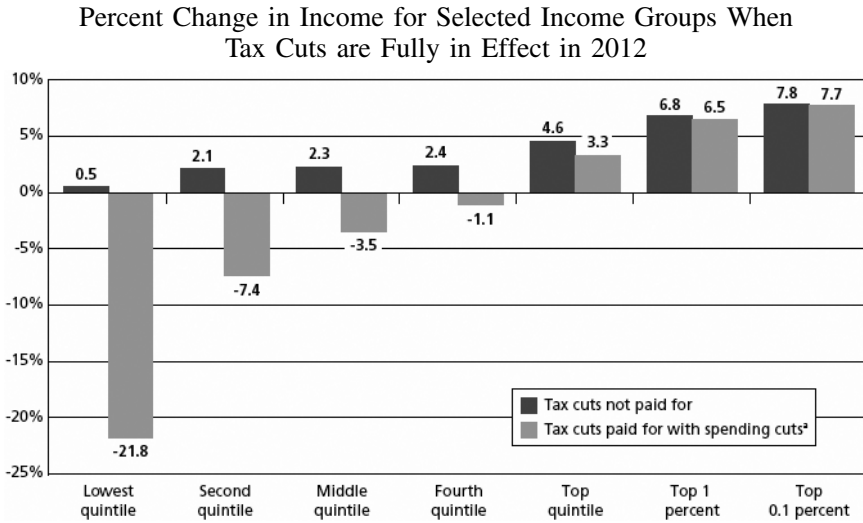
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<sup>37</sup> An ideal tax system would tax income in a manner invariant to the labels that are applied. This need not require that the statutory rates be identical for different types of income, but that there be some form of integration or reconciliation between corporate level and individual level taxes, for example.

<sup>38</sup> Edward Kleinbard, *Rehabilitating the Business Income Tax* 5 (Brookings Inst., Hamilton Proj. Discussion Paper No. 2007-09, 2007), available at [http://www.brookings.edu/papers/2007/06corporatetaxes\\_kleinbard.aspx](http://www.brookings.edu/papers/2007/06corporatetaxes_kleinbard.aspx).

<sup>39</sup> William G. Gale, Peter R. Orszag, & Isaac Shapiro, *Distributional Effects of the 2001 and 2003 Tax Cuts and Their Financing*, 103 TAX NOTES 1539, 1539 (2004).

FIGURE 2: EFFECTS OF 2001–2006 TAX CUTS MADE PERMANENT<sup>40</sup>



a. Assumes tax cuts are financed by a reduction in government transfer payments, or an increase in lump-sum taxes, that is the same total amount for each household.

Note: Estimates based on extension of 2006 AMT exemption and indexed for inflation after 2006. The income break for 2006 for the lowest quintile is \$13,640; for the second quintile is \$26,417; for the middle quintile is \$46,362; and for the fourth quintile is \$82,316. The top 1% consists of those making more than \$418,664, and the top 0.1% includes those making more than \$1,907,342.

Finally, the shift to a less progressive tax code has contributed to economic insecurity for families. One of the benefits of a progressive tax code is that when the economy does poorly, taxes automatically fall and vice versa when it does well. As a result, the tax code acts as an “automatic stabilizer”—effectively applying fiscal stimulus whenever the economy weakens. The less progressive tax code has weakened this automatic stabilizer, resulting in more macroeconomic volatility and thus more insecurity for families than would otherwise be the case. The importance of this effect was demonstrated by Alan J. Auerbach and Daniel Feenberg, who found that a \$1 change in national income resulted in a \$0.35 change in taxes in 1980 but only a \$0.25 change between the late 1980s and 1990s.<sup>41</sup>

<sup>40</sup> Authors’ calculations based on URBAN-BROOKINGS TAX POLICY CTR., COMBINED EFFECT OF 2001–2006 TAX CUTS MADE PERMANENT WITH EXTENSION OF 2006 AMT EXEMPTION, INDEXED FOR INFLATION AFTER 2006 (2007), available at <http://www.taxpolicycenter.org/numbers/Content/Excel/T07-0082.xls>.

<sup>41</sup> Alan J. Auerbach & Daniel Feenberg, *The Significance of Federal Taxes as Automatic Stabilizers*, 14 J. ECON. PERSP. 37, 41-42 (2000).

*The Dynamic Effects of Tax Cuts*

The combination of rising inequality and tax cuts that have favored those at the top warrants more progressive taxation. To be sure, excessively high tax rates can distort economic behavior, which can harm economic performance. Policymakers need to balance the desire to promote progressivity with an awareness of the effects of such policies on the economy overall, and thus on the well-being of precisely the low- and moderate-income families that progressivity is designed to help.<sup>42</sup> But the optimal balance is very different in the context of a top marginal tax rate of 91%, as existed in the 1950s and early 1960s, or even 70%, as existed in the mid-1960s, than it is with today's top statutory income tax rate of 35%.

Furthermore, regardless of the tax rates, extreme supply-side claims that tax cuts are always and everywhere good for the economy are patently false. The effect of tax rates on the economy, and thus on tax revenues, depends on how the tax cuts are designed and whether they are paid for. Three specific examples demonstrate how tax cuts can harm the economy, in potentially minor or major ways. First, taxes can be lowered without cutting tax rates. For example, expanding the child tax credit or the 10% bracket would reduce inframarginal rates for most individuals—reducing average tax rates without reducing marginal rates. Such tax cuts do not have substitution effects that would induce more work effort, saving, and investment, but instead have only income effects that actually reduce the need to work, save, and invest.<sup>43</sup> Economists from the Department of the Treasury estimate that 76% of filing tax units will see no marginal rate reductions when the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) is fully phased in.<sup>44</sup> To be sure, the economic impact of these tax cuts is likely to be minimal, and the particular examples cited above are well justified for other reasons. But they support the point that tax cuts do not automatically help the economy or pay for themselves.

Second, cutting taxes on *old capital*, for example through dividend and capital gains tax cuts that provide a windfall based on past decisions, has no

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<sup>42</sup> See generally Peter A. Diamond, *Negative Taxes and the Poverty Problem—A Review Article*, 21 NAT'L TAX J. 288 (1968); James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971). These two studies launched the modern literature formalizing this trade-off between income distribution and economic performance. See also ARTHUR OKUN, *EQUALITY AND EFFICIENCY: THE BIG TRADEOFF* (1975).

<sup>43</sup> "Changes in tax policy create two countervailing pressures on people's willingness to work. Tax cuts reduce average tax rates, which increases the after-tax income from a given amount of work and allows people to maintain the same standard of living while working fewer hours. By itself, that *income effect* implies that a tax cut would decrease the number of hours that people work. At the same time, however, tax cuts often reduce marginal tax rates, which raises after-tax compensation for an additional hour of work and thereby makes work more attractive relative to other uses of a person's time. That *substitution effect* by itself suggests that a tax cut would increase the number of hours worked." CONGRESSIONAL BUDGET OFFICE, *THE EFFECT OF TAX CHANGES ON LABOR SUPPLY IN CBO'S MICROSIMULATION MODEL 2* (2007), available at <http://www.cbo.gov/ftpdocs/79xx/doc7996/04-12-LaborSupply.pdf>.

<sup>44</sup> Donald Kiefer et al., *The Economic Growth and Tax Relief Reconciliation Act of 2001: Overview and Assessment of Effects on Taxpayers*, 55 NAT'L TAX J. 89, 97 (2002).

efficiency benefits. To the degree that such tax cuts require increases in distortionary taxes in the future, the net effect will be economic harm.

Third, and most importantly, if tax cuts are not immediately paid for, then the accumulation of deficits and debt will reduce national savings—and thus national income—potentially causing economic harm that outweighs any direct benefits from the tax cuts themselves. This third point is illustrated by the Joint Committee on Taxation's (JCT) analysis of a hypothetical 10% reduction in individual income tax rates. As shown in Table 2, in four of JCT's five financing scenarios, the tax cuts *reduced* long-term GDP.

TABLE 2. JCT ESTIMATES OF THE IMPACT OF A 10% INCOME TAX CUT ON LONG-RUN GDP <sup>45</sup>	
(ESTIMATES USING AN OVERLAPPING GENERATIONS MODEL)	
Financing Assumption	Impact on Long-Run GDP
Cut non-valued government spending after ten years	-0.04%
Cut government transfer payments after ten years	+0.10%
Increase tax rates on labor income after ten years	-0.10%
Increase tax rate on capital income after fifteen years	-0.43%
Cut government transfer payments after twenty years	-0.21%

These results show that the longer the government waits to pay for tax cuts, the more negative the long-term economic effects are. If, for example, the government cuts Social Security payments enough to pay in full for the hypothetical 10% rate reduction after ten years, the proposal would increase long-run GDP by 0.1%. But waiting twenty years would lead to larger government debt and *reduce* long-run GDP by 0.21%.

In short, the rise in income inequality and decrease in the tax code's progressivity in recent years, along with our long-term fiscal imbalance, strengthen the case for fundamental tax reform that makes the tax code more progressive. While policymakers need to balance the benefits of more progressive taxation with the potential disincentives to work, save, and invest that higher tax rates can cause, any pragmatic proposals for more progressive taxation will fall far short of the high marginal tax rates that might give credence to such worries.

<sup>45</sup> JOINT COMM. ON TAXATION, EXPLORING ISSUES IN THE DEVELOPMENT OF MACROECONOMIC MODELS FOR USE IN TAX POLICY ANALYSIS 6 tbl.3 (2006).

## II. PROGRESSIVE TAXATION AS A COMPLEMENT TO MARKET-ORIENTED POLICIES

The arguments in Part I are traditional concerns of tax policy. To be sure, they take on new force in the context of rising income inequality and the declining progressivity of the tax code. But an emerging view provides a new rationale for progressive taxation. Instead of being grounded in a specific social welfare function that places a value on a more egalitarian distribution of income, this new view can be thought of as a broad generalization of the economic concept of a “compensated Pareto improvement.” A policy is said to be Pareto-improving if it makes everyone better off. This stringent test is rarely satisfied in practice. A compensated Pareto improvement refers to a policy that creates sufficient gains for the winners such that they would be able to compensate the losers, leaving everyone better off. Such a policy is also often referred to as a Kaldor-Hicks improvement.

Often this theoretical argument has been just that—a theory. Trade, for example, has long been justified as a compensated Pareto improvement regardless of whether the compensation actually took place. Indeed, policies aimed at providing some measure of compensation, such as education and training, have proven inadequate. As inequality increases and public support for globalization wanes, progressive taxation should be a natural complement to free trade and other market-oriented policies in order to realize the promise of a compensated Pareto improvement. This view also gains some support from the shift in the patterns of trade. Historically, most U.S. trade was with other rich countries, and the losers were confined to specific sectors of the economy—not broad income classes. Today, a rising share of America’s manufacturing trade is with significantly poorer countries,<sup>46</sup> making it appear more and more plausible that trade and, more broadly, globalization are linked to rising inequality.

The case for progressive taxation as a means to effect a compensated Pareto improvement also has political logic given the differing concerns that exist about globalization’s impact. On one side, business interests with a strong stake in globalization want to see further trade liberalization, and they see rising protectionist sentiment as a threat. On the other side, an increasing number of Americans are rejecting global economic integration as they see the gains of economic growth accruing largely to those at the top of the income distribution. The result is a growing opportunity to forge consensus between free traders, economic conservatives, pro-business interests, and those worried about rising inequality in support of policies to share the gains of economic growth more broadly.

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<sup>46</sup> See Krugman, *supra* note 8, at 3 (“[D]eveloping-country imports have roughly doubled as a share of the economy since the studies that concluded that the effect of trade on income inequality was modest.”).

*The Growing Protectionist Backlash*

The U.S. economy has become increasingly integrated with the rest of the world over the past twenty years, due to advances in technology and transportation. The result has been greater flows across borders of goods, services, capital, people, and ideas. In 2007, the sum of exports and imports amounted to 29% of GDP, up from 19% in 1979.<sup>47</sup>

Concomitant with this rise in global economic integration in recent years has been a protectionist drift among Americans and their representatives. Trade deals have stalled in Congress, most notably one with South Korea, and Congress allowed the President's trade promotion authority to expire last summer. Voters, meanwhile, are becoming more skeptical of the benefits of trade. According to a recent Pew Research Center poll, the share of Americans who believe that trade is good for their country has plunged from 78% in 2002 to 59% in 2007, the lowest proportion among the forty-seven countries included in the survey.<sup>48</sup> This concern is not limited to Democrats: a *Wall Street Journal* poll in the fall of 2007 found that Republican voters were skeptical of free trade by an almost two-to-one margin (59% versus 32%).<sup>49</sup>

Beyond free trade, protectionist sentiment is likely to be fueled further by increased foreign direct investment in the United States. Voters and policymakers alike expressed outrage when the Chinese energy firm CNOOC tried to purchase the U.S.-based Unocal, and similarly when Dubai Ports World tried to purchase operations at six U.S. ports. Such concerns are likely to be exacerbated in the coming years as the sovereign wealth funds of some foreign nations increasingly seek investment opportunities in the United States.<sup>50</sup>

*The Promise of Global Economic Integration*

The growing protectionist backlash against global economic integration is a serious threat to our economic well-being. Greater openness has greatly benefited the U.S. economy—even though it admittedly can precipitate concentrated harm to workers in particular industries and communities. For example, one study found that trade provided an aggregate benefit to the U.S. economy of \$1 trillion per year.<sup>51</sup> Free trade allows people to specialize in the goods and services they produce with the most comparative efficiency—

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<sup>47</sup> BUREAU OF ECON. ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNTS TABLES, TABLE 1.1.10, <http://www.bea.gov/bea/dn/nipaweb>.

<sup>48</sup> PEW RESEARCH CTR., WORLD PUBLICS WELCOME GLOBAL TRADE—BUT NOT IMMIGRATION 14 (2007).

<sup>49</sup> John Harwood, *Republicans Grow Skeptical On Free Trade*, WALL ST. J., Oct. 4, 2007, at A1.

<sup>50</sup> See Lawrence Summers, *Sovereign Funds Shake the Logic of Capitalism*, FIN. TIMES, July 30, 2007, at 11; *Asset-Backed Insecurity*, ECONOMIST, Jan. 19, 2008, at 78–80.

<sup>51</sup> Scott C. Bradford, Paul L. E. Grieco & Gary Clyde Hufbauer, *The Payoff to America from Global Integration*, in THE UNITED STATES AND THE WORLD ECONOMY: FOREIGN ECO-

the classic idea of “comparative advantage”—while also allowing producers and consumers to benefit from economies of scale. In doing so, free trade leads to increased productivity and GDP growth, which ultimately are necessary to raise standards of living and provide the resources needed to address costly challenges such as health care and climate change. For consumers, free trade also promotes competition, which introduces new low-priced goods and services and constrains markups on existing goods and services.<sup>52</sup> For workers, free trade may be associated with competitive labor markets that can sustain lower rates of unemployment without triggering inflation.<sup>53</sup>

Closely linked to greater trade are greater international capital flows, which have grown even more quickly than trade volumes in recent decades. American firms are leaders in financial services, and financial openness allows U.S. investors to find new and more productive investment opportunities abroad and permits foreigners to invest in the United States.<sup>54</sup> America’s large budget deficit and low private savings would have had much more serious consequences were it not for America’s open capital account, which allows substantial foreign investment to help maintain America’s production. Moreover, open trade has been beneficial for the United States recently because, as the economy has slowed and the dollar has weakened, a rising share of economic growth has come from exports.

Finally, globalization is a benefit not only to the United States, but also to the rest of the world—particularly the developing world. Trade is driving economic growth throughout the world, lifting hundreds of millions of people out of poverty, and has proven far more effective at doing so than has traditional development aid.<sup>55</sup> Openness to trade and investment can facilitate growth, and growth and poverty reduction go hand in hand.<sup>56</sup> Even for those countries trapped in a cycle of poverty, one leading scholar argues that

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NOMIC POLICY FOR THE NEXT DECADE 65, 95 (C. Fred Bergsten ed., Peterson Inst. for Int’l Econ., 2005).

<sup>52</sup> As the Council of Economic Advisers notes:

There is now ample evidence across many countries that greater trade openness and the resulting exposure to foreign competition reduces the ability of a country’s firms to charge high markups above production costs. . . . At the detailed product level, many studies have linked lower prices and/or price-cost markups to measures of trade openness such as tariff rates.

ECONOMIC REPORT OF THE PRESIDENT 155 (2006).

<sup>53</sup> Joseph Stiglitz, *Reflections on the Natural Rate Hypothesis*, 11 J. ECON. PERSP. 3, 8–9 (1997).

<sup>54</sup> The benefits of greater capital mobility are broadly acknowledged among economists, though less so than the benefits of trade, even among trade’s most ardent defenders. See, e.g., Jagdish Bhagwati, *The Capital Myth: The Difference between Trade in Widgets and Dollars*, 77 FOREIGN AFF. 7, 7 (1998).

<sup>55</sup> See JAGDISH BHAGWATI, IN DEFENSE OF GLOBALIZATION 51–67 (2d ed. 2007) (2004). See generally WILLIAM EASTERLY, *THE WHITE MAN’S BURDEN: WHY THE WEST’S EFFORTS TO AID THE REST HAVE DONE SO MUCH ILL AND SO LITTLE GOOD* (2006).

<sup>56</sup> David Dollar & Aart Kraay, *Growth Is Good for the Poor*, 7 J. ECON. GROWTH 195, 195–99 (2002).



what is needed more than increased foreign aid is increased market access for the “bottom billion” to the economies of the rest of the world.<sup>57</sup>

### *Lack of Broadly Shared Growth*

Why then has there been such a strong backlash against global economic integration if it brings with it such significant economic benefits? The answer becomes apparent when one looks at how the gains of that growth have been distributed. While policymakers are fond of reciting President John F. Kennedy’s famous phrase, a “rising tide lifts all boats,” that is not inevitable. It is more an aspiration than an aphorism, and the test for economic policy is whether that aspiration is being fulfilled.<sup>58</sup> In recent years, our record on that score has been poor.

Over the past several decades, the income gains of low- and middle-income Americans have been poor relative to both the level of overall economic growth and the income growth of those at the top. Between 1947 and 1973, productivity and real median family income grew by 2.8% per year. Since 1973, however, productivity has grown by 1.8% per year while real median family income has risen by less than half of that.<sup>59</sup> And wage stagnation is not a problem just for low-skilled workers. Indeed, “[l]ess than four percent of workers were in educational groups that enjoyed increases in mean real money earnings from 2000 to 2005; mean real money earnings rose for workers with doctorates and professional graduate degrees and fell for all others.”<sup>60</sup> At the same time that workers are experiencing wage stagnation, they are witnessing historically high levels of income for those at the very top of the income distribution. As discussed earlier, the result has been a stunning rise in inequality to levels not seen in the United States since 1929.<sup>61</sup> That the economy is growing and a few are benefiting makes the many who are not feel relatively poorer. Indeed, a wide body of research shows that workers’ satisfaction with their income levels is driven more by how their income compares with that of those around them than with the absolute level of income itself.<sup>62</sup>

Various factors are responsible for rising inequality and insecurity—including technological change that increasingly rewards skilled workers (referred to as skill-biased technological change), institutional changes such

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<sup>57</sup> PAUL COLLIER, *THE BOTTOM BILLION: WHY THE POOREST COUNTRIES ARE FAILING AND WHAT CAN BE DONE ABOUT IT* 100–72 (2007).

<sup>58</sup> Gene Sperling, *Rising Tide Economics*, 6 *DEMOCRACY: A JOURNAL OF IDEAS* 61, 61–73 (2007).

<sup>59</sup> Estimates are based on Bureau of Labor Statistics productivity data and U.S. Census Bureau income data.

<sup>60</sup> Kenneth F. Scheve & Matthew J. Slaughter, *A New Deal for Globalization*, 86 *FOREIGN AFF.* 34, 34 (2007).

<sup>61</sup> AVIVA ARON-DINE, *CTR. ON BUDGET & POL’Y PRIORITIES, NEW DATA SHOW INCOME CONCENTRATION JUMPED AGAIN IN 2005 2* (2007), available at <http://www.cbpp.org/3-29-07inc.pdf>.

<sup>62</sup> See Mary Daly & Daniel Wilson, *Relative Comparisons and Economics: Empirical Evidence*, FEDERAL RESERVE BOARD OF SAN FRANCISCO ECON. LETTER 2007-30, Oct. 5, 2007.

as the decline of unions, immigration, and the decline in the real value of the minimum wage.<sup>63</sup> The degree to which inequality is linked to trade and the broader process of globalization is uncertain. A number of studies using data through the early 1990s found that trade made a relatively small contribution to inequality.<sup>64</sup> But the economy has changed substantially since then, raising the prospect that trade is playing a bigger role in inequality today. For example, as Paul Krugman has pointed out and as is shown in Figure 3, the share of manufactured imports coming from developing countries has risen dramatically in recent years.<sup>65</sup> Unfortunately, there are few up-to-date studies on the effects of trade on inequality, and difficulties in understanding and interpreting data on increasingly complicated, globally-sourced trade flows make it hard to quantify the potential impact on inequality.<sup>66</sup> As a result, tremendous uncertainty exists about its role in today's economy. Even if the relative importance of trade has increased, available evidence still suggests trade's impact on inequality has been modest compared to such factors as skill-biased technological change.<sup>67</sup> Yet even if trade is responsible for only, say, 10% to 20% of the \$884 billion income shift from the bottom 80% of workers to the top 1%, as described above, this

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<sup>63</sup> See David H. Autor, Lawrence F. Katz & Melissa S. Kearney, *Trends in U.S. Wage Inequality: Revising the Revisionists* 2–4 (2007) (unpublished manuscript), available at <http://post.economics.harvard.edu/faculty/katz/papers/AKK-ReStatRevision.pdf> (“skill-biased technical change” has increased inequality); Daron Acemoglu, *Technical Change, Inequality and the Labor Market*, 40 J. ECON. LIT. 7, 9–10 (2002) (relative skills are important to inequality); Frank Levy & Peter Temin, *Inequality and Institutions in 20th Century America* 5 (Mass. Inst. of Tech. Dep’t. of Econ., Working Paper No. 07-17, 2007) (weakened institutions have contributed to inequality); David Card, Thomas Lemieux & W. Craig Riddell, *Unionization and Wage Inequality: A Comparative Study of the U.S., the U.K., and Canada* 18–24 (Nat’l Bureau of Econ. Res., Working Paper No. 9473, 2003), available at <http://www.nber.org/papers/w9473> (decline in unionization has impacted income inequality among males); Robert Z. Lawrence, *Slow Real Wage Growth and U.S. Income Inequality: Is Trade to Blame?* 7–8 (2007) (unpublished manuscript), available at <http://ksghome.harvard.edu/~RLawrence/Lawrence%20for%20Brandeis.pdf> (trade has played a small part in increased inequality).

<sup>64</sup> See, e.g., Robert Z. Lawrence & Matthew J. Slaughter, *International Trade and American Wages in the 1980s: Giant Sucking Sound or Small Hiccup?*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY: MICROECONOMICS 161, 165–66 (1993). See also George J. Borjas, Richard B. Freeman & Lawrence F. Katz, *How Much Do Immigrants and Trade Affect Labor Market Outcomes?*, 1 BROOKINGS PAPERS ON ECON. ACTIVITY: MACROECONOMICS 1, 3 (1997).

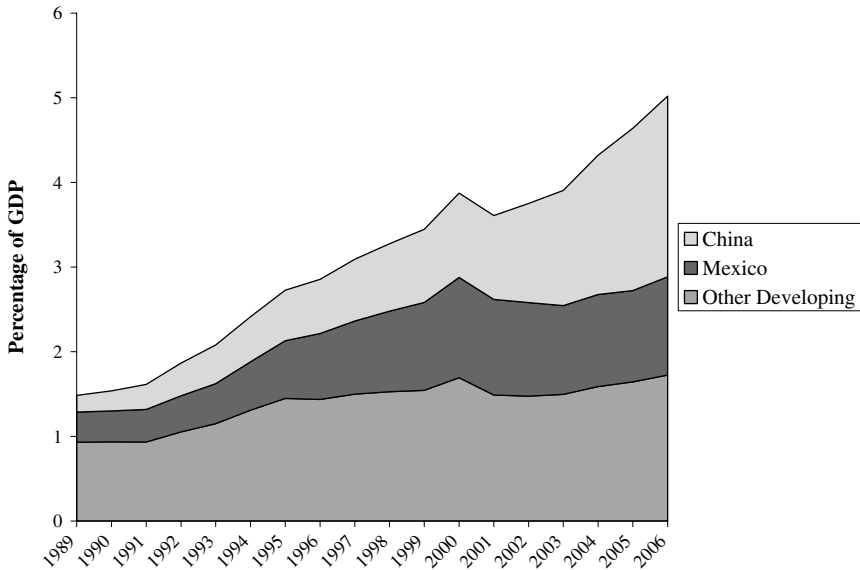
<sup>65</sup> Paul Krugman, *Trouble With Trade*, N.Y. TIMES, Dec. 28, 2007, at A23.

<sup>66</sup> See Krugman, *supra* note 8, at 3.

<sup>67</sup> See, e.g., Ben S. Bernanke, Chairman, Fed. Reserve, Speech Before the Greater Omaha Chamber of Commerce: The Level and Distribution of Economic Well-Being, (Feb. 6, 2007), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20070206a.htm> (“Overall, I read the available evidence as favoring the view that the influence of globalization on inequality has been moderate and almost surely less important than the effects of skill-biased technological change.”); Robert J. Gordon & Ian Dew-Becker, *Unresolved Issues in the Rise of American Inequality* 32–33 (paper presented at the Brookings Panel on Economic Activity, Sept. 7, 2007), available at [http://www.people.fas.harvard.edu/~idew/papers/BPEA\\_final\\_ineq.pdf](http://www.people.fas.harvard.edu/~idew/papers/BPEA_final_ineq.pdf) (finding “little solid evidence for any effect of increased trade” and “ample evidence that SBTC is a major explanation of increased skewness of labor incomes at the top”).

may still justify a shift in tax burdens of \$88 to \$177 billion—a small fraction of the \$1 trillion per year aggregate benefits of free trade.<sup>68</sup>

FIGURE 3: U.S. IMPORTS FROM DEVELOPING NATIONS, 1989–2006<sup>69</sup>



Regardless of how much impact trade has actually had on inequality, and despite the many benefits of trade on consumer prices and growth, American workers clearly perceive globalization as a key culprit in the rising economic insecurity they are experiencing.<sup>70</sup> Yale political scientist Kenneth F. Scheve and Dartmouth economist Matthew J. Slaughter, a former member of President Bush's Council of Economic Advisers, recently explained the relationship between income growth and protectionism this way in *Foreign Affairs*:

U.S. policy is becoming more protectionist because the American public is becoming more protectionist, and this shift in attitudes is a result of stagnant or falling incomes. Public support for engagement with the world economy is strongly linked to labor-market performance, and for most workers labor-market performance has been poor.<sup>71</sup>

<sup>68</sup> See Bradford, Grieco & Hufbauer, *supra* note 51.

<sup>69</sup> Data from TradeStats Express, <http://tse.export.gov> (last visited Apr. 15, 2008).

<sup>70</sup> Richard G. Anderson & Charles S. Gascon, *The Perils of Globalization: Offshoring and Economic Insecurity of the American Worker* 3 (Fed. Reserve Bank of St. Louis, Working Paper No. 2007-004A, 2007), available at <http://research.stlouisfed.org/wp/2007/2007-004.pdf>.

<sup>71</sup> Scheve & Slaughter, *supra* note 60, at 34–35.

As noted above, a disproportionate amount of blame is attributed to trade because of its highly visible consequences. Furthermore, more Americans are becoming worried about globalization because they recognize that global competition is no longer limited to manufacturing; increasingly, workers from populous countries like China and India are competing in high-skill, high-wage sectors, including accounting, legal services, editing, radiology, and other similar industries.

### *The Opportunity for a New Consensus*

More progressive tax policy is an effective and appropriate response to rising inequality and insecurity and, by directly effecting more broadly shared prosperity, can temper protectionist sentiment. As a matter of political economy, this link between protectionism and the lack of broadly-shared growth also means there may be a unique opportunity to forge a consensus in support of more progressive taxation. Not only should those worried about rising inequality be promoting such policies, but so too should those with business interests with a stake in globalization and policymakers concerned with promoting strong future economic growth, which depends critically on continued global engagement.

The American business community may be beginning to recognize the reality that continued support for trade and globalization is contingent on policies to spread the benefits of global economic integration more broadly. A June 2007 report commissioned by the Financial Services Forum reached just this conclusion.<sup>72</sup> The report found:

Economic policy should aim to produce a growing American economy in which every American can find opportunity to use their [sic] skills to craft their [sic] own economic future. That is the only way to meet the current challenge of guaranteeing that America overall continues to benefit from global engagement while also delivering on the idea of an equal-opportunity society and thereby addressing the legitimate distributional concerns about the pressures of economic openness.<sup>73</sup>

The report concluded that the most direct and efficient way to stanch the protectionist drift was to effect income redistribution through more progressive taxation, specifically through payroll tax reductions.<sup>74</sup> The report's conclusion is even more striking because two of its three authors served as high-ranking officials in the George W. Bush Administration (the third

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<sup>72</sup> Grant D. Aldonas, Robert Z. Lawrence & Matthew J. Slaughter, *Succeeding in the New Economy: A New Policy Agenda for the American Worker* 6–9 (paper presented at the Financial Services Forum, June 26, 2007), available at <http://mba.tuck.dartmouth.edu/pages/faculty/matthew.slaughter/pdf/FSF%20Final%20Report.pdf>.

<sup>73</sup> *Id.* at 8.

<sup>74</sup> *Id.* at 44–46.

served in the Clinton Administration).<sup>75</sup> As described below, we believe more progressivity in income, rather than payroll, tax rates is a more promising path. To build even further consensus, fundamental tax reform might also lower the corporate statutory tax rate in a revenue-neutral manner by broadening the base at the same time that it increases the progressivity of personal income tax rates.

The possibility that conservatives and those with pro-business interests might come out more forcefully to support more progressive taxation in order to shore up support for further global economic integration has some precedent in U.S. history. Similar arguments were voiced by those who argued against very steep tax cuts during the Gilded Age of the 1920s,<sup>76</sup> a decade in which the top 10% of the income distribution earned an average of 43.6% of the nation's income and the top 1% earned 17.3% (roughly the same figures as today).<sup>77</sup> After 1913, when the Sixteenth Amendment first legalized the income tax, the tax quickly grew as a source of federal revenue with a steeply progressive rate structure. Support for very progressive rates between 1913 and America's entry into World War I in 1917 was fueled by concern over the rapid concentration of wealth and the effects of industrialization—much like current concern over rising inequality and globalization's impact on workers.<sup>78</sup> The result, according to tax historian W. Elliott Brownlee, "was that the nation embraced a new tax system: 'soak the rich' income taxation."<sup>79</sup> When Republicans came into power in 1921, they sharply reversed course, motivated by concerns with economic growth and maximizing revenue far more than with redistribution. Treasury Secretary Andrew Mellon, foreshadowing later supply-side arguments, claimed that cutting rates would "encourage the rich to invest at higher rates, and in more productive enterprises, thereby enhancing economic efficiency."<sup>80</sup> Yet while Republicans in Congress were tempted to take this tax-cutting frenzy to extremes, Mellon fought to preserve some progressivity in tax rates based on ability to pay. His primary rationale was a pragmatic one, designed to maintain support for the free-market, capitalist economy—"enlightened self-interest," Brownlee calls it.<sup>81</sup> As Mellon biographer David Cannadine put it, Mellon "accepted that the rich should be seen to pay their full share, in order to fill the Treasury's coffers but also to diffuse radical attacks on capital."<sup>82</sup> Just as Mellon recognized that progressive taxation was a necessary tool to

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<sup>75</sup> *Id.* at 59–61.

<sup>76</sup> W. Elliott Brownlee, *Historical Perspective on U.S. Tax Policy Toward the Rich*, in DOES ATLAS SHRUG?, *supra* note 24, at 29, 44–49.

<sup>77</sup> See PIKETTY & SAEZ, *supra* note 31.

<sup>78</sup> See Brownlee, *supra* note 76, at 43.

<sup>79</sup> *Id.* at 44.

<sup>80</sup> *Id.* at 48.

<sup>81</sup> *Id.* at 49.

<sup>82</sup> DAVID CANNADINE, MELLON: AN AMERICAN LIFE 344 (2006); see also Dennis J. Ventry, Jr., *Equity vs. Efficiency and the U.S. Tax System in Historical Perspective*, in TAX JUSTICE: THE ONGOING DEBATE 25, 33 (Joseph J. Thorndike & Dennis J. Ventry, Jr. eds., 2002) ("Mellon believed that keeping tax schedules graduated (albeit flatter) could mitigate radical demands for restructuring the capitalist system.").

deflect resentment at the growing concentration of wealth and a potential backlash against the free-market, capitalist system that brought about the Industrial Age, similarly a modern-era coalition to support the goal of progressive taxation could be forged between those concerned with the effects of globalization and those worried about maintaining support for expanded free trade. By preserving free trade and promoting progressive taxation, this coalition would help share the gains of globalization more broadly while preserving growth-enhancing free trade policies.

### III. THE SUPERIORITY OF PROGRESSIVE INCOME TAXATION TO SECURE BROAD-BASED GROWTH

This Part sketches out specific steps to achieve a more progressive tax code that better promotes social efficiency and potentially economic efficiency as well. But first it explains why *progressive income taxation*, and not just other types of policies, should play a central role in responding to the concerns previously discussed.

#### *Why Use Progressive Taxation to Achieve More Broad-Based Growth?*

Even assuming that a broader consensus can be achieved in support of policies to promote more broadly-shared economic growth, there are many other policy tools that could help achieve this goal. For example, many free trade proponents have long advocated increased investments in education and workforce training to assist those workers in specific industries and communities who may be harmed by trade. While critically important, it is becoming increasingly evident that such policies alone are inadequate to the task at hand. In addition to human capital investments, our nation needs to strengthen our social insurance system and shore up our social safety net. Universal health insurance is perhaps the greatest priority in this regard to enhance economic security for American families.

Yet while all these investments are certainly necessary, tax policy has some distinct advantages of its own and thus should be a core part of any policy agenda to share the gains of growth more broadly. First, progressive taxation is often more economically efficient than other solutions, because it leaves most economic decisions to participants in a competitive marketplace. Industrial policies and direct market interventions can try to change the before-tax distribution of income, but ultimately such policies harm the economy—for example, excessively high living-wage laws can result in large job losses for low-skilled workers. Progressive taxation first lets the competitive market economy maximize the total pie, and then uses instruments such as the EITC and the top marginal tax rate, in combination with a

variety of other social policies, to help spread the gains thereby generated more widely.<sup>83</sup>

A second rationale for preferring progressive taxation, together with transfer programs, is that they can be very effectively targeted. Tax and transfer programs can be fine-tuned to deliver benefits that vary according to family income, the number of children in the family, or other characteristics. Such targeting avoids diverting scarce government resources to households who do not really need the assistance. For those who are targeted, the tax benefit can also be applied universally. For example, expanding the EITC for families who make less than \$30,000 could benefit virtually all families in that income range. It would be extremely difficult to design a set of protective trade restrictions, for example, that benefit virtually everyone making less than \$30,000, and it would be impossible to do it in a way that provided benefits proportional to family size. In fact, trade restrictions are likely to help some people—mainly the workers and business owners in the protected industry—while hurting many lower-income families who rely on inexpensive imports for their consumption or even their jobs.

Third, progressive taxation can respond at a significant scale. Other programs—whether currently existing, like worker training, or proposed, like wage insurance—are often worthy in and of themselves. But they are hopelessly mismatched against the sheer magnitude of the recent increase in inequality. They are targeted at specific groups in specific circumstances and thus fail to address a range of other causes of the rise in inequality. As targeted programs, they are typically funded at a few billion dollars annually, a small fraction of the \$42 billion that the EITC alone adds to the paychecks of low-income workers in a single year.<sup>84</sup>

Finally, progressive taxation has the ability to act nearly instantaneously. Education is a frequently mentioned and critical part of any strategy to achieve shared growth. But the gains from public investment in early childhood education, for example, may take decades to materialize. This is not at all an argument against such investment—the gains are potentially enormous, both for the economy and for the families that benefit from the expansion of opportunity. But increased education spending should not be a substitute for more immediate action.

*Why Use Income Taxes, not Payroll Taxes or a  
Progressive Consumption Tax?*

Even accepting the use of tax reform to achieve more broadly shared growth, the key question is how to achieve greater tax progressivity. As noted, other scholars have proposed focusing on the payroll tax by eliminat-

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<sup>83</sup> See Jason Bordoff, *Broken Contract*, 5 DEMOCRACY: A JOURNAL OF IDEAS 59, 66 (2007).

<sup>84</sup> Internal Revenue Service, *I Take Credit*, <http://www.irs-eitc.info> (last visited Mar. 17, 2008).

ing the full payroll tax for workers earning below the national median and raising the payroll tax income cap, which is currently \$102,000.<sup>85</sup> We are concerned about such an approach for three main reasons. First, it is more efficient and equitable to raise tax rates on a broader base rather than limiting the expansion to taxable payroll, a step that increases the likelihood of income shifting. Second, this specific proposal may not work quantitatively as the revenue raised by lifting the proposal raises political economy concerns. Although the separate budgetary treatment and financing structure of Social Security is arbitrary, it still serves the dual purposes of solidifying broad public support for the program—which is currently viewed less as redistribution and more as social insurance—and also promoting transparency, helping policymakers focus on at least one important aspect of the long-run budget challenge.

Another possibility popular with many tax reformers is to shift to a progressive consumption tax.<sup>86</sup> For example, David F. Bradford suggests an “X-tax,” which is like a “flat tax” except for the fact that it has multiple rates.<sup>87</sup> A well-designed consumption tax would indeed be worthy of serious consideration, although economic theory shows that it differs less from a well-designed income tax than is popularly appreciated.<sup>88</sup> But what often falls under the “rubric” of a consumption tax suffers from four problems.

First, many advocates describe their reform as moving towards a “consumption tax” when in fact they are really advocating for retaining taxes on wages while eliminating taxes on capital gains, dividends, and interest.<sup>89</sup> One problem with this approach is that people could exploit the malleable label and avoid taxation by shifting what is really “labor income” to “capital income,” narrowing the tax base and raising efficiency and equity concerns. More fundamentally and subtly, it is now understood that a pure consumption tax should only exempt the normal, risk-free rate of return on capital from taxation. In other words, a consumption tax, like an income tax, should tax economic rents like returns to new inventions and also like the returns associated with taking greater risks. These, however, are missing from the wage tax base that is the focus of current proposals.

Second, eliminating taxes on capital gains and dividends, while retaining the deductibility of interest for corporations and mortgages, results in an

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<sup>85</sup> Scheve & Slaughter, *supra* note 60, at 45.

<sup>86</sup> See, e.g., David Weisbach & Joseph Bankman, *Consumption Taxation Is Still Superior to Income Taxation* (Univ. of Chicago Law Sch. John M. Olin Law & Econ. Paper No. 358, 2007), available at <http://ssrn.com/abstract=1012953>; Joseph Bankman & David Weisbach, *The Superiority of an Ideal Consumption Tax Over an Ideal Income Tax*, 58 STAN. L. REV. 1413, 1413-17 (2006).

<sup>87</sup> See David F. Bradford, *The X Tax in the World Economy* 3-5 (Princeton Univ. Ctr. for Econ. Pol’y Studies, Working Paper No. 93, 2003), available at <http://www.princeton.edu/~ceps/workingpapers/93bradford.pdf>.

<sup>88</sup> R. Glenn Hubbard, *How Different Are Income and Consumption Taxes?*, 87 AM. ECON. REV. 138, 138 (1997).

<sup>89</sup> See Daniel Shaviro, *Simplifying Assumptions: How Might the Politics of Consumption Tax Reform Affect (Impair) the End Product?* 38-40 (N.Y. Univ. Law and Econ. Working Paper Series, Paper No. 06-17, 2006), available at <http://ssrn.com/abstract=896160>.



incoherent tax system that, although sometimes labeled a consumption tax, is in practice no such thing. Such a system would have a negative tax rate on debt-financed investment (as opposed to the intended consumption tax rate of zero) and would provide substantial sheltering opportunities.<sup>90</sup>

Third, if a consumption tax is implemented through a tax on spending, rather than the exclusion of capital income, a different set of problems arise. If our current tax expenditures were kept in place, a flat-rate consumption tax would need to impose a rate of roughly 60% in order to be budget-neutral.<sup>91</sup> It is unlikely that the political system could withstand the outrage provoked by a 60% increase in the cost of goods and services. Additionally, it is unlikely that the political system would be able to get rid of popular tax deductions such as those for home mortgages and health insurance.

Finally, much of the empirical benefit of a well-designed consumption tax results not from eliminating the tax on the risk-free rate of return, but from a transition process that requires a one-time levy on old capital.<sup>92</sup> Such a levy is economically efficient because it taxes people based on past decisions that cannot be changed; moreover, since the transition to a consumption tax is a *sui generis* event, the expectation is that such a levy would not be repeated. To understand what this would mean in practice, however, consider how it would affect a hypothetical taxpayer. Under an income tax, someone who earned \$100 yesterday and paid, say, \$30 in taxes would have \$70 to spend tomorrow. Under a consumption tax, that person would also pay \$30 in taxes assuming the same tax rate and that all of the \$100 was spent. But consider the person who earned \$100 yesterday, paid income tax of \$30, and then, if we switch to a consumption tax tomorrow, *also* must pay that tax on the remaining \$70 if it is all spent, leading to double taxation. As is evident from this example, any shift to a consumption tax will inevitably generate enormous political pressure to provide transition relief to those who would otherwise see the value of their existing assets reduced by the tax reform. But a key finding in academic analysis is that almost all of the economic benefit from moving to a consumption tax in fact derives from the one-time tax it places on existing assets.<sup>93</sup>

These concerns—the likelihood that a consumption tax will raise less revenue and be regressive, that it will inadequately broaden the base and thus lead to higher rates, and that political necessities will require transition

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<sup>90</sup> See *id.* at 26–28.

<sup>91</sup> See William G. Gale, *The National Retail Sales Tax: What Would the Rate Have to Be?*, 107 TAX NOTES 889, 895 (2005).

<sup>92</sup> See JOINT COMM. ON TAXATION, TAX MODELING PROJECT AND 1997 SYMPOSIUM PAPERS 7–8, 42 (1997); David Altig et al., *Simulating Fundamental Tax Reform in the United States*, 91 AM. ECON. REV. 574, 588–91 (2001).

<sup>93</sup> See Alan J. Auerbach, *Tax Reform, Capital Allocation, Efficiency and Growth*, in ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM 29, 67 (Henry J. Aaron & William G. Gale eds., 1996); Eric M. Engen & William G. Gale, *Consumption Taxes and Saving: The Role of Uncertainty in Tax Reform*, 87 AM. ECON. REV. 114, 115–16 (1997); William G. Gale & Peter R. Orszag, *Bush Administration Tax Policy: Down Payment on Tax Reform?*, 105 TAX NOTES 879, 880 (2004); Altig et al., *supra* note 92.

relief that blunts a consumption tax's potential benefits—all caution against using an opportunity for fundamental tax reform to shift our system from an income to a consumption tax. Rather, fundamental tax reform should increase progressivity, broaden the base particularly at the business level, simplify the tax system, and do a better job of collecting the taxes that are owed.

### *Reforming Individual Income Taxes*

To achieve these aims within the context of fundamental tax reform, several specific steps should be taken to restore the lost progressivity of our tax system. Regarding personal income taxation, at a minimum the tax cuts of 2001 and 2003 should be repealed or allowed to expire for married couples making above \$200,000 per year. This alone would offset roughly one sixth of the increase in inequality since 1979, according to our estimates. It is hard to argue that returning to the top rates that prevailed in the 1990s—the period that saw the longest economic expansion in U.S. history, with strong job growth and rising incomes at all levels—would hurt the economy. At the same time, reform should make taxes more progressive for lower-income households, for example by expanding the Earned Income Tax Credit.<sup>94</sup>

Even higher rates may be warranted as part of a broader package to reduce the deficit or to pay for progressive tax reform. One way to implement higher rates would be to design the tax system such that rates automatically change as the distribution of income changes, to offset a certain percentage of the change in inequality.<sup>95</sup> The merits of such a proposal would depend on what percentage of the change in inequality was to be offset. As noted above, some degree of inequality is inevitable and likely even desirable, and, regardless of the percentage, there are drawbacks to such a mechanical rule. But at the very least, increases in inequality should inform efforts to achieve more progressive taxation.

Additionally, progressive tax reform should retain a robust tax on large bequests and gifts. More than a third of the reduction in the average tax rate for the top 0.1% of households is due to a reduction in estate taxes—and the Piketty-Saez estimates do not include most of the scheduled reduction and eventual repeal of the estate tax enacted as part of the 2001 tax cut.<sup>96</sup> This tax has several beneficial features: it is highly progressive (affecting less than one percent of the population in total); it promotes equality of opportu-

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<sup>94</sup> See Jason Furman, *Tax Reform and Poverty*, 111 TAX NOTES 1293, 1297–98 (2006); John Karl Scholz, *Employment-Based Tax Credits for Low-Skilled Workers* 7–8 (Brookings Inst., Hamilton Proj. Discussion Paper No. 2007-14, 2007), available at [http://www.brookings.edu/papers/2007/~media/Files/rc/papers/2007/12\\_taxcredit\\_scholz/12\\_taxcredit\\_scholz.pdf](http://www.brookings.edu/papers/2007/~media/Files/rc/papers/2007/12_taxcredit_scholz/12_taxcredit_scholz.pdf).

<sup>95</sup> Leonard E. Burman et al., *The Rising Tide Tax System: Indexing the Tax System for Changes in Inequality* 1–2 (paper prepared for the N.Y. Univ. Sch. of Law Colloquium on Tax Pol'y & Pub. Fin., Mar. 22, 2007), available at <http://www.law.nyu.edu/colloquia/taxpolicy/papers/07/LeonardBurmanSp07.pdf>.

<sup>96</sup> PIKETTY & SAEZ, *supra* note 31.

nity by reducing dynastic concentrations of wealth; it may be a relatively efficient way to collect taxes progressively; and it serves as a backstop to the income tax system, bringing back into the system gains that may have escaped taxation for years or even decades.<sup>97</sup>

Finally, our system of subsidizing certain socially desirable activities through the tax code, such as saving and home ownership, should be made more effective, equitable, and efficient—for example, by shifting from the use of tax deductions to the use of refundable tax credits.<sup>98</sup> A deduction of \$1 is worth \$0.35 to someone in the 35% marginal tax bracket, but only \$0.15 to someone in the 15% bracket. Not only is the use of refundable tax credits more equitable, but it is also a more effective and efficient use of government resources. The goal of tax expenditures is often to encourage people to consume more of something—for example, health insurance. But since deductions reduce the after-tax price more for high-income families than for low-income families, they generally produce too much added consumption by the former and too little by the latter.<sup>99</sup> Moreover, in the case of subsidizing saving for retirement, evidence shows that tax deductions do not achieve much “bang for the buck” because the tax incentives do not encourage much additional saving among high-income households (who are the primary beneficiaries of deductions), but rather simply subsidize saving that these households would have done anyway.<sup>100</sup>

### *Corporate Income Tax Reform*

In addition to more progressive personal income taxes, corporate income tax reform should be part of any effort at progressive tax reform. As noted earlier, the erosion of the corporate income tax, without any corresponding increase in income tax rates, is the primary reason why average tax rates on high-income households have fallen.<sup>101</sup> The collection of taxes at the business level has failed to respond to the challenges of globalization and

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<sup>97</sup> Michael J. Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 270–73 (1983).

<sup>98</sup> Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN L. REV. 23, 24 (2006).

<sup>99</sup> *Id.* at 61.

<sup>100</sup> William G. Gale, Jonathan Gruber & Peter R. Orszag, *Improving Opportunities and Saving by Middle- And Low-Income Households* 7 (Brookings Inst., Hamilton Proj. Discussion Paper No. 2006-02, 2006), available at [http://www.brookings.edu/~media/Files/rc/papers/2006/04saving\\_gale/200604hamilton\\_2.pdf](http://www.brookings.edu/~media/Files/rc/papers/2006/04saving_gale/200604hamilton_2.pdf).

<sup>101</sup> Piketty & Saez, *supra* note 33, at 7, assume that corporate taxes reduce the before-tax rate of return to noncorporate forms of capital such as housing, and that the incidence of corporate taxes thus falls in proportion to ownership of the capital stock. See Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 230–31 (1962). There is, however, considerable uncertainty about the actual incidence of corporate taxes: they may fall entirely on owners of corporate stock (which would exacerbate the trends discussed in the text), they may fall entirely on workers (which would partly ameliorate the trends), or somewhere in between. For extensive discussion, see generally Alan Auerbach, *Who Bears the Corporate Tax?*, in 20 TAX POLICY AND THE ECONOMY 1 (James M. Poterba ed., 2006).

financialization, and today the business income tax system is badly broken. The business tax code is enormously complex and unnecessarily inefficient, and often it does not raise the revenue it is meant to raise. The United States has the second highest corporate tax rate among the thirty countries in the Organisation for Economic Co-operation and Development (OECD), but because the United States has so many generous special tax preferences for businesses, it collects the fourth lowest corporate tax revenues as a share of GDP among all OECD countries.<sup>102</sup> As the Department of the Treasury explained:

[T]he high U.S. corporate tax rate does not result in higher corporate tax revenue relative to GDP due to the narrowness of the U.S. corporate tax base. The narrow corporate tax base results not only from accelerated depreciation allowances, but also from special tax provisions for particular business sectors (such as domestic production activities) as well as debt finance and tax planning.<sup>103</sup>

The high corporate statutory tax rate in the United States has been a concern of business leaders and policymakers worried about the competitiveness and profitability of American firms and foreign direct investment in the United States. Conservative analysts have long called for a reduction in the corporate tax rate.<sup>104</sup> As such, lowering the corporate rate as part of a broad progressive tax reform may be a way to bring more conservatives to support such an effort. In doing so, corporate tax reform should follow the classic model pursued during the last fundamental reform in 1986: lower tax rates and broaden the tax base by curtailing corporate tax loopholes and limiting special exemptions. Indeed, House Ways and Means Chairman Charles Rangel recently proposed a corporate tax rate reduction from 35% to 30.5%, while eliminating a variety of targeted tax breaks for businesses.<sup>105</sup>

Beyond the revenue-raisers proposed by Rangel, progressive tax reform needs to address three major failings of our current corporate tax code that weaken the corporate income tax and distort economic behavior: the book-tax income gap, the treatment of foreign source income, and the treatment of different types of investments.

First, a large part of the erosion of corporate taxes is highlighted by the widening gap between the book income that corporations report to their

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<sup>102</sup> ORG. FOR ECON. CO-OPERATION & DEV. (OECD), REVENUE STATISTICS: SPECIAL FEATURE, TAXES PAID ON SOCIAL TRANSFERS 1965–2005 69 (2006), [http://www.oecd.org/document/58/0,3343,en\\_2649\\_201185\\_39498298\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/58/0,3343,en_2649_201185_39498298_1_1_1_1,00.html); OECD TAX DATABASE, CORPORATE INCOME TAX RATE tbl.II.1 (2006), [www.oecd.org/document/60/0,2340,en\\_2649\\_34533\\_1942460\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/60/0,2340,en_2649_34533_1942460_1_1_1_1,00.html).

<sup>103</sup> OFFICE OF TAX POLICY, U.S. DEPARTMENT OF THE TREASURY, APPROACHES TO IMPROVE THE COMPETITIVENESS OF THE U.S. BUSINESS TAX SYSTEM FOR THE 21ST CENTURY 10 (2007), available at [http://www.ustreas.gov/press/releases/reports/hp749\\_approachesstudy.pdf](http://www.ustreas.gov/press/releases/reports/hp749_approachesstudy.pdf).

<sup>104</sup> KEVIN A. HASSETT, AMERICAN ENTERPRISE INSTITUTE, LET'S CUT CORPORATE TAXES TO CREATE MORE JOBS (2006), [http://www.aei.org/publications/pubID.23656/pub\\_detail.asp](http://www.aei.org/publications/pubID.23656/pub_detail.asp); R. Glenn Hubbard, *The Corporate Tax Myth*, WALL ST. J., July 26, 2007, at A13.

<sup>105</sup> H.R. 3970, 110th Cong. (2007).

shareholders and the tax income they report to the IRS. The evidence suggests that much of the increase in this gap cannot be explained by standard accounting differences (such as the treatment of depreciation or stock options) but is instead likely due to increased sheltering activity.<sup>106</sup> An IRS contractor has estimated the tax revenue loss from such shelters in 1999 at \$14.5 billion to \$18.4 billion, although the IRS admits some uncertainty about the methodology used.<sup>107</sup> Joseph Bankman has estimated the loss at \$10 billion annually.<sup>108</sup>

For the corporate tax system to function effectively, it is essential that these mounting problems be addressed. At a minimum, policymakers should undertake steps to ensure greater transparency. Current law even prevents enforcement agencies, like the IRS and the Securities and Exchange Commission (SEC), from sharing information about tax and book profits.<sup>109</sup> More broadly, public disclosure of the profits that public corporations report to the IRS could potentially motivate better public policy and improve corporate governance. But transparency may not be enough, and policymakers should seriously consider whether the law should prevent companies from reporting widely variable incomes to their shareholders and the IRS through so-called book-tax conformity.<sup>110</sup> Finally, a large part of the book-tax gap problem is the ambiguity over the rules that govern tax shelters and other borderline abusive transactions. Policymakers should adopt robust anti-shelter legislation that formally codifies tax shelters as transactions that are undertaken for no reason other than reducing taxes. Moreover, shelters could be further curbed by legislation to disallow unrelated losses.

Second, as U.S. firms become increasingly global, the treatment of their foreign income has emerged as one particularly problematic source of tax avoidance. The U.S. government taxes U.S. multinationals on income earned both at home and abroad. Income earned abroad, however, is generally not taxed until it is repatriated, and firms receive a credit for any foreign taxes paid on that income. This “deferral” of taxation allows foreign-earned income to grow tax-free, distorts investment decisions, potentially leads to overinvestment abroad, creates an incentive for firms to earn (or report) profits in low-tax countries, and reduces U.S. corporate tax revenue. Moreo-

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<sup>106</sup> Mihir Desai, *The Divergence Between Book and Tax Income*, in 17 TAX POLICY AND THE ECONOMY 169, 173 (James. M. Poterba ed., 2003).

<sup>107</sup> GOVERNMENT ACCOUNTABILITY OFFICE, INTERNAL REVENUE SERVICE: CHALLENGES REMAIN IN COMBATING ABUSIVE TAX SHELTERS 12 (2003), available at <http://www.gao.gov/new.items/d04104t.pdf>.

<sup>108</sup> Joseph Bankman, *The New Market in Corporate Tax Shelters*, 83 TAX NOTES 1775, 1781 (1999).

<sup>109</sup> See I.R.C. § 6103 (2008) (precluding the IRS from sharing information derived from a tax return or audit with the SEC or other government agencies except in limited, prescribed circumstances).

<sup>110</sup> See David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX. L. REV. 215, 231 (2002). For a discussion of the arguments for and against book-tax conformity, see generally JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO CORPORATE INCOME TAX REFORM: ISSUES OF CONFORMING BOOK AND TAX INCOME AND CAPITAL COST RECOVERY (2006), available at <http://www.house.gov/jct/x-16-06.pdf>; Bankman, *supra* note 108.

ver, multinational firms can reduce their tax liability by shifting income between their U.S. operations and foreign subsidiaries. For example, if a firm faces a higher corporate income tax rate in the United States than abroad, it can lower the internal (transfer) price that its foreign subsidiary pays to its U.S. operation for goods, services, or intangibles (such as intellectual property). This reduces the profits, and therefore the taxable income, of the U.S. operation but has no impact on the firm's total before-tax income.<sup>111</sup>

One particularly dramatic illustration of these problems is that the top three source countries of overseas profits reported by American multinationals in 2003 were (in descending order) the Netherlands, Ireland, and Bermuda, which together accounted for more than 30% of the total. Not coincidentally, these countries have effective corporate tax rates of 5.3%, 6.1%, and 1.7%, respectively, compared with 26.3% in the United States. Tax scholars Kimberly Clausing and Reuven Avi-Yonah argue that this allocation of profits reflects tax planning, not genuine economic activity, as evidenced by the fact that none of these three countries is among the top ten locations of U.S. multinational jobs.<sup>112</sup> In a separate study, Clausing estimates that international tax avoidance lowered U.S. corporate tax collections by about \$60 billion in 2004.<sup>113</sup>

In response, policymakers should eliminate abusive tax shelters, reduce opportunities for transfer pricing abuse, and close other loopholes. For example, lawmakers could end deferral and tax all foreign income immediately, perhaps exempting income earned in countries with a corporate tax rate comparable to that of the United States and thus obviating the need for foreign tax credits to prevent double taxation.<sup>114</sup> Some scholars have proposed even more sweeping reform. For example, Clausing and Avi-Yonah propose an alternative reform to the international tax system known as formula apportionment, whereby U.S. firms would be taxed on a percentage of their worldwide profits equal to the U.S. share of their total sales.<sup>115</sup> Clausing and Avi-Yonah argue that this reform, which is similar to the way U.S. states tax the income of companies operating in several states, would simplify international taxation while eliminating the opportunity for transfer pricing schemes and other international tax abuses because taxes would be

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<sup>111</sup> In theory, such tax-motivated transfer pricing should be limited by the requirement that firms set prices for intrafirm transactions no differently than if the transaction were between parties acting at "arm's length." In practice, however, establishing such arm's length prices is often difficult and creates significant opportunities for tax avoidance, a problem likely to worsen as the economy becomes increasingly global.

<sup>112</sup> Kimberly A. Clausing & Reuven S. Avi-Yonah, *Taxing Firms in a Global Economy: A Proposal to Adopt Formula Apportionment* 10 (Brookings Inst., Hamilton Proj. Discussion Paper No. 2007-08, 2007), available at [http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes\\_clausing/200706clausing\\_aviyonah.pdf](http://www.brookings.edu/~media/Files/rc/papers/2007/06corporatetaxes_clausing/200706clausing_aviyonah.pdf).

<sup>113</sup> Kimberly A. Clausing, *Multinational Firm Tax Avoidance and U.S. Government Revenue 1-2* (2007) (unpublished manuscript, on file with the Harvard Law and Policy Review).

<sup>114</sup> See James Kvaal, *Removing Tax Subsidies for Foreign Investments*, 111 TAX NOTES 1299, 1299 (2006).

<sup>115</sup> Clausing & Avi-Yonah, *supra* note 112, at 2.

based on market prices and would not require imputing prices on intrafirm transactions.<sup>116</sup>

Third, the taxation of business income also unnecessarily distorts domestic business decisions, leading to inefficient use of resources. Perhaps the most serious example of this is the enormous discrepancy between the taxation of corporate debt and corporate equity. To the extent this leads corporations to over-leverage themselves, it can increase financial fragility throughout the economy and worsen corporate governance. The effective tax rate on corporate debt is actually negative—below even the zero tax rate on capital income that a consumption tax would apply. This happens because businesses can both deduct the interest on their borrowings and take “accelerated depreciation” deductions that exceed the true economic depreciation of the corresponding investments, and meanwhile the entities receiving this interest often are tax exempt or else pay less in taxes on that interest than the business saves on its deduction. One proposal to respond to this problem would tax all forms of capital income in a uniform manner by allowing businesses to deduct the cost of capital at the enterprise level while requiring individuals to pay taxes on the accrued normal returns of all their capital investments.<sup>117</sup>

#### *Other Tax Reforms to Increase Progressivity*

In addition to achieving greater progressivity through the personal and corporate income taxes, any fundamental tax reform effort should address two additional shortcomings: reducing complexity and closing the tax gap.

The complexity of our present tax system is a perennial lament of reformers. Examples abound: in 1940, instructions to the Form 1040 were about four pages long. Today the instruction booklet fills more than one hundred pages, and the form itself is accompanied by more than ten schedules and twenty worksheets.<sup>118</sup>

Complexity adversely impacts progressivity in several ways. One of the worst culprits is the alternative minimum tax (AMT). The Internal Revenue Service and the Taxpayer Advocate have flagged the AMT as one of the most complicated tax provisions to comply with and administer. The AMT was originally enacted to prevent a small number of wealthy individuals from escaping taxation, but, by 2017, it will affect thirty-six million filers (fifty-one million if the tax rates in the 2001 bill are extended), who must calculate their tax liability under both methods and pay the higher amount.<sup>119</sup> About half of the AMT’s expanding reach results from the fact that it was

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<sup>116</sup> *Id.* at 14.

<sup>117</sup> Kleinbard, *supra* note 38, at 2.

<sup>118</sup> Michael Graetz, Op-Ed, *To the Point of No Returns*, N.Y. TIMES, Nov. 15, 2004, at A21.

<sup>119</sup> JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE INDIVIDUAL ALTERNATIVE MINIMUM TAX 12, 15 fig. 3 (2007), available at <http://www.house.gov/jct/x-38-07.pdf>.

never indexed for inflation and thus impacts taxpayers with lower real incomes over time. The other half results from the tax cuts of 2001–2006, which, by lowering marginal tax rates, dramatically increased the number of people subject to this alternative tax rate in a deliberate effort to produce a low estimate of the cost of the tax cuts.<sup>120</sup>

Also, many government subsidies targeted at low-income individuals—such as the Earned Income Tax Credit, the child credit, and various education tax credits—are delivered through the tax code. These can be complex for low-income people to navigate and claim; indeed, roughly two-thirds of EITC recipients use a paid tax preparer.<sup>121</sup> Finally, simplifying the tax code would be progressive because the tax gap itself, which stems from complexity in addition to purposeful evasion, may be disproportionately due to underpayment by high-income families.

Several steps could be taken to achieve simplification. First, subsidizing certain behavior through the tax code can be greatly simplified by consolidating various subsidies with similar purposes. New credits, deductions, and exemptions tend to get layered on top of old ones, creating a confusing set of rules with different phase-outs, contribution limits, and eligibility criteria. That is the case, for example, with three of the main tax subsidies for higher education: the Hope credit, the Lifetime Learning credit, and the tuition deduction. Additionally, the IRS could eliminate the need for roughly forty percent of tax filers with relatively simple tax situations to file returns. Under such a program, the IRS would use information that it already receives from employers and financial institutions to send pre-filled-out tax returns to tax filers with sufficiently simple finances.<sup>122</sup> Finally, AMT reform would reduce tax complexity for the tens of millions of filers who will face the AMT in the coming years unless it is curtailed or repealed entirely. The problem is that repealing the AMT is expensive; it would reduce revenue by \$750 billion through 2016 if the 2001–2006 tax cuts expire as scheduled, and \$1.3 trillion if they are extended. In order to achieve AMT reform in a revenue-neutral manner, other progressive tax measures will likely be necessary to make up the lost revenue. House Ways and Means Chairman Charles Rangel, for example, has proposed paying for AMT repeal with a 4.0–4.6% income tax surcharge on high-income individuals.<sup>123</sup> Various policy analysts have also put forth a number of sensible options to achieve AMT reform, with some of the most promising being

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<sup>120</sup> LEONARD E. BURMAN, WILLIAM G. GALE & JEFF ROHALY, TAX POL'Y CTR., *THE EXPANDING REACH OF THE INDIVIDUAL ALTERNATIVE MINIMUM TAX 6* (2005), [http://www.taxpolicycenter.org/UploadedPDF/411194\\_expanding\\_reach\\_AMT.pdf](http://www.taxpolicycenter.org/UploadedPDF/411194_expanding_reach_AMT.pdf).

<sup>121</sup> INTERNAL REVENUE SERVICE, *IRS EARNED INCOME TAX CREDIT INITIATIVE, FINAL REPORT TO CONGRESS 2* (2005), available at [http://www.irs.gov/pub/irs-utl/irs\\_earned\\_income\\_tax\\_credit\\_initiative\\_final\\_report\\_to\\_congress\\_october\\_2005.pdf](http://www.irs.gov/pub/irs-utl/irs_earned_income_tax_credit_initiative_final_report_to_congress_october_2005.pdf).

<sup>122</sup> Austan Goolsbee, *The Simple Return: Reducing America's Tax Burden Through Return-Free Filing 2* (Brookings Inst., Hamilton Proj. Discussion Paper No. 2006-04, 2006), available at [http://www.brookings.edu/papers/2006/~media/Files/rc/papers/2006/07useconomics\\_goolsbee/200607goolsbee.pdf](http://www.brookings.edu/papers/2006/~media/Files/rc/papers/2006/07useconomics_goolsbee/200607goolsbee.pdf).

<sup>123</sup> See H.R. 3970, 110th Cong. (2007).



either eliminating deductions, such as for state and local taxes, or raising tax rates on high-income households.<sup>124</sup>

Partly due to the inadvertent errors resulting from complexity, as well as purposeful evasion, the IRS collects less in taxes each year than taxpayers actually owe. In 2001, this “tax gap” was estimated to be about \$345 billion, which was 16.3% of the total tax liability that year, although the IRS estimates it recovered about \$55 billion, leaving a net tax gap of \$290 billion. The majority of the tax gap (an estimated 57%) is attributable to underreporting of individual income taxes. Compliance rates are highest where there is third-party reporting or withholding, such as wages and salaries, and lowest where sources of income are not disclosed to the IRS, such as for some of the self-employed.

Some evidence suggests that underpayment of taxes undermines the progressivity of the tax code. The tax gap is substantially larger for business income (where underreporting is estimated at 43%) and capital income (8%), both of which are disproportionately earned by high-income households, than for labor income (1%). Moreover, the percentage of total adjusted gross income that is unverifiable because there is no third-party reporting to the IRS is substantially higher for upper- than for lower-income families, and this gap has grown in the last two decades (Table 3; this income includes such items as capital gains, income of sole proprietors and partnerships, and alimony). These data, however, are only suggestive and do not directly indicate the true impact of tax underpayment on progressivity.

TABLE 3. UNVERIFIABLE INCOME BY TAXPAYER INCOME GROUP, 1980 AND 2000 <sup>125</sup>		
Percent of adjusted gross income		
	1980	2000
Bottom 95% of taxpayers	6%	8%
Top 5% of taxpayers	19%	38%
All taxpayers	9%	18%

Closing the tax gap will be difficult and is not a fiscal elixir. Policy-makers must weigh the benefit of increased revenue against the cost of increased enforcement and more burdensome requirements and oversight for firms and individuals. Still, some specific steps can improve the situation. First, improved IRS customer service can facilitate tax paying, although this step would have only a limited impact on tax avoidance by high-income

<sup>124</sup> LEONARD E. BURMAN ET AL., *URBAN INST.*, *OPTIONS TO FIX THE AMT* 13 (2007), [http://www.urban.org/UploadedPDF/411408\\_fix\\_AMT.pdf](http://www.urban.org/UploadedPDF/411408_fix_AMT.pdf).

<sup>125</sup> Kim M. Bloomquist, *Tax Evasion, Income Inequality, and the Opportunity Costs of Compliance* 7 tbl. 3 (paper presented at the 96th Annual Conference of the Nat'l Tax Ass'n, Nov. 2003), available at <http://www.irs.gov/pub/irs-soi/bloomqp.pdf>.

households. Second, enhanced enforcement, especially for high-income taxpayers and corporations, can increase tax collections; empirical studies show that taxpayer compliance increases when the probability of being audited increases.<sup>126</sup> Third, improved reporting and withholding requirements would address the main source of noncompliance; for example, the government might require credit card companies to report how much money was charged every year at merchants using their services (though privacy issues and potential burdens on credit card firms require that this proposal be studied further), or financial institutions might be required to report the basis (that is, the original purchase price) for investments on which capital gains have been earned.<sup>127</sup> Finally, steps to simplify the tax code, as discussed above, could reduce errors, both intentional and unintentional. Taken together, if these four steps eliminated 10% of the tax gap, that would raise \$500 billion over the next decade (assuming the tax gap grows with the economy).

#### IV. CONCLUSION

In the past several decades, except for the latter half of the 1990s, the gains of our nation's growing prosperity have not been broadly shared but have rather accrued largely to those at the very top. Indeed, for the first time in our nation's history, we risk breaking that quintessential American promise that with hard work and education, each generation will have the opportunity to do better than the one that came before it. A consequence of the lack of broadly-shared growth has been an increasing protectionist backlash against global economic integration, which threatens to compound the problem. Openness to the global economy ultimately enhances economic growth, which is a prerequisite to raising living standards for American families. The relationship between rising inequality and protectionism magnifies what is at stake in trying to effect policies to secure more broad-based growth, but also presents a unique opportunity to build a consensus to do so. Along with other policies to expand social insurance programs and shore up the social safety net, at the core of any such collaborative effort should be progressive income tax reform. Progressive taxation is an effective, efficient, and near-term policy response to share the gains of America's prosperity more widely and thereby preserve support for global economic integration policies that will promote even greater prosperity in the years to come.

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<sup>126</sup> See James Alm & Michael McKee, *Audit Certainty, Audit Productivity, and Taxpayer Compliance*, 59 NAT'L TAX J. 801, 801 (2006); Joel Slemrod, Marsha Blumenthal & Charles Christian, *Taxpayer Response to an Increased Probability of Audit: Evidence from a Controlled Experiment in Minnesota*, 79 J. PUB. ECON. 455, 455-57 (2001).

<sup>127</sup> Capital gains are determined by the sale price minus the purchase price, which is not reported. Inflating the purchase price reduces the taxable gain, contributing to the tax gap. The IRS estimates that the tax gap for capital gains is \$11 billion (a 12% noncompliance rate), more than three times that for interest and dividends (\$3 billion, 4% noncompliance rate), which are subject to third-party reporting requirements.