

Remarks by
Alan Greenspan
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The purpose of this weekend's retreat, as I understand it, is to review various different options that have been offered for tax reform. The very impressive faculty you have engaged for this endeavor, I am certain, is about as good as it gets. As a consequence, I have no inclination to delve into the number of issues that will be the central focus of your discussions over the next couple of days. I would like, however, to raise a related issue which this Committee and, more broadly, the nation may be grappling with in the years immediately ahead; a possible reemergence of the debate on the appropriate degree of progressivity in our tax code. This is an issue which one could reasonably assume was dormant, and fundamentally resolved, in large measure, with the Tax Reform Act of 1986. However, history suggests the possibility of more debate on this question than we have had for quite awhile.

The degree of progressivity of the American tax system over the generations seems to reflect the deepest values of our society with respect to work, effort, and monetary reward. When free market transactions were perceived to be "just" in outcome, progressivity held little sway. Indeed, an income tax of any type was considered government expropriation. When the results of market transactions were perceived as exploitive and arbitrary, above average incomes were labeled "unearned" and largely taxed away.

In the early nineteenth century, for example, when laissez faire reigned as the dominant governing national

philosophy, the values of market capitalism were part of the ethical structure of our society. If a market rewarded you for hard work, the income was yours by right. You earned it, and no one had the right to take it away. In that climate, an income tax was presumed to be government confiscation of legally--and presumed ethically--acquired property.

A century later, in the depths of the Great Depression, capitalism was widely judged as exploitation of the masses and deeply flawed. Tax progressivity was perceived as a tool to right the presumed injustices of an exploitive marketplace.

The reason the issue of progressivity may arise in the near future is the rather dramatic increase in the sense of job insecurity experienced by a significant segment of our work force in recent years. To be sure, such a concern may not rise to the level of real doubts about the justice of economic outcomes, but it does put the issue in play. Job insecurity has been a major factor in the slowing of gains in hourly labor compensation, and it explains the dramatic decline in labor militancy, reflected last year in the lowest level of strike activity in a half century, and the unprecedented endeavors to ensure job security through five- and six-year labor agreements.

The root of the growing insecurity is doubtless the acceleration of technological change that has dramatically foreshortened the average life of our capital stock--the assets with which our work force must engage on a day-to-day basis. The rapid changes in the structure of our capital is evidenced by

dramatic corporate restructuring coupled with highly publicized layoffs and dismissals.

The resulting sense of job insecurity--on the edge of fear in numerous cases--while not yet fully surfaced as a serious question of the justice of our economic system, has moved in that direction.

There is also some apparent discomfort with what is deemed a "winner-take-all" society, where, in virtually all walks of life, the best earn far more than those who are perceived to be only a small fraction less skilled. The outsized incomes of a few rock stars, movie idols, basketball players, and hedge fund operators, make a significant part of our society edgy, but there appears to be little expressed concern that their skills and incomes are at the expense of others. Few seem to begrudge an entrepreneurial Bill Gates his billions.

Nonetheless, the enthusiasm for free market capitalism is less evident today than it was, for example, in the 1980s. The view that free market outcomes reflect the deep-seated values of the society is a shade less secure than a decade ago. Still, the view of unfettered markets as exploitation, so prevalent in earlier generations, is largely missing. The acceleration of technological advance is seen--rightly in my view--as the dominant force in the creation of job insecurity.

But fear is a debilitating force, not one for which a prognosis is clear. And that fear has been reinforced by the technologically driven increased dispersions of income during the

last couple of decades. As a consequence, a significant part of our work force has experienced declines in real incomes, an issue I plan to return to later.

The philosophy undergirding American taxation has swung over wide ranges throughout our history. Today it seems to have come to rest, perhaps temporarily, somewhere in the middle.

Just after World War II, following years of heavy wartime government economic intervention, the support for laissez faire capitalism had dwindled to a low ebb. So had the view that record levels of tax progressivity were essential to right the presumed wrongs of the marketplace. In 1947, for example, President Truman vetoed a tax reduction bill that reduced tax rates on lower earners by a larger percentage than for the upper income earners, and therefore increased the progressivity of the tax system. Nonetheless, among other reasons for the veto, the President was concerned that the tax bill would have increased the after tax income of high income families by a greater percentage than for lower income families, thereby raising the degree of inequality of the distribution of after tax income. The reason of course was any reductions from the upper bracket 91 percent marginal tax rate of that time would have had very large positive effects on the after tax incomes of high income earners. Rarely is such a standard of progressivity raised in today's discussions.

The reason, of course, is that in the years since, the notion of free markets being exploitive has gradually faded.

Early on, President Kennedy had sponsored a reduction in the upper marginal individual income tax rate to 70 percent. There was little explicit philosophical debate, other than the oft repeated "a rising tide lifts all boats." It was more that changing notions of market place efficiency were evolving slowly with little evidence of any sharp defining event to alter the national psyche. Closest was when, in 1978, the late Congressman Bill Steiger's amendment to reduce the capital gains tax rate passed this Committee with bipartisan support. Perhaps as a consequence of the Steiger success, and certainly to President Reagan's delight, a 50 percent marginal rate was seen as feasible in the early 1980s. This view was bolstered, unless my memory miserves me, by seeming Democratic support for such a move in this Committee. Finally, capping a four decade trend, the top marginal rate was reduced to a post-war low of 33 percent with the Tax Reform Act of 1986. Reflecting the ending of a number of tax preferences, including capital gains, the effective average tax rate was not perceived to have changed much. The effective marginal rate has edged up moderately since.

While in recent decades the degree of progressivity in the tax system mirrored a broader view of market justice, it was not always thus. Preceding the enactment of our first income tax during the Civil War, and later in the early discussions leading up to the ratification of the income tax amendment in 1913, progressivity was generally given a pro-capitalist rationale.

As Senator John Sherman, Chairman of the Senate Finance Committee, framed it in 1872, "While the expenses of the national government are largely caused by the protection of property, it is but right to require property to contribute to their payment."

Before the income transfer and redistribution programs of the 1930s, the major force of the Federal government in the economy was the protection of property. The more property, i.e. usually the more income, the greater the degree of protection needed. In today's terms, progressivity was justified as a fee for services rendered. It was an affirmation of capitalistic markets being just, rather than as exploitive.

It is unclear, however, whether prior to 1913 this was the universal view. The antagonisms against the emergence of trusts, which led to the Interstate Commerce Act of 1887 and the Sherman Anti-Trust Act of 1890, among part of the population, reflected judgements of free market imperfections. Accordingly, a more modern view of progressivity did surface in those years. Indeed, the striking down by the Supreme Court of a widely popular income tax bill in 1894, was what led to the perceived need of a constitutional amendment.

Let me now turn to the more recent focus of tax policy--the desire for economic neutrality, or economic efficiency. I do not believe there is terribly much dispute that lower marginal tax rates enhance incentives to risk taking and investment. If one believes in the general justness of market outcomes, as I do, it is not difficult to demonstrate that lower

marginal rates lead to a more rational structure of markets. I suspect the case will be made by many of your guests this weekend. But for those who still perceive the existing system as, at least partially, exploitive of certain groups in our society, why would they wish such a system to be more efficient? The efficiency argument for low tax rates is thus at root still driven by one's view of whether the system, which engenders our incomes, is just. As I stated earlier, I belong to the school that believes that, especially compared with other regimes, market solutions are the most just. But that is not an economic judgement. It rests on more fundamental notions of how individuals in society should deal with one another, and what is the role of law in adjudicating and enforcing these dealings.

This is a broad subject which would project us far beyond the purposes of this weekend. Indeed we would have to venture back into the Middle Ages view of "just price" and before, to the Greeks and Romans to unearth the beginnings of such discussions.

I wish only to stress that those of us who hold that economic efficiency should be the crucial determinant of a tax code, can be lulled into the notion that there is some value-neutral basis for such a view. At root we are making an ethical judgment that free markets are just, and that greater material welfare is the major economic goal of a society.

I have raised the hypothesis that the differential pressure for progressivity of the tax structure largely reflects

the view of society toward the justice of free market outcomes. Earlier I raised the issue that along with job insecurity, lagging real incomes were a cause of dissatisfaction with the results of our economic system. For the moment, these concerns, as I indicated earlier, have not engendered major dissatisfaction with our economic system, and the reason is that most people believe that it is accelerated technology that is the major cause of our unease. Luddites have not gained much ground in recent years.

Although few are explicitly aware of it, the composition of the gross domestic product is becoming increasingly conceptual as distinct from physical and it is generally accepted that in order to compete, one has to have the skills associated with the new technologies. Even of the number of workers who have seen their skills becoming increasingly obsolescent in today's environment, few have been inclined to rail against the system. But in the last year or so, some previously dormant voices have started to raise serious questions about the presumed stagnation of standards of living and increasing gaps between the affluent and the less affluent. That is only one step short of questioning the workability and justice of the system as a whole.

There is little doubt that the income data for the last two decades show both a relative slowing in average real incomes, increased dispersion and an emergence of a significant proportion of our work force whose real incomes, irrespective of how

measured, are truly falling. The general notion that standards of living in recent years have stagnated is rather widespread.

To be sure, while growth in standards of living has slowed, it is not apparently by much. Income is only part of a measure of one's standard of living. While real household income growth may have slowed appreciably since the mid 1970s, the growth in the stock of household assets has not. A significant part of our standard of living is derived from the use of VCRs, personal computers, television sets, dishwashers, automobiles, etc.

Per household growth of such assets between, for example, 1959 and 1973 was 3 percent per annum. From the period 1973 to 1995, a period of significant slowing in real income growth, per household real durable assets, nonetheless, grew at 2-1/2 percent per annum.

Moreover, there is some evidence that income recipients at the lower edges of our income distribution have also shown very significant increases in durable assets. For example, in 1984 only 17 percent of lower income households owned a microwave oven; by 1990, the figure was 62 percent. Similarly, ownership of color TVs by lower income households climbed from 79 percent to 92 percent. Indeed, the increasing dispersion which is so noticeable in the income data of the last twenty years is not so readily mirrored in the household asset data.

Thus, although there is current significant job insecurity, evidence that real incomes have slowed, and

dispersion increased, in one important sense, growth in standards of living on average have not slowed appreciably. While perception is more important than reality in the ongoing national dialogue on progressivity, the evidence of high and still growing living standards, at least on average, appears to me much too evident to be completely disregarded.

But whether this more benevolent reality can overcome increasingly adverse perceptions about the effectiveness of our economy is an open question. I would thus venture to conclude that to engage in detailed deliberations on tax reform, without an historical context of where we may be heading on the issue of progressivity, could readily blindside us.