Fairness in Taxation

Senate Committee on Finance

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Growth, Fairness, and Economic Well Being

Chairman Hatch, Senator Wyden, Members of the Committee. It is an honor to be here today to discuss the role taxes play in promoting and broadening economic well-being in our country. It is no secret that many if not most Americans are dissatisfied with our economic performance and they have a right to be. Earnings are stagnating and people are concerned about their future and that of their children.

Ultimately our economic well-being depends on what we are able to produce. Government spending doesn't create prosperity, borrowing doesn't create prosperity, printing money doesn't create prosperity. Taking the income one person produces and giving it to another person doesn't create prosperity, it merely moves it around. As Adam Smith observed 240 years ago, the wealth of a nation is driven by its productive capacity. Society can't consume what it doesn't produce and it can't redistribute what it doesn't produce, so when we consider how policies can create widespread economic well-being that is the place we must start.

The most common measure of our ability to produce is a data series issued by the Commerce Department known as "Productivity in the Non-Farm Business Sector". It shows why we are so unhappy with our economic performance. In the last four years productivity has shown average growth of just 0.7 percent per year. That is the worst four year performance since the Carter Administration. By contrast, average productivity growth over the last three decades had been much higher and had been accelerating, averaging 1.7 percent annually in the 1980s, 2.2 percent annually in the 1990s, and 2.6 percent annually in the first decade of the 21st century. In short, our productivity growth in the last four years has only been about one third what it averaged over the previous thirty years.

In terms of living standards for the typical person in a country, productivity growth completely dominates distributional considerations over a long period of time. Consider a thought experiment I just did with my son who is now taking introductory economics. If productivity grew as slowly as it has in the last four years, output per worker today would be a bit less than 5 times what it was when George Washington was President. By contrast, if output per worker grew as quickly as it did during the previous 30 years, living standards would be almost 80 times what they were when Washington was President. That is a 16-fold difference in living standards, roughly the difference between quality of life in today's America and that of Yemen or Kyrgyzstan.

Indeed, growth wipes out distributional differences. Consider how the typical American lives today compared to George Washington. Most of us have been to Mount Vernon. Nice place. And Washington was not just in the top one percent in his day, he was probably well within the top tenth-of-one-percent. Mount Vernon has seven bedrooms and about 7000 sq. of living space. It had no bathrooms. No running water. No central heating. No air conditioning. A severely outdated kitchen that could only be accessed by going outside. I dare say that almost any family in the Fairfax County housing market today would opt for a typical home in a subdivision over Mount Vernon circa 1776. Mount Vernon would be listed as a real "fixer upper," and housing is just the start of it. Washington died at 67, more than a decade before a typical male today. He had dentures made of wood – and doubtless suffered from tooth aches regularly. He traveled a lot for a man of his day, but never overseas, and probably put on in his lifetime fewer miles on horseback than a typical person puts on their car in a year. Not a lot of fresh fruits and vegetables in his diet during much of the year. Obviously no electronics. The simple fact is that the typical American today lives far better than George Washington did.

Why is that? Although there has been some reduction in inequality since that time, the reason a typical American lives better than Washington did is productivity growth, not redistribution. Over the history of the Republic growth has probably been quite a bit better than in the last four years, but probably not as good as the previous thirty. Real per capita incomes are probably up by a factor of about 40 implying real productivity growth of about 1.7 percent per year. But as a result, a median family today, or even one well below median, lives far better than someone who was in the top one tenth of one percent when the country was founded.

This is a critical point. An overemphasis on redistribution at the expense of economic growth and economic dynamism and entrepreneurship is severely misplaced if what one really cares about is the well-being of the typical citizen of the country both today and in the future. As our Founding Fathers said when they wrote the Constitution, our purpose is to "secure the blessings of liberty for ourselves and our posterity." It provides a basic lesson in tax design. In the short run an emphasis on fairness is at best a zero sum game. In the long run, policies that promote economic growth are almost invariably the ones that help the typical individual the most.

There is a second reason why an overemphasis on redistribution as the goal of tax policy is a mistake: history suggests that it is not very successful even at achieving the narrow goal for which it is intended. Let us consider the historical record. Although a lot of political rhetoric is expended talking about redistribution, neither political party has been particularly effective at fostering policies that make American income distribution more equal. Chart 1 shows the change in three measures of income inequality used by the Department of Commerce to give a summary statistic of the state of income inequality in America. In all cases a positive number indicates a more unequal distribution of income over that Presidential term. Note that by most

measures, income inequality has risen under every President for half a century, most rapidly under President Clinton, increasing more during his eight years than the eight years of President Reagan and the eight years of President Bush combined. And, in President Obama's first term income inequality rose as much or more than it did during both of President Bush's two terms combined. Rising income inequality was not the intent of any of these Presidents; it just has not been something that has proven very tractable to public policy. If anything, the historical record suggests that a political preoccupation with redistribution is associated with a rise in income inequality, not a reduction.

In fact, data from the Census Bureau suggests that inequality has risen quite sharply in the last few years despite an enormous increase in the attention of the political process to the problem. The ratio of the income of a family in the 95th percentile relative to the median has risen to a new historic record in the last six years, from 3.58 to 3.78. The ratio of the income of a family in the 95th percentile relative to a family in the 20th percentile has risen even more, from 8.69 to 9.38, also an historic record. The share of income receive by the top 5 percent has risen from 21.5 percent to 22.3 percent over the same time frame. Yet, I cannot remember a period in my life when so much political effort and legislation was devoted to the topic of inequality.

Chart 2 shows how much more progressive income taxation has become since 1980. The first column shows the share of income received by the top 5 percent of the income distribution according to the Department of Commerce. The second column shows the share of income taxes that they pay. Note that both columns have grown. The share of income received by the top 5 percent has risen a little over 5 percentage points in the last 30 years. The share of income taxes paid by the top 5 percent has risen a bit more than 20 percentage points over the same time. The third and fourth columns compare the taxes paid and income received by the top

5 percent and by the other 95 percent of households. In 1980, for example, the share of taxes paid by the top 5 percent of the income distribution was roughly 2 1/4 times their share of the income they received. For the remaining 95 percent, the share of taxes they paid was about ¾ their share of income. Thus, by comparing these ratios we get a sense of how much the average taxes paid by the top 5 percent compares with the share of taxes paid by everyone else. In 1980 the top 5 percent paid about three times what everyone else paid in terms of their share of income. By 2010, the share of taxes relative to the share of income for the top 5 percent had risen to about 2 ¾ while the same ratio for everyone else had fallen to about ½. This means that by 2010 the relative tax burdens had risen from 3 times to 5 ¼ times.

The chart is illustrative for two reasons. First, the top marginal tax rate generally declined during that period. It was 70 percent in 1980 and fell to just over 35 percent by 2010. Despite this, the share of taxes paid by the top 5 percent rose consistently, and it also rose consistently faster than their share of income. Second, despite an ever increasing share of income taxes being paid by the top 5 percent, income inequality continued to rise. In other words, higher taxes are simply not an effective means of leveling out the income distribution. I suspect that when the data come out for 2015 the trend will have continued. The average tax rate on higher earners will have risen relative to others as will have their share of income. The policies of the last few years have been ineffective at best, and possibly counterproductive, at producing a more equal distribution of income.

The other important indicator about the inability of government policy to affect income distribution is that income inequality has risen despite a massive increase in the share of income that government redistributes. Consider the third chart in this presentation. It shows the shares of personal income that come from government transfer payments to individuals and the share of

income coming from what the national income accounts call property income – interest and dividends. Despite the indications of rising income inequality over the last half century or so, the share of personal income coming from transfer payments has roughly tripled, from six cents on the dollar to eighteen cents on the dollar. It is almost incomprehensible that one can move a full twelve percent of income around in an effective matter and not make income distribution more equal if that is the intent. The other line on the chart shows the share of income that is property income. That shows a more complicated pattern, rising until 1980 and then falling after 1990. Today transfer payments are a more important source of personal income than are interest and dividends, an enormous change. If anything, the decline in property income relative to transfers makes the failure of redistributionist policies even more compelling. Politically inspired policies may sound good rhetorically on the evening news, and certainly promote a narrative the news media finds compelling, but the success of this rhetoric or the policies they advance is not borne out by the facts.

In conclusion, I would leave this committee with three points. First, rising income inequality probably cannot be successfully addressed through the tax code or through other intentional redistributionist policies. Second, the best way to increase the well-being of the typical citizen is to focus on productivity and economic growth, not on redistribution. Finally, I would strongly urge this Committee to focus on the simplification of taxation. Complex taxation neither promotes economic growth nor redistributional objectives. Those with the greatest resources have the greatest ability to promote complexity and to exploit it once legislation is passed.

Thank you and I would be happy to answer any questions.

Chart 1

Neither Party Has Reduced Income Inequality

Presidency		Change in GINI Coefficient	Change in Mean-Log Coefficient	Change in Theil Coefficient
Nixon/Ford -	8 years	+ 0.012	+ 0.005	- 0.002
Carter	4 years	+ 0.005	+ 0.014	+ 0.003
Reagan	8 years	+ 0.023	+ 0.026	+ 0.040
Bush - 41	4 years	+ 0.007	+ 0.015	+ 0.019
Clinton	8 years	+ 0.029	+ 0.074	+ 0.081
Bush - 43	8 years	+ 0.004	+ 0.051	- 0.006
Obama	4 years	+ 0.011	+ 0.045	+ 0.025

Source: US Dept. of Commerce, The Lindsey Group, See Also Lindsey *The Growth Experiment Revisited* (2013) p. 208

Chart 2

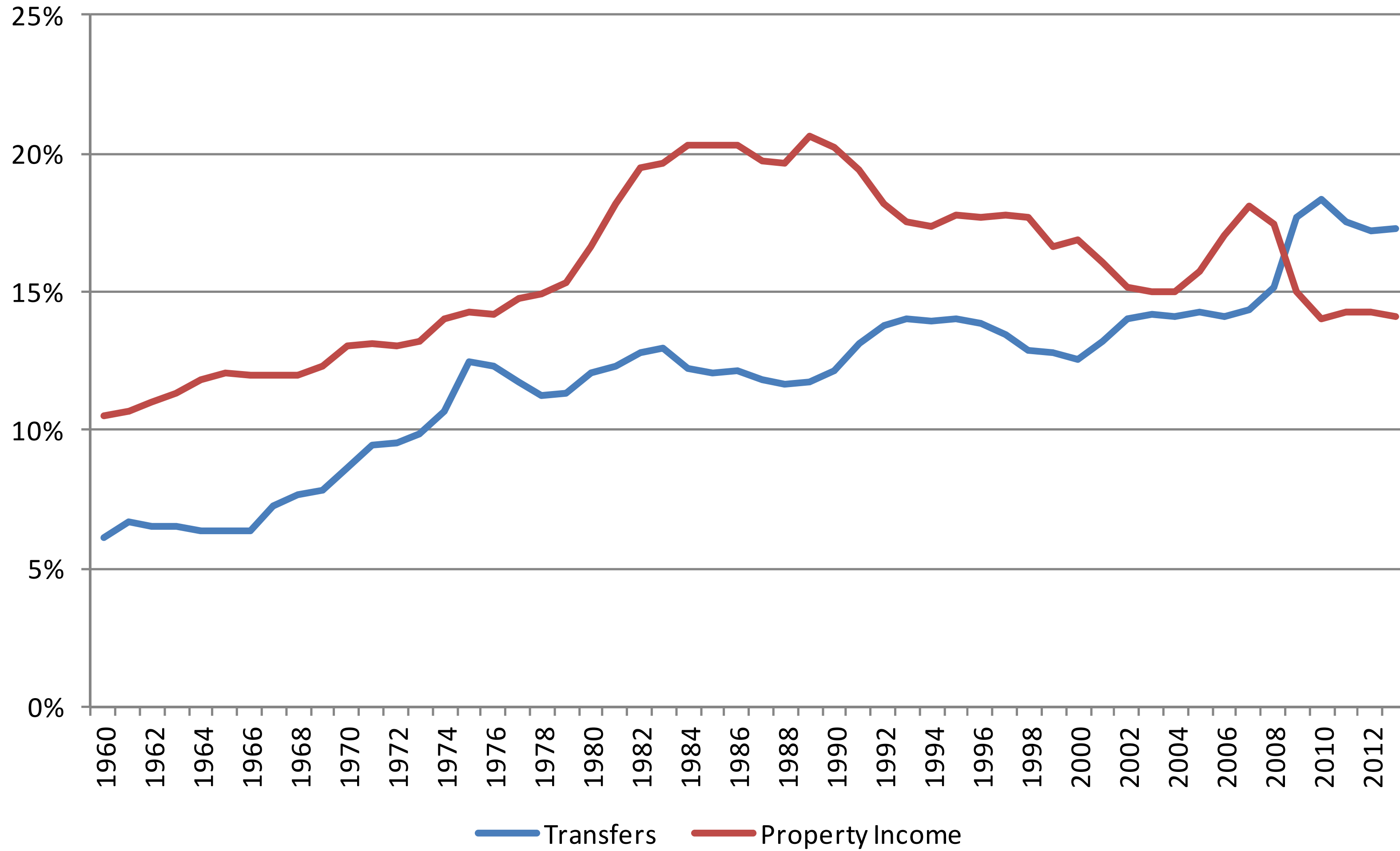
Share of Taxes Paid by Rich Rose Faster Than Their Share of Income

	Top Five Percent		Tax Share / Income Share		Ratio of Tax/Income
	Share of Income	Share of Income Tax	Top 5%	Everyone Else	Shares Top/Bottom
1980	16.5	36.9	2.24	0.76	2.95
1990	18.5	43.6	2.36	0.69	3.42
1995	21.0	48.9	2.33	0.65	3.58
2000	22.1	56.4	2.55	0.56	4.55
2005	22.2	58.9	2.65	0.53	5.00
2010	21.7	59.1	2.72	0.52	5.23

Source: Bureau of Census, Internal Revenue Service

Chart 3

Transfer Payments Now Bigger Than Capital Income



Source: Bureau of Economic Analysis