Statement by James K. Galbraith, Lloyd M. Bentsen, Jr. Chair in Government/Business Relations and Professor of Government, The University of Texas at Austin, and Senior Scholar, Levy Economics Institute, before the Senate Finance Committee, March 8, 2011, hearing on Principles of Efficient Tax Reform.

Chairman Baucus, Senator Hatch, Members of the Committee, it is an honor for me to appear before you this morning, to discuss the fundamental principles of an efficient tax reform.

1. **Taxes and Deficits.** Let me begin by noting that the realized budget deficit is an economic outcome, not a policy choice. So long as the economy faces high unemployment, there is no fiscal formula – no combination of tax increases and spending cuts – that can make it go away.

Our present very large budget deficits arise for two reasons. First, because of the collapse of private credit, the decline of employment and activity, and therefore the fall of tax revenues in the slump and recession. This is a problem we share with the whole world, as the International Monetary Fund's staff has recently shown. Second, in the (almost unique) case of the United States, part of our budget deficit is due to the global role of the dollar and the use by the rest of the world of Treasury bonds as a reserve asset. That they do so – "exorbitant privilege" – is greatly to our advantage.

Neither of these forces can be controlled by cutting spending or raising taxes. One can reduce *projected* deficits – for future years – by raising future tax rates or cutting programmed spending for those years. But this is an artificial and unreliable exercise. The actual realized deficits in the future will depend on economic performance at that time, and it is economic performance that actually matters, not the deficit or the public debt. Thus tax reform – and spending policy as well, in my view – should properly focus on economic performance and not on deficits.

On the broader question of deficits, I am attaching for your record a brief statement by Trustees, Directors and Fellows of Economists for Peace and Security, a professional association. It affirms that the US government is not broke, that budget deficits are normal, and that our pressing priorities are related to economic performance. The statement is signed by distinguished economists including Kenneth Arrow, Andrew Brimmer, Robert J. Gordon, and Alan Blinder.

2. **Tax Incentives.** When economists address tax policy, they often speak of "distortions." The implied claim is that distortions are bad, and should be removed from the tax code as a matter of principle. You will not hear this language from me. To economists, the phrase"tax distortion" generally implies comparison is to a system with a "lump-sum head-tax" – a poll tax – because that is the only kind of tax that cannot be reduced by changing behavior. Yet the poll tax is the most regressive and pernicious tax available. In the real world, practically every other tax is plainly superior to that one.

Tax incentives are therefore an inescapable fact of life. The proper question is: which incentives work best, for which worthy objectives? And how best to reconcile the incentives in the tax code with the other function of taxation, namely the regulation of demand? Let me begin with an example.

In the years 1981 through 1984, I served first as Executive Director of the Joint Economic Committee under Chairman Henry Reuss, and then as Deputy Director under Vice Chairman Lee Hamilton. The Senate Democratic Members were Senators Bentsen, Proxmire, Kennedy and Sarbanes. In 1984, in the Joint Economic Report, we endorsed the Bradley-Kemp Tax Reform Bill. That bill later evolved into the famous Tax Reform Act of 1986.

The concept of the Tax Reform Act was to promote simplicity and fairness, without changing the overall burden or incidence, by broad income class, of the income tax. The method was to reduce or eliminate many exemptions and deductions, mainly taken by wealthy people, and then to tax the expanded Adjusted Gross Income at a lower marginal rate. The effect was to redistribute tax burdens mainly within upper-income groups, to the benefit of those who had relatively simple earned incomes (a category that had at one time included Bradley, Kemp, and also President Reagan), and to the detriment of many whose incomes were related to tax-favored activity.

President Reagan deserves full credit for adopting the Bradley-Kemp principles, which he did on the recommendation of his Treasury Department after a year of study, intended to delay consideration of the issue past the 1984 election. During that year, the Treasury tax policy office had conducted among other things an analysis of the Value-Added Tax, and had rejected that alternative for reasons that remain, in my view, valid today. Bradley-Kemp achieved an important improvement in tax fairness.

The Tax Reform Act saved the income tax. But in retrospect it had at least two problematic effects.

The first effect – and here I speak broadly of the movement toward lower top marginal tax rates from 1978 through 1986 – was on corporate executive pay. It is probably not accidental that the years after lower marginal income tax rates took hold – along with lower rates on capital gains – saw the CEO pay explosion.

Why? In part, because lower marginal rates reduced the cost to companies of raising post-tax executive pay (just as the high marginal rates had deterred big pay packages in the first place). The new rules made it irresistible for those who controlled CEO pay to reward themselves in this way. Crudely put, companies quit building skyscrapers and their chiefs built themselves mansions instead. Many ills of American corporate governance can be traced to this new age of executive self-dealing.

Second, as a political compromise, the TRA disallowed deduction of consumer interest payments except for mortgages. This led to an inexorable rise in the use of homes as collateral for loans that supported consumer, student, vacation and health-care-related spending, and therefore to the depletion of home equity as an element in the financial security of the middle class. As the process unfolded over time, it helped produce the systematic abuse of mortgage lending that became pandemic in the middle years of the last decade and that produced the financial crisis.

On the whole, there is no reason to believe that the TRA improved economic performance. The aftermath of tax reform saw the market crash of 1987 and then the recession of 1989-91, from which the economy recovered only very slowly. There were no significant increases in private savings as a share in income, nor in work effort. Thus, I do not believe that the Tax Reform Act of 1986 should be viewed today as the single ideal for the tax code going forward. In particular, a new tax reform should not make a virtue of low marginal rates. If higher taxes are needed, one of the best ways would be to impose a new rate or rates on the highest incomes. And tax reform should not aim indiscriminately at existing tax preferences for middle class Americans, some of which serve their purposes well.

For example, the Reagan years invented and the late Clinton years saw major expansion of the Earned Income Tax Credit. The EITC stabilizes the incomes of workers in the lowest-paid and hardest jobs, and protects them from unstable employment. It is invisible to employers; therefore it is likely to have little effect on the proffered wage. It is a well-designed and effective program; there is no reason to cut it just to reduce “tax distortions,” and also none to cut it for “deficit-reduction.”

Equally, the home mortgage interest deduction worked for many decades to promote home ownership in stable communities and neighborhoods. It became pathological only when it became the vehicle for all forms of lending, and when mortgage originators took advantage of the law to create massively abusive and fraudulent mortgage instruments, including exploding ARMS, NINJA loans, liars' loans, no-doc loans, and the rest. The appropriate solution is not to eliminate the tax preference for a standard 15-to-30 year self-amortizing mortgage with a substantial required down payment. It would be more sensible to write the law so that only that type of plain-vanilla, fully-documented mortgage received tax-deductible status.

3. **Bad and good incentives: the payroll tax and the estate tax**.

The payroll tax was increased sharply in 1983 and is the largest direct tax paid by most working people. It tails off, as a proportion of income, for upper-income Americans on account of the cap on earnings, and the fact that non-wage incomes are not subject to the tax. The high payroll tax rates on working people – yielding revenues which were for many years vastly higher than benefit payments under Social Security – were partly intended to shield Social Security benefits from pressures to cut them when the baby boomers began to retire. But they were also a way to shift the burden of taxes in general onto labor and away from non-labor income.

The payroll tax penalizes job creation. By extension it fosters the gray economy, welfare-dependency and crime. This was not a serious problem in (say) the late 1990s, when strong credit creation propelled us to full employment. It is a major problem today. That is why a payroll tax holiday, with the federal government holding the Social Security Trust Fund harmless, was a good idea when enacted last year. On the employee side payroll tax relief helps increase household disposable income; on the employer side it helps cash flow and to reduce the cost of job creation. There may be more efficient job-creation incentives – the TJTC comes to mind – but they are also harder to implement.

In the United States, uniquely among nations, about eight percent of all employment is in the non-profit sector. Why? In substantial part, because for over a century we have given wealthy citizens a strong tax incentive to make philanthropic gifts to universities, hospitals, churches, museums, foundations and other not-for-profit organizations, in advance of the grim reaper. This is partly responsible for our broadly excellent employment performance (compared to Europe) over many years. It is partly responsible for the greatness of our universities and hospitals, and for the vibrancy of our religious life. It integrates wealthy Americans back into their communities, helping to foster and strengthen our democracy. It fosters a broad decentralization of important public activities: for example, higher education policy decisions that in other countries are often vested in a single cabinet ministry, are here made by thousands of independent university administrations.

These benefits and advantages are threatened by the campaign against the estate tax, pushed heavily by one group of wealthy citizens, yet opposed by many other wealthy citizens. History and experience support the second group. There is a very strong incentive-based case for an estate tax with a high tax rate, a high level of exemption, and a one-hundred percent deduction for qualified philanthropic contributions.

4. Simplicity? A frequent stated concern of tax reformers is how best to simplify the code. One proposal before you would reduce the income tax for most filers and to replace it with a value-added tax. An appeal of this proposal is that it would eliminate many income tax returns. But of course, a large number of lower-income filers use the short form. This is not a complicated document, and to eliminate it does not seem to be a pressing priority in itself.

Yet, eliminating the federal income tax for low-income filers would make state government taxation much harder, since state income taxes are keyed to the federal tax. Meanwhile the proposed VAT would force a major restructuring of state sales taxes, which would have to convert to piggy-back on the VAT at variable rates, depending on the amount of income tax that would have to be replaced. This, in turn, would create new location incentives for business, to the disadvantage of high-tax states. These changes would create impressive challenges for states and localities already in the grip of fiscal crisis.

As a rule, let me urge you to work slowly. Any truly radical reform is likely to have far-reaching effects. They should be studied carefully, and by analysts with a wide range of views. Actions in this area should always be cautious and incremental, and claims of great gains over the existing system should always bear a heavy burden of proof. Things are often not so simple as they seem.

5. **Growth**? Tax reformers often promise that their proposals will favor economic growth. But there is little evidence that this has ever happened in the past. In principle, this should be no surprise. The long-run potential for economic growth depends on the growth rate of our population, the cost of natural resources, technological progress and the rate of business investment. It is very difficult for any tax reform to change these factors materially. Business investment can sometimes be stimulated by tax favors in the short-run, such as the investment tax credit. Sometimes, this is desirable policy. But a one-time increase in investment does not yield a long-term increase in the rate of growth.

Despite the tradition of hype that suffuses this topic, the most any tax law change can reasonably promise is modest improvement in economic conditions in the fairly short run. History also teaches that most of that effect comes from increasing purchasing power when it is too low – that is, from the Keynesian effect and not the supply-side effects. Tax law changes do not supply magic bullets for financial crises, nor for a period of slow technological innovation or rising costs of energy.

6. **Should we tax capital, labor – or rent**? Is it a good idea to shift the tax burden from high-income to low-income Americans, in the guise of shifting the tax burden from capital to labor, in order to promote "saving and investment"? In particular, will this create new jobs? History say not: we have been shifting this burden for decades with no appreciable effect on savings, investment or jobs.

And there is also no shortage of capital in our economy. As the economist Mason Gaffney wrote in a paper delivered to the National Tax Association in 1978: "The key to making jobs is changing the use and form of capital we already have. Tax preferences for property income, in their present and proposed forms, bias investors against using capital to make jobs, doing more harm than good."

Economists from Smith to Ricardo to Mill understood that fixed investments, however useful, do not generate many permanent jobs. What creates jobs is the revolving capital that supports payrolls. A tax policy aimed at supporting employment would shift the tax burden away from labor, and off of short-term capital, and place it instead on long-term capital accumulations. If this reduces the investment in fixed capital that is desired for other reasons – in particular, investment with broad public benefits – then that sort of investment should be done by public authority, funded by an infrastructure bank.

Thus as a general rule fixed assets – notably land – should be taxed more heavily than income. The tax on property is a good tax, provided it is designed to fall as heavily as possible on economic rents. This basic argument, going back to Ricardo, remains sensible, for it aims to not-interfere where there is, in fact, no public purpose to interfere with private decision-taking. Payroll taxes and profits taxes do interfere directly with current business decisions. Taxes effectively aimed at economic rent, including land rent and mineral rents, and at "absentee landlords" as Veblen called them, do not.

An important question is how best to treat the “quasi-rents” due to new technology and thus the incentives for innovation. These are presently held as long-term capital gains and they tend to escape tax to a very large degree, with the consequence that a small number of successful innovators (and patent holders) have become an oligarchy of never-before-equaled wealth.

The incentive for innovation is an important public policy objective. But it does not require the vast prizes presently available. And it does not require that those prizes escape tax indefinitely. A sensible approach is to tax unrealized capital gains after a certain amount of time has elapsed – perhaps at fates that rise with time – and again subject to a full charitable deduction. In the final analysis – that is to say at death – once again setting the estate tax at a high rate with a high exemption encourages the early transfer of large quasi-rents to independent foundations or other non-profit institutions (universities, hospitals, churches), and into activities consistent with public purpose. I would also favor raising required foundation payout rates, so as to assure that foundations do not last in perpetuity unless they find new donors.

7. **Energy and Carbon**. I have explained why I do not favor substituting a value-added tax for the income tax. It might however be sensible to replace the payroll tax. In view of the oncoming crises of energy security and climate change, a tax on energy or on carbon would make a good substitute for the payroll tax, especially if it were designed to hold working families harmless, while increasing the incentives for conservation facing companies, retirees, and those with non-labor incomes.

8. **Summary.** Tax law serves two broad goals: the regulation of effective demand and the pursuit of public purpose. The Tax Reform Act of 1986 was gave us an income tax structure that is viable for the long run. But its purposes are not ours. We face four pressing priorities: to create jobs, to change how we produce and use energy, to restructure our financial sector, and to curtail the pernicious power of a small number of wealthy persons – our new American oligarchs – who have taken undue advantage of past tax reforms. A shift of the tax burden away from labor, onto energy, and onto accumulated wealth – with the philanthropic escape clause – would help give us back a healthier, more egalitarian, and more democratic society in future years.

The statement by my EPS colleagues follows. I thank you again for your time and attention.

FEDERAL SPENDING AND THE RECOVERY: A Statement by Directors, Trustees and Fellows of Economists for Peace and Security, (www.epsusa.org) February 28, 2011.

The budget adopted by the House of Representatives on February 19, 2011 does not make economic sense and is likely to do more harm than good. First, the rationale for the measure is based on a false premise. Secondly, the budget cuts being proposed will impede and may end the recovery. If the recovery fails, unemployment will increase and the financial crisis could re-emerge.

The premise that the US government is broke is false. The US government has never defaulted and will not default on any of its financial obligations. Deficit spending is normal for a great industrial nation with a managed currency, and it has been our normal economic condition throughout the past century. History proves, and sensible economic theory confirms, that in recessions, increased federal spending – not balancing the budget – is the tried and true way to return to a path of sustained growth and high employment.

Eliminating waste in government spending is desirable. But that is not what the House proposes; indeed the House budget failed to address the largest waste in federal government, namely in the military, and the House failed to remove our most egregious subsidies, such as to oil companies. To adopt a policy of deep budget cuts at this stage of recovery is to surrender to irrational fears in the service of a political, not an economic, agenda.

As economists, as citizens, and as long-time critics of waste in government, we call on the Senate to reject the House proposal and to craft an alternative that places first priority on sustaining economic recovery and on dealing with the country's true economic and social problems, which include unemployment, home foreclosures, the fiscal crisis of states and cities, our infrastructure needs, energy security and climate change.

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