The Starving State

Why Capitalism's Salvation Depends on Taxation

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For millennia, markets have not flourished without the help of the state. Without regulations and government support, the nineteenth-century English cloth-makers and Portuguese winemakers whom the economist David Ricardo made famous in his theory of comparative advantage would have never attained the scale necessary to drive international trade. Most economists rightly emphasize the role of the state in providing public goods and correcting market failures, but they often neglect the history of how markets came into being in the first place. The invisible hand of the market depended on the heavier hand of the state.

The state requires something simple to perform its multiple roles: revenue. It takes money to build roads and ports, to provide education for the young and health care for the sick, to finance the basic research that is the wellspring of all progress, and to staff the bureaucracies that keep societies and economies in motion. No successful market can survive without the underpinnings of a strong, functioning state.

That simple truth is being forgotten today. In the United States, total tax revenues paid to all levels of government shrank by close to four percent of national income over the last two decades, from about 32 percent in 1999 to approximately 28 percent today, a decline unique in modern history among wealthy nations. The direct consequences of this shift are clear: crumbling infrastructure, a slowing pace of innovation, a diminishing rate of growth, booming inequality, shorter life expectancy, and a sense of despair among large parts of the population. These consequences add up to something much larger: a threat to the sustainability of democracy and the global market economy.

This drop in the government's share of national income is in part the result of conscious choices. In recent decades, lawmakers in Washington—and, to a somewhat lesser extent, in many other Western countries—have embraced a form of fundamentalism, according to which taxes are a hindrance to economic growth. Meanwhile, the rise of international tax competition and the growth of a global tax-avoidance industry have put additional downward pressure on revenues. Today, multinationals shift close to 40 percent of their profits to low-tax countries around the world. Over the last 20 years, according to the economist Brad Setser, U.S. firms have reported growth in profits only in a small number of low-tax jurisdictions; their reported profits in most of the world's major markets have not gone up significantly—a measure of how cleverly these firms shift capital to avoid taxes. Apple, for example, has demonstrated as much inventiveness in tax avoidance as it has in its technical engineering; in Ireland, the technology giant has paid a minuscule annual tax rate as low as 0.005 percent in some years.

It is not just corporations that engage in tax avoidance; among the superrich, dodging taxes is a competitive sport. An estimated eight percent of the world's household financial wealth is hidden in tax havens. Jurisdictions such as the Cayman Islands, Panama, and Switzerland have structured their economies around the goal of helping the world's rich hide their assets from their home governments. Even in places that don't show up on international watch lists—including U.S. states such as Delaware, Florida, and Nevada—banking and corporate secrecy enable people and firms to evade taxes, regulation, and public accountability.

Unchecked, these developments will concentrate wealth among a smaller and smaller number of people, while hollowing out the state institutions that provide public services to all. The result will be not just increased inequality within societies but also a crisis and breakdown in the very structure of capitalism, in the ability of markets to function and distribute their benefits broadly.

A WORLD FOR PLUTOCRATS

The parlous state of affairs today stems from policy choices that allowed elites to limit the reach of governments, including their ability to implement taxes. In the United States, the Supreme Court has at various times played the role of guardian of plutocratic privilege, making legally dubious rulings against a direct income tax in 1895 and early New Deal policies in the 1930s. At the state level, an emphasis on sales taxes over property taxes shifted the burden disproportionately onto the poor and people of color, while sheltering wealthier white households. Despite these obstacles, the United States succeeded in implementing one of the world's most progressive tax systems from the 1930s to the late 1970s, with top marginal income tax rates exceeding 90 percent, top estate tax rates nearing 80 percent, and effective tax rates on the very wealthy of about 60 percent at the middle of the century. But the administration of President Ronald Reagan dismantled this system, slashing the top marginal income tax rate to 28 percent in 1986, at the time the lowest among industrialized countries. There was a brief moment in 2010 when the estate tax was phased out completely under the terms of President George W. Bush's 2001 and 2003 tax cuts (those cuts were repealed in 2011, and the estate tax was reinstated).

The Bush administration broke with historical norms by starting a war in 2003 at the same time as it lowered taxes on the rich. It slashed top marginal rates, especially on those earning income from capital, while launching a calamitous war in Iraq that is estimated to have cost the United States upward of $3 trillion. In 2017, the Trump administration pushed this trend still further, not only lowering top marginal tax rates and corporate taxes but also creating so-called opportunity zone schemes that allow the wealthy to avoid capital

gains taxes by investing in poor neighborhoods. In practice, however, real estate developers have used the new tax incentives to build luxury condos and yoga studios in affluent communities that are adjacent to—and even included in—the opportunity zones.

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Over the last four decades, new loopholes, the rise of a cottage industry of advisers eager to help firms avoid taxes, and the spread of a corporate culture of tax avoidance have led to a situation in which a number of major U.S. companies pay no corporate taxes at all. This phenomenon is hardly unique to the United States. Many governments around the world have made their tax systems less progressive, all in the context of rising inequality. This process has been driven by reductions in the taxation of capital, including the fall of corporate taxes. The global average corporate income tax rate fell from 49 percent in 1985 to 24 percent in 2018. Today, according to the latest available estimates, corporations around the world shift more than $650 billion in profits each year (close to 40 percent of the profits they make outside the countries where they are headquartered) to tax havens, primarily Bermuda, Ireland, Luxembourg, Singapore, and a number of Caribbean islands.

Much of the blame lies with the existing transfer price system, which governs the taxation of goods and services sold between individual parts of multinational companies. This system was invented in the 1920s and has barely changed since then. It leaves important determinations (such as where to record profits) to companies themselves (regardless of where the profit-making activity took place), since the system was designed to manage the flows of manufactured goods that defined the global economy in the 1920s, when most trade occurred between separate firms; it was not designed for the modern world of trade in services, a world in which most trade takes place between subsidiaries of corporations. When one of us (Stiglitz) chaired the Council of Economic Advisers, in the 1990s, under President Bill Clinton, he waged a quiet but unsuccessful campaign to change the global system to the kind used within the United States to allocate profits between states (this arrangement is known as “formulary apportionment,” whereby, for the purpose of assessing a company’s tax, profits are assigned to a given state based on the share of the firm’s sales, employment, and capital within that state). Entrenched corporate interests defended the status quo and got their way. Since then, intensifying globalization has only further encouraged the use of the transfer price system for tax dodging, compounding the problems posed by the flight of capital to tax havens.

Nowhere is tax avoidance more striking than in the technology sector. The richest companies in the world, owned by the richest people in the world, pay hardly any taxes. Technology companies are allowed to shift billions of dollars of profits to places such as Jersey, one of the Channel Islands, where the corporate tax rate is zero, with complete impunity. Some countries, including France and the United Kingdom, have attempted to impose a tax on some of the revenues the technology giants generate in their jurisdictions. But France’s small, three percent tax, for example, has only reinforced the need for a new global agreement, for the tax does not go far enough; it targets only the digital sector, even though profit shifting is rampant across the board, including in the pharmaceutical, financial services, and manufacturing industries.

HOW THE RICHEST GET RICHER

Many policymakers, economists, corporate tycoons, and titans of finance insist that taxes are antithetical to growth. Opponents of tax increases claim that firms will reinvest more of their profits when less gets siphoned off by the government. In this view, corporate investment is the engine of growth: business expansion creates jobs and raises wages, to the ultimate benefit of workers. In the real world, however, there is no observable correlation between capital taxation and capital accumulation. From 1913 to the 1980s, the

saving and investment rates in the United States have fluctuated but have usually hovered around ten percent of national income. After the tax cuts in the 1980s, under the Reagan administration, capital taxation collapsed, but rates of saving and investment also declined.

The 2017 tax cut illustrates this dynamic. Instead of boosting annual wages by $4,000 per family, encouraging corporate investment, and driving a surge of sustained economic growth, as its proponents promised it would, the cut led to minuscule increases in wages, a couple of quarters of increased growth, and, instead of investment, a $1 trillion boom in stock buybacks, which produced only a windfall for the rich shareholders already at the top of the income pyramid. The public, of course, is paying for the bonanza: the United States is experiencing its first $1 trillion deficit.

Lower taxes on capital have one main consequence: the rich, who derive most of their income from existing capital, get to accumulate more wealth. In the United States, the share of wealth owned by the richest one percent of the adult population has exploded, from 22 percent in the late 1970s to 37 percent in 2018. Conversely, over the same period, the wealth share of the bottom 90 percent of adults declined from 40 percent to 27 percent. Since 1980, what the bottom 90 percent has lost, the top one percent has gained.

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This spiraling inequality is bad for the economy. For starters, inequality weakens demand: the bulk of the population has less money to spend, and the rich don't tend to direct their new income gains to the purchase of goods and services from the rest of the economy; instead, they hoard their wealth in offshore tax havens or in pricey art that sits in storage bins. Economic growth slows because less money overall is spent in the economy. In the meantime, inequality is passed down from generation to generation, giving the children of the wealthy a better shot at getting into the top schools and living in the best neighborhoods, perpetuating a cycle of ever-deeper division between the haves and the have-nots.

Inequality also distorts democracy. In the United States especially, millionaires and billionaires have disproportionate access to political campaigns, elected officials, and the policymaking process. Economic elites are almost always the winners of any legislative or regulatory battle in which their interests might conflict with those of the middle class or the poor. The oil magnates the Koch brothers and other right-wing financiers have successfully built political machines to take over state houses and push anti-spending and anti-union laws that exacerbate inequality. Even rich individuals who are seen as more politically moderate—technology executives, for instance—tend to focus their political efforts on narrow technocratic issues rather than the distributional conflicts that define today's politics.

MAKE THEM PAY

Nothing less than a bold new regime of domestic and international taxes will save wealthy democracies and economies from the distortions and dangers of rampant inequality. The first order of business should be establishing a fiscal system that generates the tax revenue required for a twenty-first-century economy—an amount that will need to be even higher than those prevalent in the middle of the twentieth century, the period of the fastest economic growth in the United States and in which prosperity was more evenly shared. In today's innovative economy, governments will need to spend more on basic research and education (12 years of schooling might have sufficed in 1950, but not today). In today's urbanized society, governments need to spend more on expensive urban infrastructure. In today's service economy, governments need to spend more on health care and caring for the aged, areas in which the state has naturally played a central role. In today's dynamic and ever-changing economy, governments will have to spend more to help individuals cope better with the inevitable dislocations of economic transformation. Addressing the existential problem of climate change will also require large amounts of investment in green infrastructure.

With more and more income going to the very wealthy and to corporations, only a far more progressive tax code will provide the necessary level of revenue. There is no reason that the salaries of workers should be taxed at a higher rate than capital. Plumbers, carpenters, and autoworkers should not pay a higher rate than private-equity managers; mom-and-pop retailers should not pay a higher rate than the world's richest corporations.

The next step would be to eliminate special provisions that exempt dividends, capital gains, carried interest, real estate, and other forms of wealth from taxation. Today, when assets are passed on from one generation to another, the underlying capital gains escape taxation altogether; as a consequence, many wealthy individuals manage to avoid paying capital gains taxes on their assets. It is as if the tax code were designed to create an inherited plutocracy, not to create a world with equality of opportunity. Without increasing tax rates, eliminating these special provisions for the owners of capital—making them pay the same rate as workers—would generate trillions of dollars over the next ten years.

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Another improvement would be a wealth tax, such as the one recently proposed by Elizabeth Warren, the Democratic U.S. senator from Massachusetts who is currently running for president. She has proposed a tax of two percent on wealth above $50 million and six percent on wealth above $1 billion. Such a tax could raise nearly $3.6 trillion over the next decade. It would be paid by the 75,000 richest American families—less than 0.1 percent of the population.

To curb the evasion of income and wealth taxes, countries will have to cooperate much more with one another. Instead of allowing rich people and corporations to hide their assets through elaborate offshore trusts and other legal vehicles, countries must create a global wealth registry that records the ultimate owners of all assets. The United States could start by drawing on the comprehensive information that already exists within private financial institutions such as the Depository Trust Company. The European Union could easily do the same, and these registries could eventually be merged.

Governments would also have to tax corporations chartered in their jurisdictions on their global income and not allow them to shift money to low-tax jurisdictions through the use of subsidiaries or other means. Instead of effectively letting firms self-declare the national provenance of their profits, governments should attribute taxable corporate income to places through formulary apportionment. Under this system, Apple could not get away with its profit-shifting gimmicks. Finally, a global minimum tax should be instituted to set a floor on how low would-be tax havens could drop their rates.

Once these new rules are in place, they will need adequate enforcement—as will the tax laws already on the books. The Internal Revenue Service has been devastated in recent years, losing thousands of employees between 2010 and 2016, a trend that has only gotten worse in the Trump era. The agency needs to add thousands of employees, offer them competitive salaries, and upgrade its outdated information technology systems.

At the international level, policymakers have to find the right mode of cooperation that will produce the best and most rigorous enforcement of tax collection. One option would require the biggest developed economies (the United States and western European countries) to move first, demanding that firms that trade in their markets follow the new rules and using diplomatic pressure to get other countries to adopt a similar system (which would benefit them through the collection of tax revenue they cannot tap now). There is a substantial debate raging over whether the world needs new trade agreements after decades of trade liberalization have boosted inequality within countries; regardless, it would make sense to condition the signing of any new trade deals on adherence to stricter rules on tax cooperation. There may be room for a multilateral approach—for instance, by turning the currently beleaguered World Trade Organization into a body that could help with tax enforcement and other matters of international cooperation, such as climate change. Substantial changes would be needed to the culture and personnel of the WTO to make that happen. Whichever path governments choose, it is important to recognize that there is an alternative to neoliberal trade policy. Instead of a model that limits the ability of sovereign states to guard against the flight of capital and tax avoidance, governments can build a model of trade that supports tax justice.

In the United States, most of these reforms could be achieved within the existing constraints of the U.S. Constitution. There is a debate about the wealth tax, which conservatives have claimed would run up against constitutional strictures on direct taxation; many historians and legal scholars dispute this conservative objection. Some critics might also allege that these proposals are too extreme, claiming that they will discourage investment, hurt the economy, and slow down growth. Nothing could be further from the truth. In fact, what is truly extreme is the experiment in taxation that began during the Reagan era, when tax rates on the rich and corporations began their dramatic descent. The results have been clear: slow growth, high deficits, and unprecedented inequality.