Huffington Post, Posted: March 8, 2011 01:04 PM

Testimony on Sensible Tax Reform

Cross-posted from New Deal 2.0.

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.

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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.

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