

Taxes

 lanekenworthy.net/taxes

Lane Kenworthy, *The Good Society*
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Hardly anyone loves taxes. Yet most of us recognize that, as Oliver Wendell Holmes once put it, taxes are the price we pay for a civilized society.¹ We want a government that performs a variety of services, and in order to have one we need to fund it. Moreover, as societies get richer, citizens tend to be willing to allocate more income to ensure economic security and to enhance fairness and opportunity for the less advantaged. That means government spending, and hence taxes, will tend to rise over time.

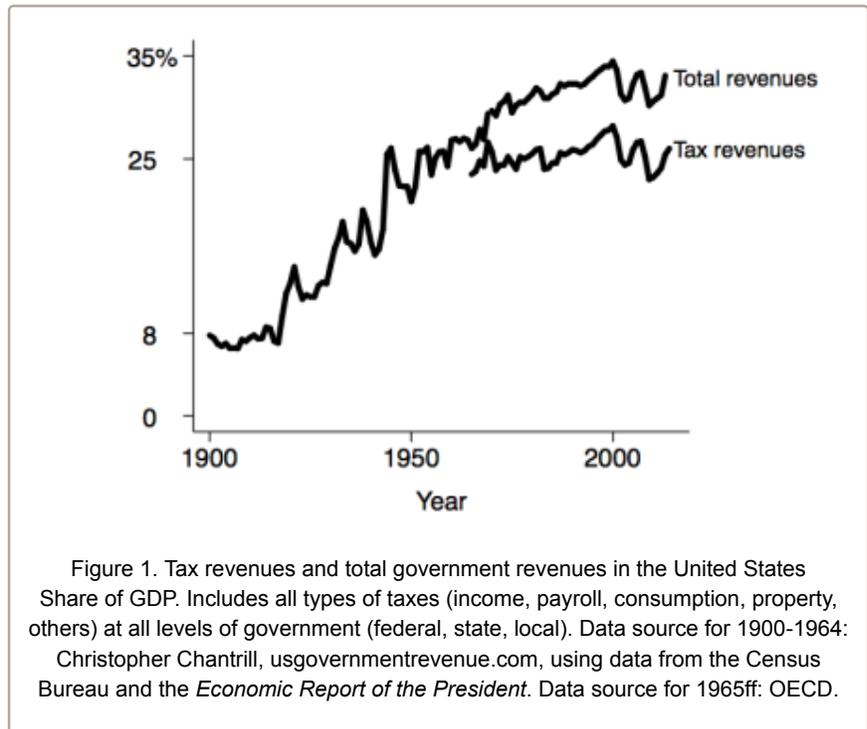
How much do Americans pay in taxes? Through what types of taxes is the money raised? Do taxes reduce income inequality? Do they harm the economy? If the US were to increase taxes, what would be the best way to do it?

TAX REVENUES

Figure 1 shows tax revenues and overall government revenues in the United States since 1900. With the introduction of the federal income tax in 1913, government revenues began a steady rise, from 8% of GDP to a peak of 35% in 2000. Since then they have been flat. Tax revenues, meanwhile, have hovered around 25% of GDP for the past 50 years.

How does the US compare to other affluent nations? Figure 2 shows trends in tax revenues since the mid-1960s. Half a century ago America's taxation level was in the middle of the pack. It's now at the bottom.

Despite the country's comparatively low tax level, and despite the fact that that level hasn't changed for the past 50 years, a majority of Americans say they'd like to pay less, as figure 3 shows. Virtually none feel they currently pay too little.



Why Did Tax Revenues Rise in

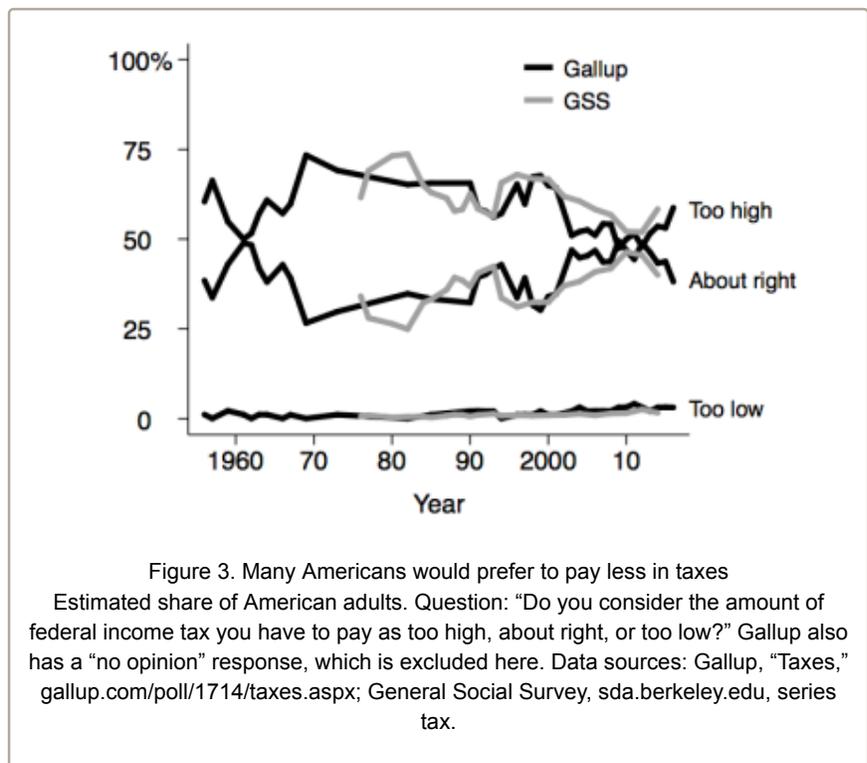
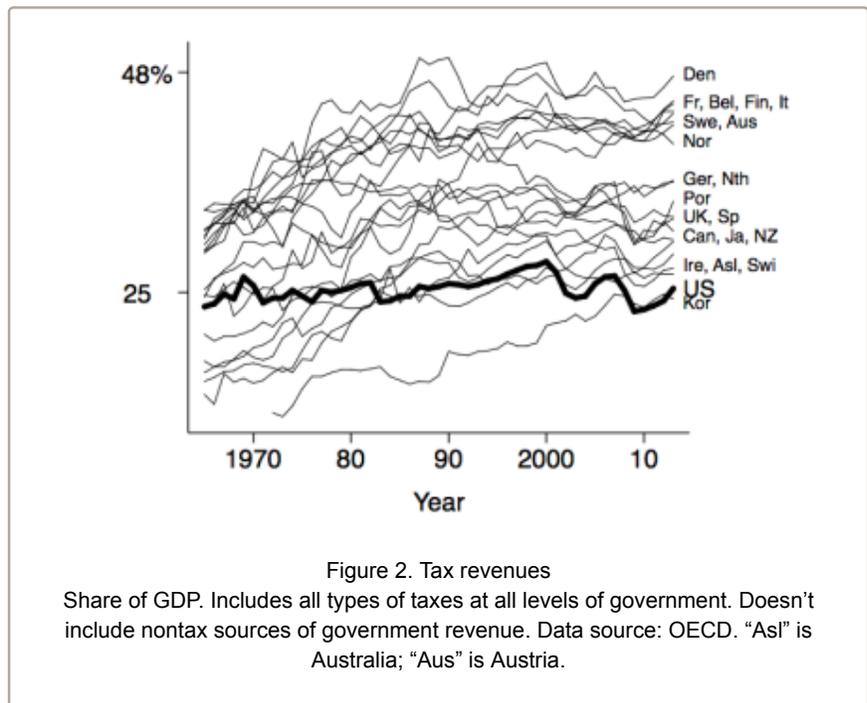
Most Rich Countries in the 1960s, 1970s, and 1980s?

Among the world's affluent nations, tax revenues rose from 26% of GDP in 1965, on average, to 35% in 1990. The percentage point increase in Belgium, Denmark, Finland, France, Norway, and Sweden was about twice as large as in Australia, Canada, Japan, New Zealand, Switzerland, and the United States. Why did tax revenues rise during this period, and why did they grow more rapidly in some countries than in others?

One obvious possibility is that the quantity of revenues raised is determined by the quantity of government spending a country wants — that to spend is to tax. As the rich nations expanded public insurance programs during this period, they increased taxation in order to pay for it.

An alternative hypothesis holds that a country's ability to increase revenue depends on its tax mix. The nations that expanded taxation most rapidly in the 1960s, 1970s, and

1980s, in this view, were able to do so by relying on increases in consumption and payroll taxes rather than income taxes.² Taxes on consumption and payroll may be less visible to citizens — they tend to be paid in small increments, and there is no end-of-the-year settling up where we see the grand total — so they generate less political opposition. Also, income taxes may be more vulnerable than consumption and payroll taxes to cross-national competition. That is particularly true for corporate income taxes, since firms are more mobile than people, but individuals too are thought to be more likely to decamp in search of a lower income tax rate than a lower tax rate on



consumption or payroll.³

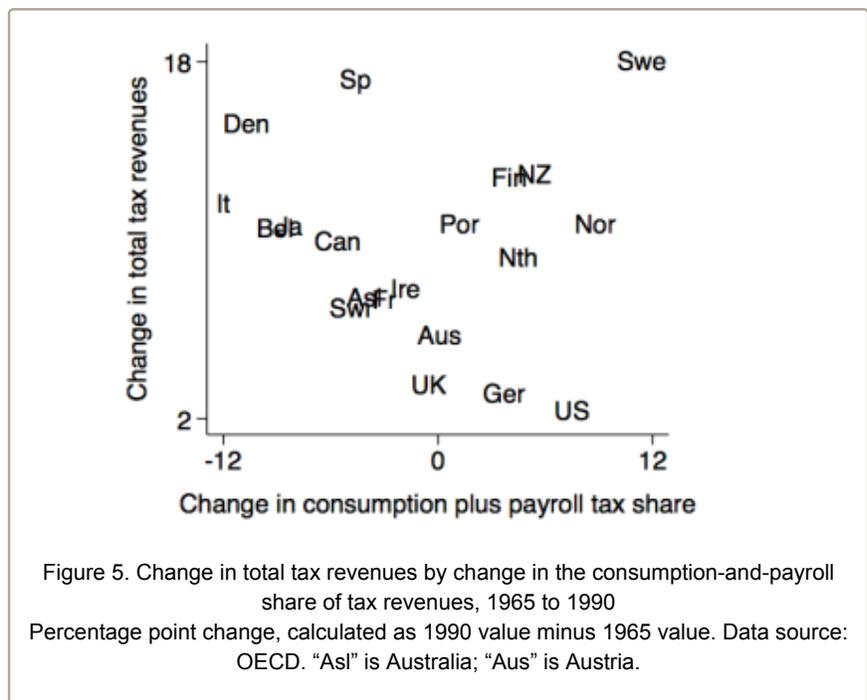
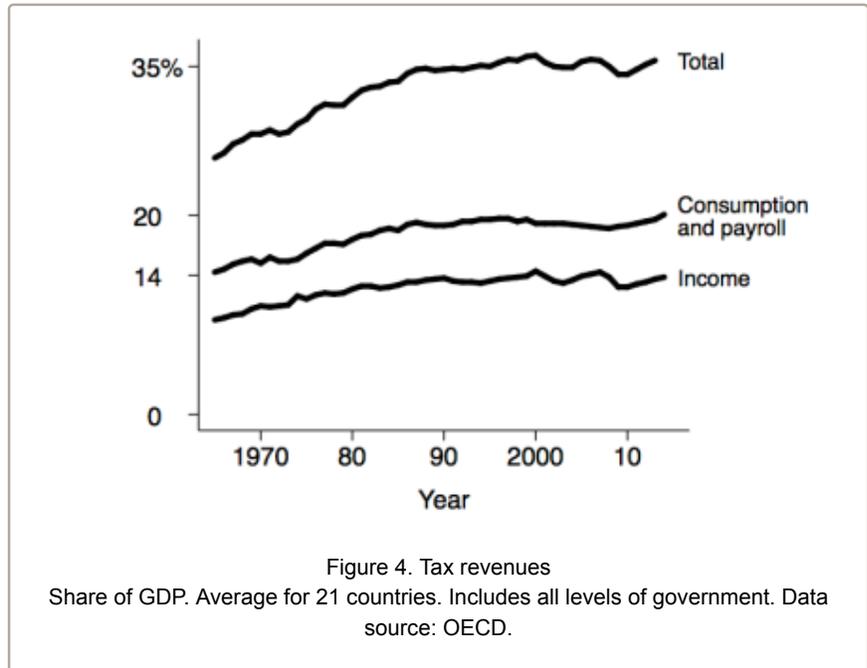
Figure 4 shows over-time trends in total tax revenues, income tax revenues, and consumption-plus-payroll tax revenues in the rich longstanding democracies. Contrary to the prediction, income tax revenues increased at about the same pace as revenues from consumption and payroll taxes.

Figure 5 offers another way to assess the hypothesis that consumption and payroll taxes were the key to expanded tax revenues in the 1960s, 1970s, and 1980s. If the hypothesis is correct, countries that increased tax revenues as a share of GDP during that period should exhibit a rising share of total tax revenues that come from consumption and/or payroll taxes. That's not, however, what we see in the data. Sweden conforms to the prediction: consumption and payroll taxes rose significantly as a share of its tax revenues (horizontal axis), and its increase in total tax revenues was quite large (vertical axis). But Sweden is the exception, not the rule.

Together, figures 4 and 5 tell us that rising income taxes were as important as consumption and payroll taxes in facilitating the increase in tax revenues in the world's affluent nations in the 1960s, 1970s, and 1980s.⁴

Why Have Tax Revenues Been Flat Since 1990?

Since 1990, tax revenues (as a share of GDP) in virtually all rich democracies have barely budged. After rising steadily for much of the twentieth century, and particularly in the 1960s, 1970s, and 1980s, they



suddenly came to a standstill. Why?

Unions and left (labor, social democratic, socialist) political parties were a key reason why government spending, and therefore taxation, grew more rapidly in some nations than in others leading up to the 1990s.⁵ They are less likely to be a major determinant of why taxation stopped rising, because union strength and the political influence of left parties continued to vary sharply across countries whereas the flatlining of tax revenues happened in nearly all.

The 1980s commenced an ideological shift among parties on the right, led by the Thatcher government in the UK and the Reagan administration in the US, in favor of aggressive tax reduction. Before long, a number of center-left parties had altered their thinking about the size of government. In the United States, the Democratic president Bill Clinton declared in 1996 that “the era of big government is over.” Yet here too, we observe considerable cross-country variation. To note just one example, the Blair and Brown governments in the United Kingdom, often viewed as kindred “third way” or “neoliberal” spirits to the Clintonites, oversaw a significant expansion of government spending during their three terms in office between 1997 and 2010. And in the United States tax revenues had already stopped rising by the mid-1960s, long before the Democratic Party’s neoliberal turn.

Public opinion shifted against further increases in taxation in some countries, and antitax social movements cropped up. In the United States, a revolt against property taxes succeeded in passing state-level referendums or legislation limiting such taxes. But this, too, varied significantly across countries.⁶

The most important cause of the nearly-universal flatlining of tax revenues beginning around 1990 may be financial globalization — the growing ability of firms and individuals to move their money from their home country to one with lower taxes. This significantly increases the possibility of gradual or rapid capital flight. In response, nearly all rich countries have reduced income tax rates (see below), though most have offset this by also reducing tax deductions and loopholes (“broadening the tax base”).⁷

TAXES’ EFFECT ON THE DISTRIBUTION OF INCOME

It’s helpful to think about the distribution of income in two stages. One is the distribution of wages and other sources of “market” income. The other is government redistribution. Taxes can play a role in both.

Taxes and Redistribution

Taxes can contribute to income redistribution in two ways. The first is direct: if the tax system is progressive, the posttax distribution of income will be less unequal than the pretax distribution. The second is indirect: tax revenues provide the funds for government transfers, and if more of those transfers go to the poor than to the rich, they will reduce income inequality.

Let’s begin with taxes’ direct redistributive effect. If households with high pretax incomes pay a

larger share of their income in taxes than do those with low incomes, we call the tax system “progressive.” If the rich and poor pay a similar share of their incomes, the tax system is termed “proportional.” If the poor pay a larger share than the rich, the tax system is “regressive.”

Income taxes almost always are progressive; those with higher incomes pay at higher rates. Deductions and exemptions reduce the degree of progressivity, but they don’t eliminate it. Consumption taxes and payroll taxes usually are regressive.⁸ Typically they are levied at a flat rate, which in principle should make them proportional. But the poor (by necessity) tend to spend a larger share of their income than the rich, which means a larger share of their income is subject to consumption taxes. And payroll taxes often are capped, with earnings above the cap not subject to the tax. This means a larger portion of the earnings of low and middle earners is subject to payroll taxes.

Most studies of taxes’ direct effect on the distribution of income use data that don’t, unfortunately, include the top 1%. These data provide us with information about the effect of taxes on income distribution within the bottom 99%. What they tell us is that, for this group, taxes tend to have little direct impact on the distribution of income. Figure 6 shows the reduction in the Gini coefficient for income achieved by income and payroll taxes in twelve countries. In most of these countries taxes achieve only little direct income redistribution. And the amount they achieve is overstated in this figure, because the data don’t include consumption taxes, which are regressive.⁹

Transfers, by contrast, do achieve considerable reduction in income inequality, albeit less in the United States than in nations such as Sweden and Denmark.¹⁰

Countries achieving the most redistribution do so mainly via transfers. And they do so with a large volume of transfers, rather than with transfers that are heavily targeted to the poor.¹¹ In order to transfer large quantities of income, a government needs a large quantity of tax revenues. Figure 7 shows that there is a strong correlation between tax revenues as a share of GDP and the amount of redistribution a nation achieves via government transfers.

Rich nations have discovered that in order to get a large quantity of tax revenues, it’s best to tax everyone — not just the rich — fairly heavily. That’s partly because a not-too-progressive tax system will generate less political opposition from the rich, and it’s partly due to the need to go where the money is. So the rich nations that redistribute the most tend to have relatively proportional tax systems and high tax rates. This generates a large volume of tax revenues, which is used to fund a large volume of transfers, and those transfers accomplish the bulk of the income redistribution.¹²

Do we see an effect on the level of income inequality? Or is inequality mainly a function of the “market” distribution, with redistribution having just a minor impact? As figure 8 shows, countries with higher taxes revenues do indeed tend to have lower levels of income inequality.

As noted earlier, the estimates of redistribution and income inequality in figures 6-8 leave out the top 1% because the data come from household surveys, which “topcode” the information they get

about incomes. Would the picture change if the top 1% were included? Are top incomes taxed at a much higher rate, increasing the progressivity of the tax system?

Figure 9 suggests that the answer probably is “no.” It shows average effective tax rates in the United States at various points along the pretax income distribution, including the top 1%. (An “effective tax rate” is calculated as taxes paid divided by pretax income.) These tax rates include all types of taxes at all levels of government. The top 1% pay about 33% of their pretax income in taxes — about the same as others in the top quintile. The overall tax system is progressive, though only mildly so.

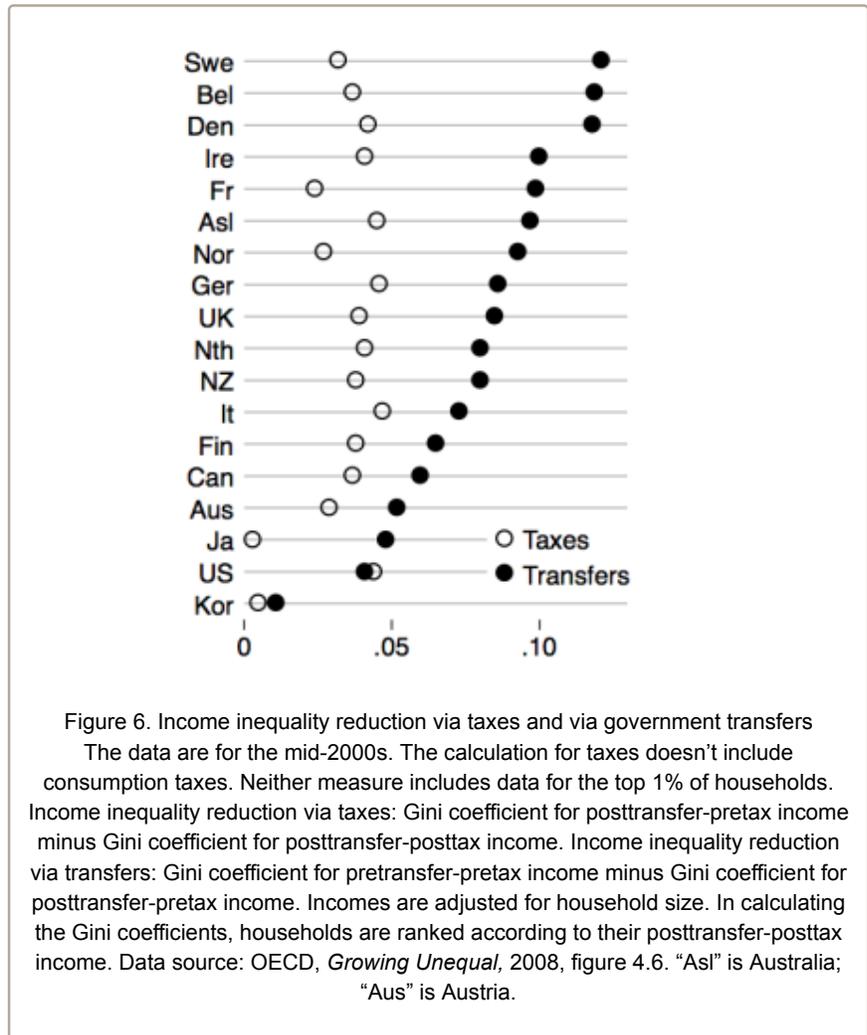


Figure 6. Income inequality reduction via taxes and via government transfers
 The data are for the mid-2000s. The calculation for taxes doesn't include consumption taxes. Neither measure includes data for the top 1% of households. Income inequality reduction via taxes: Gini coefficient for posttransfer-pretax income minus Gini coefficient for posttransfer-posttax income. Income inequality reduction via transfers: Gini coefficient for pretransfer-pretax income minus Gini coefficient for posttransfer-pretax income. Incomes are adjusted for household size. In calculating the Gini coefficients, households are ranked according to their posttransfer-posttax income. Data source: OECD, *Growing Unequal*, 2008, figure 4.6. "Asl" is Australia; "Aus" is Austria.

Figure 10 gives us another way to answer the question. It shows the difference between the top 1%'s pretax income and its posttax income in the United States. The difference has been relatively small throughout the past several decades, suggesting, consistent with the picture in figure 8, that taxes on the top 1% do relatively little redistributive work.

What about cross-country differences in tax progressivity with the top 1% included? Unfortunately, for most other rich nations we don't have comparable data. But figure 11 shows a somewhat-comparable set of effective tax rates for Sweden. The main source of noncomparability is that these Swedish rates leave out consumption taxes, which are sizable in Sweden and thus an important omission.

To help with comparability, I include another set of effective tax rates for the United States that leaves out state and local taxes such as consumption (sales) taxes. For the US, the effective tax rates that include consumption taxes (black dots) are much less progressive than those that don't include consumption taxes (gray dots). From this we can infer that Sweden's tax system probably is a good bit less progressive than the rates shown here imply.

Given this, the data in figure 11 suggest that effective tax rates in Sweden are higher across the board than in the United States and that Sweden's tax system is less progressive. This is consistent with the picture painted by the household survey data that don't include the top 1%.

Taxes and the Pretax Income Distribution

Taxes can influence the "market" distribution of income too. One prominent hypothesis suggests that when top statutory income tax rates are lower, those at the top have greater incentive to try to maximize their income. They may do so by working harder or smarter, or perhaps by grabbing more "rent."¹³

Figure 12 shows over-time trends in the United States for the top statutory federal income tax rate and the top 1%'s share of pretax income. Consistent with the hypothesis, the trends tend to move in opposite directions. In the 1920s the top tax rate decreased and the top 1%'s income share shot up. The top tax rate rose sharply between 1929 and 1945, and the top 1%'s income share fell sharply. From 1979 to 2007, the top tax rate decreased a good bit and the top 1%'s income share jumped. The correlation is -.68.

But there are notable exceptions. The 1963 Kennedy tax reform reduced the top statutory tax rate

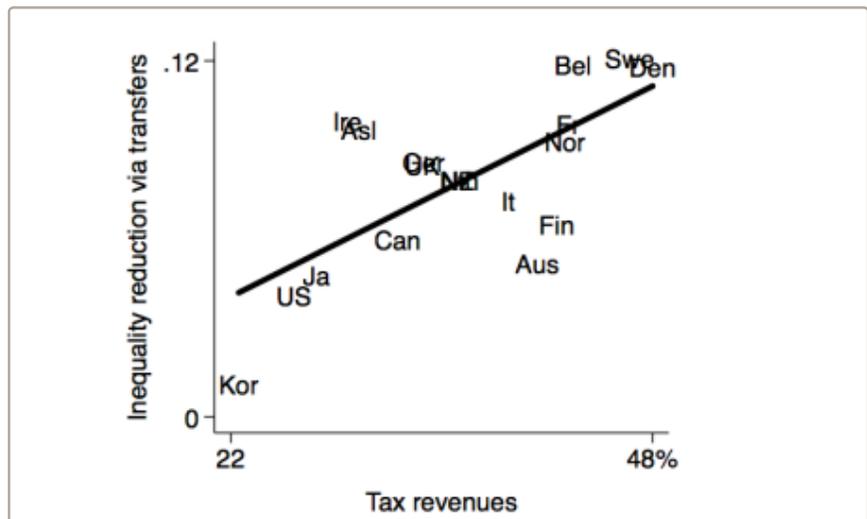


Figure 7. Income inequality reduction via government transfers by tax revenues. The data are for the mid-2000s. The line is a linear regression line. Tax revenues: Share of GDP. Includes all types of taxes at all levels of government. Data source: OECD. Income inequality reduction via transfers: Gini coefficient for pretransfer-pretax income minus Gini coefficient for posttransfer-pretax income. Incomes are adjusted for household size. In calculating the Gini coefficients, households are ranked according to their posttransfer-posttax income. Doesn't include the top 1% of households. Data source: OECD, *Growing Unequal*, 2008, figure 4.6. The correlation is +.69. "Asl" is Australia; "Aus" is Austria.

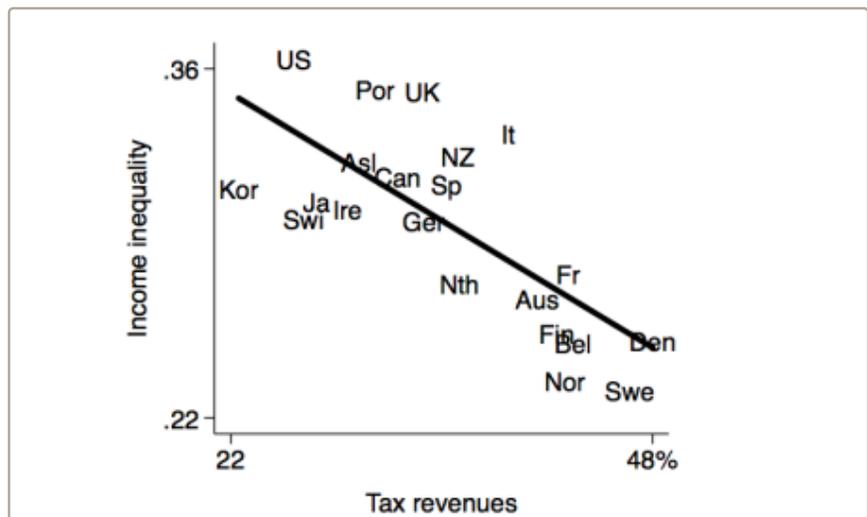


Figure 8. Income inequality by tax revenues. The data are for the mid-2000s. The line is a linear regression line. Tax revenues: Share of GDP. Includes all types of taxes at all levels of government. Data source: OECD. Income inequality: Gini coefficient for posttransfer-posttax income. Incomes are adjusted for household size. Doesn't include the top 1% of households. Data source: Standardized World Income Inequality Database. The correlation is -.73. "Asl" is Australia; "Aus" is Austria.

from 90% to 70%, yet the top 1%'s pretax income share continued its slow, steady post-World War II decline. In the early 1990s the (first) Bush administration and the Clinton administration increased the top tax rate from 28% to 40%, yet the top 1%'s market income share continued its sharp post-1979 rise.

Carola Frydman and Raven Molloy have looked closely at whether compensation for top executives in large US firms changes in response to shifts in top statutory tax rates. Drawing on data going back to the 1940s, they find no noteworthy correlation between top tax rates and executive compensation.¹⁴

What does the cross-country pattern tell us? Figure 13 shows the top 1%'s pretax income share as of 2007 by the average top statutory income tax rate over the years 1979 to 2007. As predicted, there is a negative association: the share of income going to the top 1% is lower in nations with higher top statutory tax rates.

Yet there are many other contributors to the cross-country variation in top-end income inequality. One way to get closer to identification of a true causal effect is to examine changes in top tax rates and changes in top income shares. All of these countries reduced top income tax rates during this period, but they differed significantly in the *degree* of reduction. Did the nations with larger decreases in top tax rates experience larger increases in their top 1%'s income share? As figure 14 indicates, the answer is “yes.” But here the

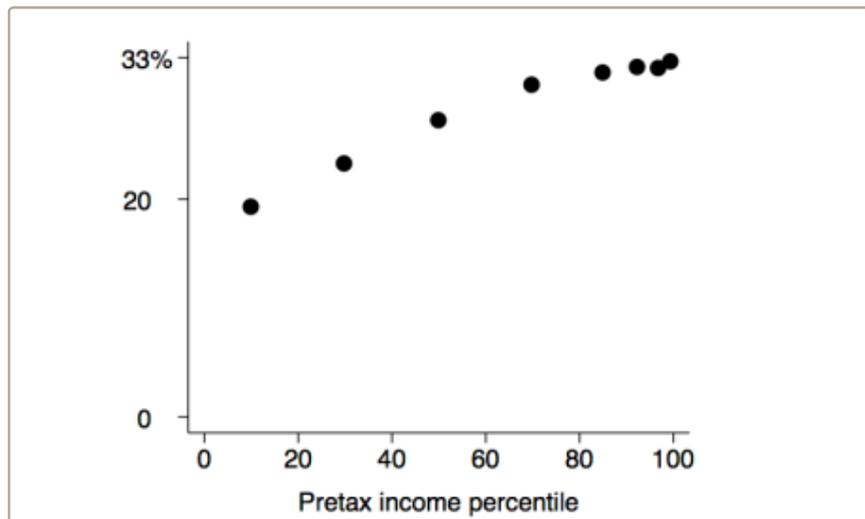


Figure 9. Effective tax rates, United States
Taxes paid as a share of pretax income. The tax rates are averages for the following groups: p0-20, p40-60, p60-80, p80-90, p90-95, p95-99, p100 (top 1%). Includes all types of taxes (personal and corporate income, payroll, property, sales, excise, estate, other) at all levels of government (federal, state, local). The data are for 2015. Data source: Citizens for Tax Justice, “Who Pays Taxes in America in 2015?”

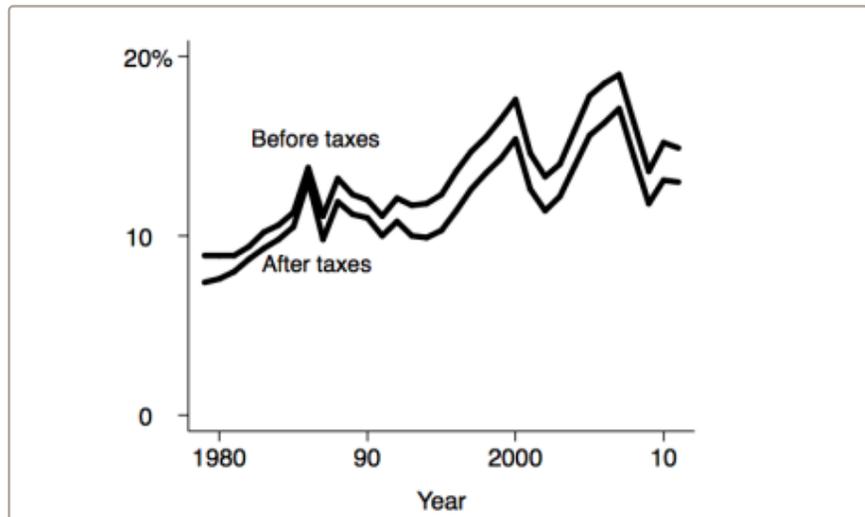


Figure 10. Top 1%'s income share before and after federal government taxes, United States
Includes capital gains. Federal taxes only; does not include state and local tax payments. Data source: Congressional Budget Office, “The Distribution of Household Income and Federal Taxes, 2011,” data set, alternative income definition, worksheet 13.

association is weaker, especially if the US is excluded. Of particular note is that four English-speaking countries — the US, the UK, Canada, and Australia — are among those with largest increase in the top 1%'s income share even though only one of them, the United States, enacted very large tax rate reductions.

Why isn't the association stronger? Part of the reason, surely, is that statutory tax rates aren't necessarily a good proxy for effective tax rates. Hiding behind statutory rates are an assortment of loopholes, deductions, and "tax expenditures." These reduce the effective tax rate on persons or households with high incomes by shielding some, potentially much, of their pretax income from taxation. Warren Buffett's famous discovery that he pays a lower effective federal income tax rate than his office staff illustrates the point.¹⁵

Figure 15 gives a sense of this, for the US case. It shows the top statutory federal income tax rate along with the effective federal tax rate paid (on average) by the top 1% of taxpayers. The top statutory rate dropped sharply in the early 1960s and in the 1980s. The 1%'s effective rate fell too, but far less.

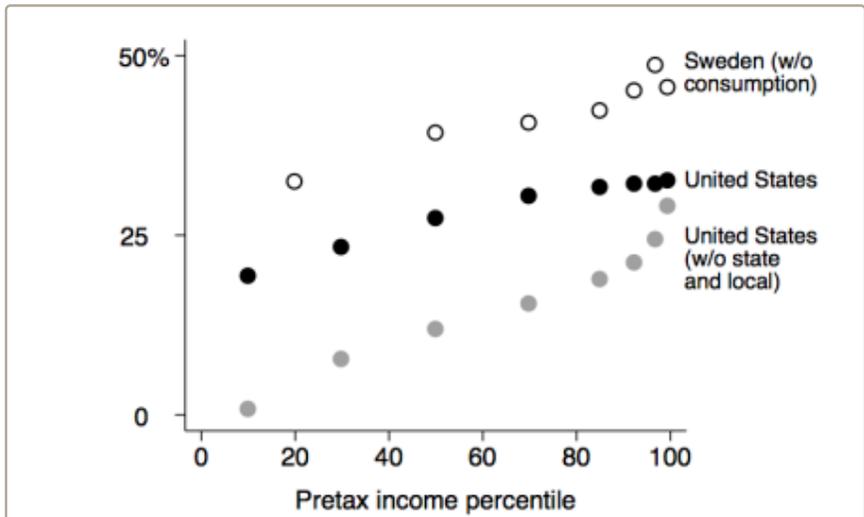


Figure 11. Effective tax rates, United States and Sweden
 Taxes paid as a share of pretax income. The tax rates are averages for the following groups: p0-20 (US only), p0-40 (Sweden only), p40-60, p60-80, p80-90, p90-95, p95-99, p100 (top 1%). United States data: 2015. Includes all types of taxes (personal and corporate income, payroll, property, sales, excise, estate, other) at all levels of government (federal, state, local). Data source: Citizens for Tax Justice, "Who Pays Taxes in America in 2015?" United States (w/o state and local) data: 2011. Includes federal personal and corporate incomes taxes, payroll taxes, and federal excise taxes. Data source: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2011," data set, alternative income definition, worksheet 13. Sweden (w/o consumption) data: 2009. Excludes consumption taxes. Ages 20-64 only. Data source: Niklas Bengtsson, Bertil Holmlund, and Daniel Waldenström, "Lifetime versus Annual Tax and Transfer Progressivity: Sweden, 1968-2009," 2014, table 1.

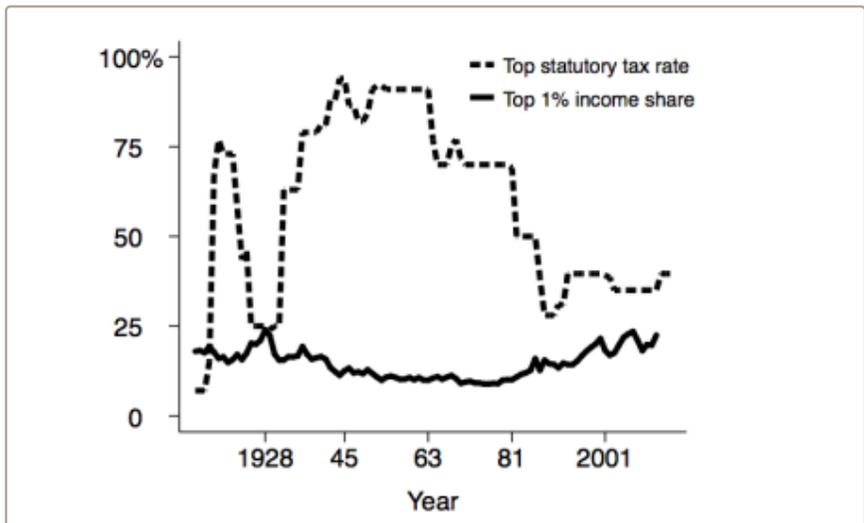


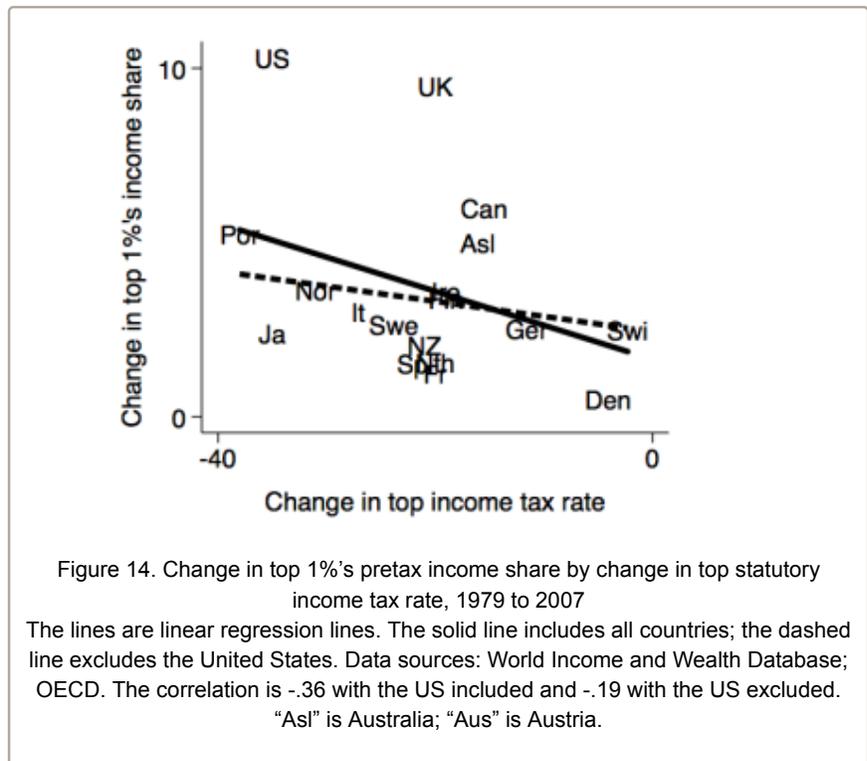
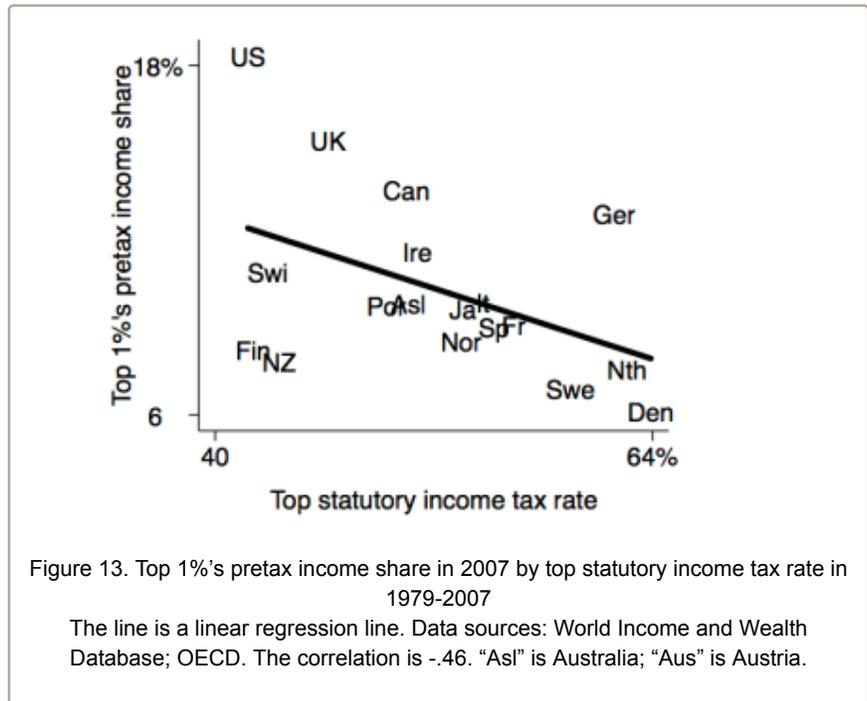
Figure 12. Top statutory income tax rate and the top 1%'s income share, United States
 Data sources: *Economic Report of the President*; World Income and Wealth Database.

Another reason why the association in figure 14 isn't especially strong may be that other institutions affect the degree to which those at the top are able to grab more income in response to lower tax rates. This might help account for why the large 1963 Kennedy tax cut had little or no impact on the top 1%'s income share: perhaps unions or large-firm norms were strongly opposed to high compensation levels for executives, so CEOs who wished to sharply increase their compensation were unable to do so.

If the top statutory tax rate does affect pretax income inequality between the top 1% and the bottom 99%, does that carry over to posttax inequality? The answer is likely to be yes over time in the United States, as the trend in posttax top-end inequality, shown in figure 10 above, has been driven almost entirely by the trend in pretax inequality. For understanding cross-country differences, we have no way to judge, as comparable data aren't available.

TAXES' EFFECT ON THE ECONOMY

A key worry about taxation is that it weakens the financial payoff to work effort, investment, innovation, and entrepreneurialism, and may thereby reduce economic growth. Yet the experience of the world's rich countries over the past century suggests little if any negative impact of higher taxes on growth performance.¹⁶



Peter Lindert has suggested that this may be a function of the tax mix. Countries with higher tax revenues may rely disproportionately on consumption taxes, and these, he says, create less in the way of investment and work disincentives than do taxes on individual and corporate income.¹⁷ Can we see this effect in the cross-country data? Figure 16 plots (catchup-adjusted) economic growth from 1979 to 2007 by consumption taxes' share of total tax revenues. Ireland appears to fit the hypothesis nicely, but Ireland's growth experience during these three decades was exceptional in so many respects that attributing it to the country's tax mix would be dubious. If Ireland is discounted we see no association. The same is true if the quantity of total tax revenues is controlled for.

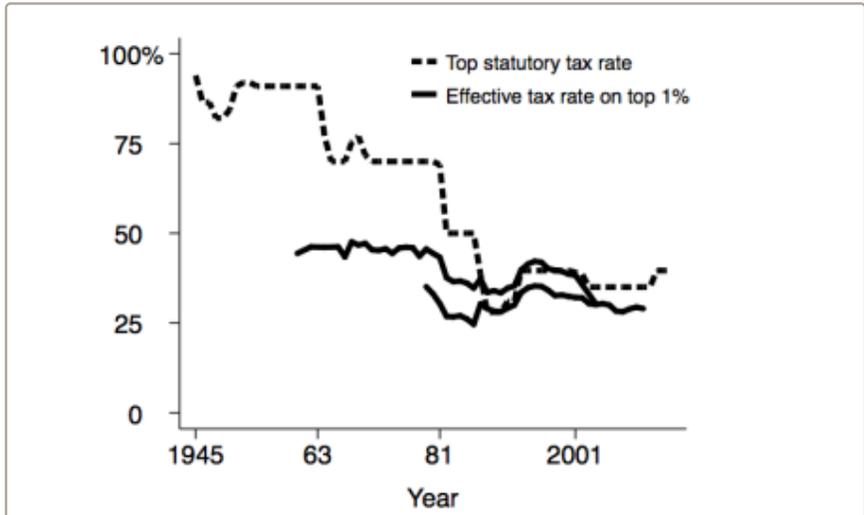


Figure 15. Top statutory federal income tax rate and effective federal tax rate on the top 1%, United States

Effective rate on top 1%: tax payments as a share of pretax income for the top 1% of taxpayers. Federal taxes include personal income, corporate income, payroll, and excise. Data source for the top effective tax rate line: Thomas Piketty and Emmanuel Saez, data set for "How Progressive Is the U.S. Federal Tax System?," *Journal of Economic Perspectives*, 2007, elsa.berkeley.edu/~saez. Data source for the lower effective tax rate line: Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2011," 2014.

What about employment? Here research has tended to suggest reason for worry about heavy use of payroll taxes. The concern has to do mainly with the way in which these taxes raise the price of labor in low-productivity services. Fritz Scharpf put the point as follows¹⁸:

The negative impact on service employment is particularly acute in those countries which, like Germany and France, rely to a large extent on payroll taxes

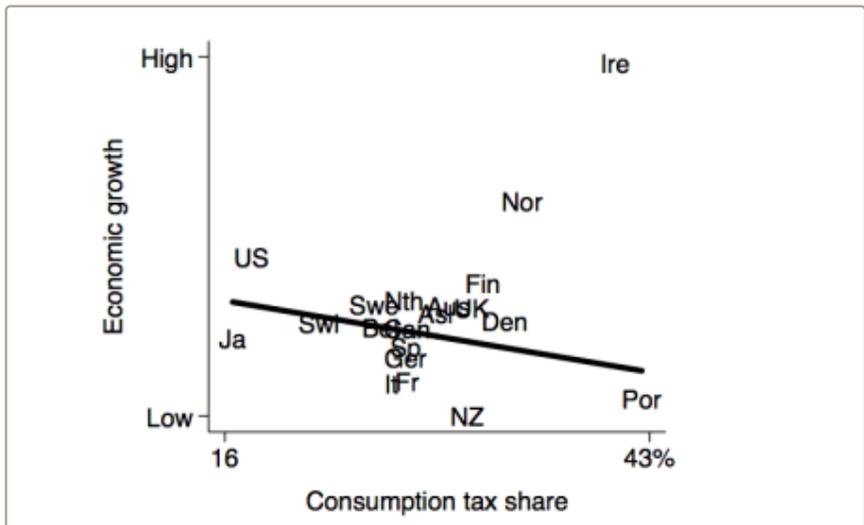


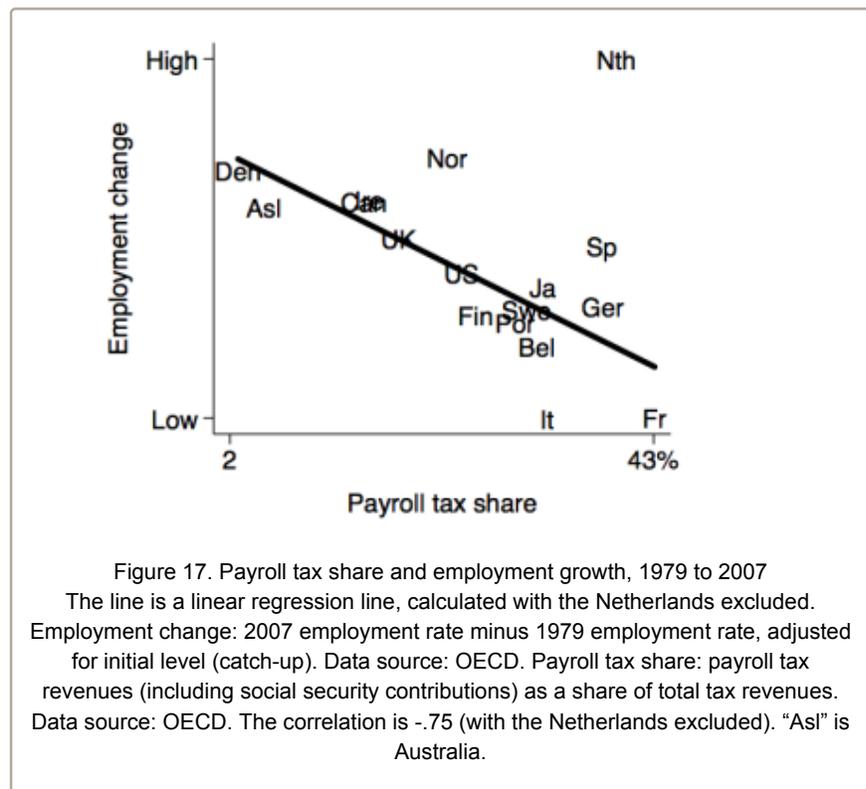
Figure 16. Consumption tax share and economic growth, 1979 to 2007
The line is a linear regression line, calculated with Ireland and Norway excluded. Economic growth: average annual rate of change in GDP per capita, adjusted for initial level (catch-up). Data source: OECD. Consumption tax share: consumption tax revenues as a share of total tax revenues. Data source: OECD. The correlation is $-.38$ (with Ireland and Norway excluded). "Asl" is Australia; "Aus" is Austria.

for the financing of the welfare state.... In Germany, these contributions presently amount to about 42% of the total wage paid by the employer.... If the net wage of the worker cannot fall below a guaranteed minimum [the level of unemployment benefits and social assistance], the consequence is that any social insurance contributions, payroll taxes, and wage taxes that are levied on jobs at the lower end of the pay scale cannot be absorbed by the employee but must be added to the total labor cost borne by the employer.... As a consequence, a wide range of perfectly decent jobs, which in the absence of payroll taxes would be commercially viable, are eliminated from the private labor market.

Several studies have found supportive evidence: employment, particularly in low-end services but also overall, has tended to grow more slowly in nations with heavier payroll taxes.¹⁹

Figure 17 plots (catchup-adjusted) change in the employment rate between the peak business cycle years of 1979 and 2007 by the payroll tax share during this period. The pattern suggests a fairly strong negative association. There are a number of other policies and institutions that may influence employment growth and with which a high payroll tax share is correlated across these countries, but controlling for them does not make the association go away.²⁰

Is there a rationale for heavy payroll taxes? In the countries in which payroll taxes are most significant — France, Germany, the Netherlands, and Spain — the welfare state is “Bismarkian.”²¹ Pensions, unemployment benefits, and sickness benefits are administered jointly by unions, employers, and the state. These programs are financed by payroll taxes, paid by both employers and employees. In these systems payroll tax payments are referred to as “social security contributions” rather than taxes. Though the programs operate on a pay-as-



you-go basis — money paid in goes directly to current beneficiaries — they are popularly viewed as akin to private insurance. People tend to think of their contributions as investments set aside to benefit them directly in the event of job loss, illness, disability, or retirement. This is an illusion, but it is an illusion that has, arguably, underpinned the generosity of these programs. Were these

programs to be financed largely by income and/or consumption taxes, they might end up being less generous because public support would be narrower and shallower.

Nevertheless, there now is relatively widespread sentiment that the employment cost of such heavy reliance on payroll taxes outweighs this advantage. And most of these countries have moved to alter this financing structure and/or its impact on employment.²² Most, for instance, have introduced partial or full exemptions on social contributions for certain types of low-end jobs. The shifts have been relatively limited, though, because this is a “insider-outsider” dilemma.²³ While heavy payroll taxes impose costs on the nonemployed, they underwrite generous social insurance programs, so they are happily paid and strongly supported by those with steady jobs and their families. It’s in the (short-term) interest of these “insiders” to maintain the status quo.

WHAT’S THE BEST WAY FOR THE UNITED STATES TO INCREASE TAXES?

In coming decades, the cost of Social Security and Medicare will rise by 2% to 3% of GDP, due to the aging of the baby boom generation. The US has significant infrastructure deficiencies that need repairing. And many Americans would benefit from the addition or expansion of an array of public insurance programs — fully universal health insurance, sickness insurance, paid parental leave, early education, free or cheaper college, a larger Child Tax Credit and Earned Income Tax Credit, and more. As a ballpark estimate, these additional expenditures might total around 10% of GDP.

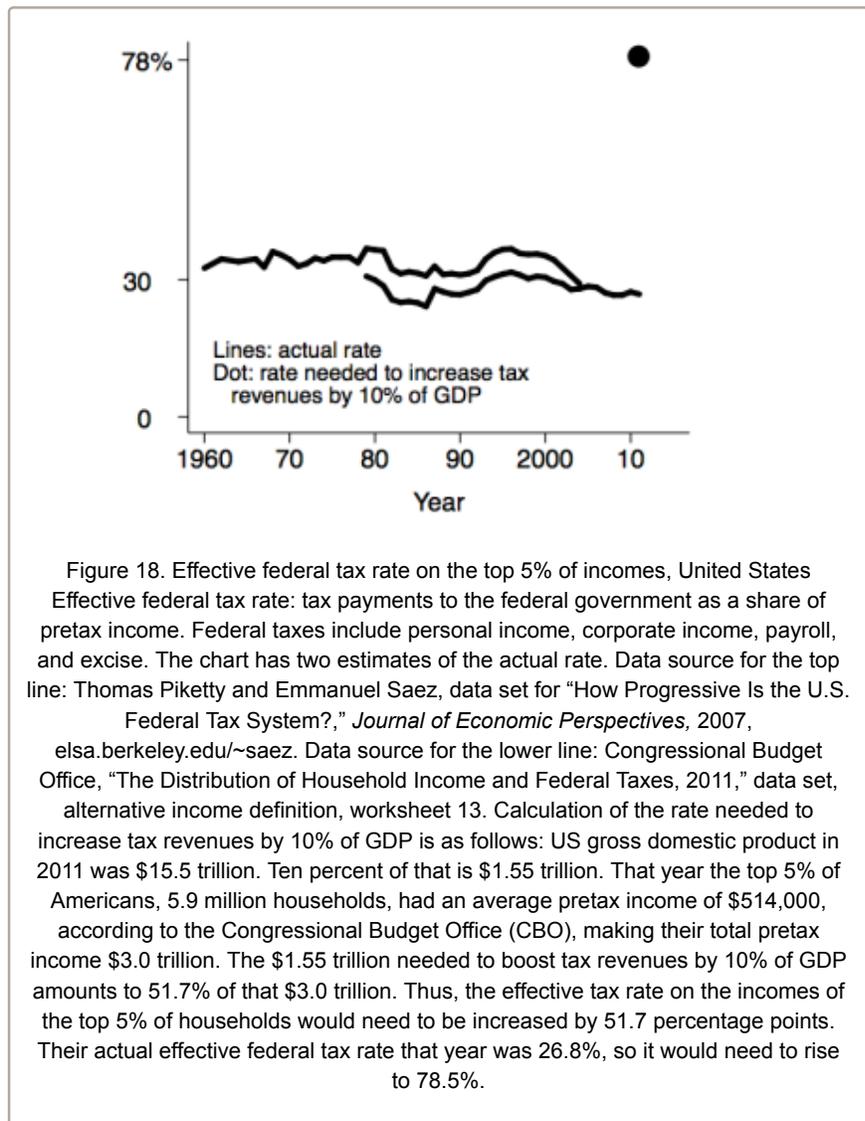
While increasing tax revenues by 10% of GDP would be a significant change for the United States, it wouldn’t be unprecedented. During the course of the twentieth century, revenues’ share of America’s GDP rose by about 25 percentage points. And an increase of 10% would put the US merely in the middle of the pack — not at the front — among the world’s rich countries.²⁴

As a presidential candidate in 2008, Barack Obama pledged to not increase taxes for households with incomes in the bottom 95%. Hillary Clinton, the Democratic nominee in 2016, has made the same pledge. There is some sense in focusing on those at the top in the search for more revenue. The chief rationale for progressive taxation is that those with more income can afford to pay a larger share of that income than those with less.²⁵ The incomes of Americans in the middle and below have risen slowly over the past few decades. Meanwhile, the incomes of those at the top have soared, so they’re now able to pay a larger share of those incomes.

To get a *lot* more revenue, however, we would have to go beyond the top 5%. Figure 18 shows the effective federal tax rate on the top 5% of households going back to 1960. This includes all types of federal taxes — personal income, corporate income, payroll, and excise. We have two estimates of this tax rate, one beginning in 1960 and the other in 1979. The dot for the year 2011 indicates what the effective tax rate on this group would need to have been in that year to increase tax revenues by 10% of GDP. This is far above the actual rate at any point in the past half century. Whether desirable or not, an increase of this magnitude won’t find favor among policy makers.

If getting the needed revenues solely from the rich is unlikely, where could we get it? A multipronged approach might work. Here is one possibility:

- 5.0%: add a national consumption tax (VAT) at a rate of 12%, with limited deductions or a small flat rebate
- 2.0%: return to the 2000 (pre-Bush) federal income tax rates for all taxpayers
- 0.7%: add several new federal income tax rates for households in the top 1%, increasing the average effective tax rate for this group by 7 percentage points
- 0.6%: end the mortgage interest tax deduction
- 0.7%: add a carbon tax
- 0.5%: add a financial transactions tax of 0.5% on trades
- 0.2%: increase the cap on the Social Security payroll tax so the tax covers 90% of total earnings, as it did in the early 1980s
- 0.3%: increase the payroll tax by 1 percentage point



Begin with a national consumption tax. As figure 19 shows, the US raises the least revenue from consumption taxes of any rich nation. Currently we collect only about 5% of GDP in consumption taxes, almost entirely at the state and local levels. Most other affluent countries collect 10% or more.²⁶ A value-added tax (VAT) at a rate of 12%, with limited deductions, would likely bring in about 5% of GDP in revenue.²⁷

Because of its regressivity, the idea of a large consumption tax has yet to be embraced by America's left.²⁸ The degree of regressivity can be lessened by exempting more items from the tax²⁹; but the greater the exemptions, the less revenue the tax will bring in. A better strategy

might be to offset the regressivity of a new consumption tax with other changes to the tax system.

The right tends to object to a VAT for fear it will become a “money machine” — a tax that can be steadily increased over time. But this fear is based on a misreading of the experience of other rich nations. Some countries have decreased their VAT rate, some have held it constant, and most of those that have increased it did so mainly in the 1970s and early 1980s, when high inflation made such increases less noticeable.³⁰ Some argue that tax increases in rich countries since the 1960s have come mainly via VAT increases, but

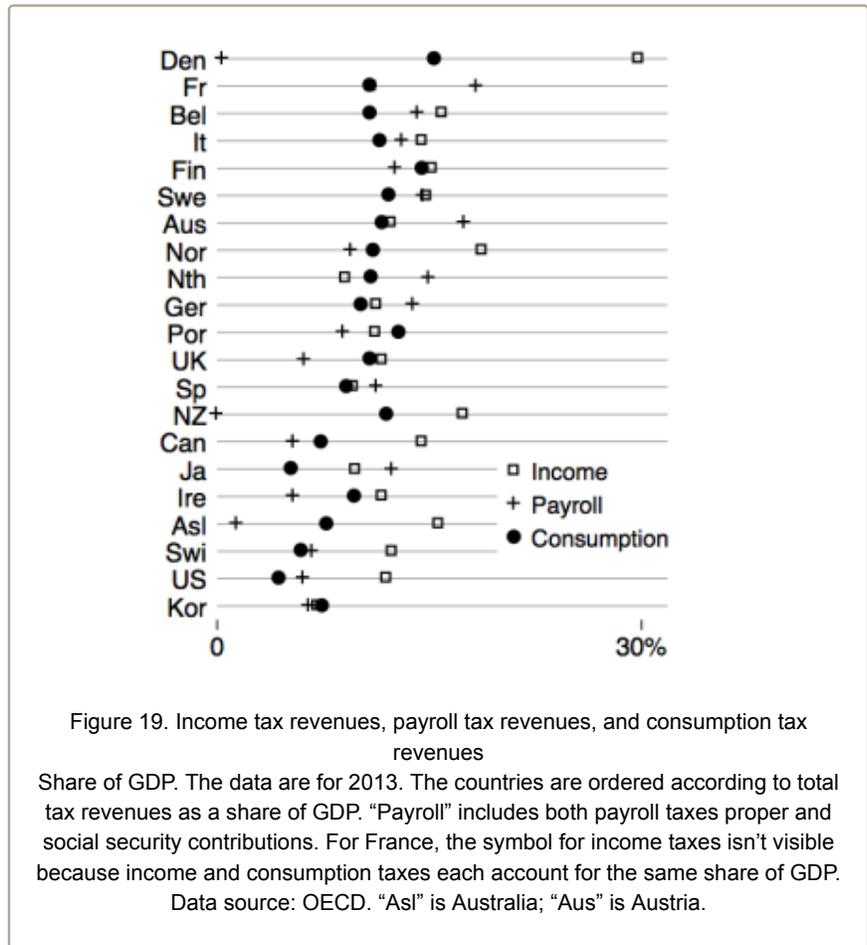
in fact they have come as much or more via increases in income and payroll taxes (see above).³¹

Second, we could return to the pre-Bush income tax rates for everyone. This would increase revenues by about 2% of GDP.³²

Third, we could raise income tax rates for those in the top 1% a bit more.³³ Increasing the average effective tax rate for this group by 7 percentage points would generate about 0.7% of GDP. The effective tax rate on the top 1% currently is 33%.³⁴ An increase of 7 percentage points, to a 40% effective rate, would hardly be confiscatory.

Could we go further in this direction? Getting an additional 1% of GDP in tax revenues from the top 1% requires increasing their effective tax rate by about 10 percentage points. Increasing that rate by 20 percentage points, yielding 2% of GDP in revenues, would be a large shift, but perhaps a doable one. What if we prefer to zero in on the top 0.1%? For this group, we’d need to raise the effective tax rate by approximately 22 percentage points to get 1% of GDP in additional revenues.³⁵ Doing that isn’t out of the realm of possibility, but going much beyond it seems unlikely.

Fourth, we could get rid of the tax deduction for interest paid on mortgage loans. This would increase revenues by about 0.6% of GDP. The aim of the mortgage interest deduction is to boost



home ownership, but other affluent nations, such as Australia and Canada, have homeownership rates comparable to ours or higher without a tax incentive. Moreover, most of this deduction goes to households in the top fifth of incomes.³⁶ Few in the middle or below benefit from it.

Fifth, a carbon tax could generate about 0.7% of GDP in revenues. The United States arguably should have a carbon tax anyway, in order to shift resources away from activities that contribute to climate change.

Sixth, a modest tax on financial transactions, such as purchases of stock shares, would bring in about 0.5% of GDP. Opponents warn that this might cause trading to flee to other financial centers that don't have such a tax, but the United Kingdom has long had one in place without any apparent damage.

Seventh, we could increase the cap on earnings that are subject to the Social Security payroll tax. A person's earnings above \$118,500 (as of 2015) are not subject to the tax. Because a growing share of total earnings in the US economy has gone to those at the top in recent decades, a growing share has been exempt from the tax. In the early 1980s, about 90% of earnings was subject to the Social Security payroll tax; this has dropped to below 85%.³⁷ Raising the cap to get back to 90% would increase tax revenues by about 0.2% of GDP.

Finally, to get an additional 0.3% of GDP, bringing the total to 10%, we could increase the payroll tax by 1 percentage point (half a percentage point on employees and half a point on employers).³⁸ This would leave the payroll tax rate well below that in many European countries, and almost certainly below the level at which it would be a significant deterrent to employment.

This is just one of many possible ways to increase tax revenues. And I haven't even included potential gains from improving collection of unpaid taxes and reducing the use of tax havens.³⁹ The point is that the technical details of getting an additional 10% of GDP are not difficult.

SUMMARY

Many Americans would prefer to pay less in taxes, but they already pay less than their counterparts in nearly all other rich democratic countries. Moreover, after rising for a good bit of the twentieth century, US tax revenues have been flat since the mid-1960s, at about 25% of GDP. (Total government revenues continued to increase up to the year 2000.)

Some argue that this taxation stagnation is a product of our lack of a national consumption tax, such as a VAT. Adding such a tax surely would help to generate more revenue. But that doesn't mean it's necessary. Nations that increased tax revenues in the 1960s, 1970s, and 1980s did so just as much via income taxes as via consumption (or payroll) taxes.

Around 1990, taxation flattened out in all affluent countries. While many developments probably contributed — shifts in the ideology of right and left parties, union decline, public opposition to further tax increases, among others — the most important may have been the growing threat of capital flight due to financial globalization.

Taxes help to reduce income inequality. Their main contribution is indirect: taxes fund the transfers that redistribute income. For this reason, the quantity of revenues a country raises turns out to matter more for inequality reduction than the progressivity of its tax system.

High top statutory tax rates reduce top-end inequality in the pretax distribution of income, though this effect is likely small.

A key concern about taxation is that higher levels will hurt the economy. Heavy reliance on payroll taxes seems to reduce employment. But the record over the past century offers no observable adverse effect of high overall levels of taxation on either economic growth or employment growth.

1. Oliver Wendell Holmes, Jr., dissenting opinion, *Compañía General de Tabacos de Filipinas v. Collector of Internal Revenue*, 1927. The actual quote was “Taxes are what we pay for civilized society.” ↩
2. Harold Wilensky, *The Welfare State and Equality*, University of California Press, 1976; Wilensky, *Rich Democracies*, University of California Press, 2002, ch. 10; Gary S. Becker and Casey B. Mulligan, “Deadweight Costs and the Size of Government,” *Journal of Law and Economics*, 2003; Junko Kato, *Regressive Taxation and the Welfare State*, Cambridge University Press, 2003; Thomas R. Cusack and Pablo Beramendi, “Taxing Work,” *European Journal of Political Research*, 2006; Pablo Beramendi and David Rueda, “Social Democracy Constrained: Indirect Taxation in Industrialized Democracies,” *British Journal of Political Science*, 2007; Achim Kemmerling, *Taxing the Working Poor*, Edward Elgar, 2009. In addition to the two reasons discussed here, Becker and Mulligan note that consumption and payroll taxes are thought to be more economically efficient than income taxes, because they vary less by income, and they hypothesize that more efficient taxes might induce less opposition from citizens and interest groups to increases in taxation. ↩
3. In contrast, Steffen Ganghof notes that Denmark has very high tax revenues (as a share of GDP) and yet relies heavily on income taxation. Ganghof suggests that pressure for low income tax rates applies mainly to a particular type of income: corporate profits and capital income. There is much less pressure on taxation of wage and salary income. Hence, if policy makers are willing to tax wage and salary income at a different rate than capital income and corporate profits (a so-called “dual income tax”), as Denmark does, they can choose to rely mainly on income taxes rather than consumption and payroll taxes to finance a large welfare state. Steffen Ganghof “Globalization, Tax Reform Ideals, and Social Policy Financing,” *Global Social Policy*, 2005; Ganghof, “Tax Mixes and the Size of the Welfare State: Causal Mechanisms and Policy Implications,” *Journal of European Social Policy*, 2006; Ganghof, “The Political Economy of High Income Taxation: Capital Taxation, Path Dependence, and Political Institutions in Denmark,” *Comparative Political Studies*, 2007. ↩
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6. Isaac William Martin, *The Permanent Tax Revolt*, Stanford University Press, 2008. ↩
7. Steffen Ganghof, “Adjusting National Tax Policy to Economic Internationalization: Strategies and Outcomes,” in *Welfare and Work in the Open Economy. Volume II: Diverse Responses to Common Challenges*, edited by Fritz W. Scharpf and Vivien A. Schmidt, Oxford University Press, 2000; Philipp Genschel, “Globalization, Tax Competition, and Welfare State,” *Politics and Society*, 2002; Philipp Genschel and Peter Schwartz, “Tax Competition: A Literature Review,” *Socio-Economic Review*, 2011. ↩

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10. Stein Ringen, *The Possibility of Politics: A Study in the Political Economy of the Welfare State*, Clarendon Press, 1987, ch. 8; Deborah Mitchell, *Income Transfers in Ten Welfare States*, Avebury, 1991; Sven Steinmo, *Taxation and Democracy: Swedish, British, and American Approaches to Financing the Modern State*, Yale University Press, 1993; Vincent Mahler and David Jesuit, "Fiscal Redistribution in the Developed Countries: New Insights from the Luxembourg Income Study," *Socio-Economic Review*, 2006; Lane Kenworthy, *Jobs with Equality*, Oxford University Press, 2008; Kenworthy, *Progress for the Poor*, ch. 8; OECD, *Divided We Stand*, 2011, ch. 7; Chen Wang and Koen Caminada, "Disentangling Income Inequality and the Redistributive Effect of Social Transfers and Taxes in 36 LIS Countries," Working Paper 567, Luxembourg Income Study, 2011. ↩
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12. See also Edward Kleinbard, *We Are Better Than This: How Government Should Spend Our Money*, Oxford University Press, 2014, ch. 12. ↩
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18. Fritz W. Scharpf, "Employment and the Welfare State: A Continental Dilemma," Working Paper 97/7, Max Planck Institute for the Study of Societies, 1997. ↩
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