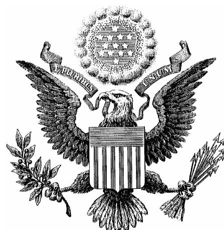
Reducing Tax Impediments to Capital Formation



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Abstract

Recent tax changes lowered taxation on capital. These cuts improved the current structure of capital taxation. Nonetheless, the existence of a mostly income-tax base continues to impose a bias against savings, investment, and hence capital formation. This anti-capital bias of income taxation has long been recognized by many generations of prominent economists who preferred an expenditure tax base.

Remedies for this bias in the form of wholesale restructuring of the tax code have been proposed in recent years. But public choice theory suggests that there are important political obstacles to such sweeping reform. Consequently, instead of a one-time sweeping overhaul, an incremental approach to removing the tax bias against saving may prove to be more feasible politically. This paper delineates such an approach and examines the short-and long-run macroeconomic effects of reducing capital taxation. While the initial, short-term effects are straight forward and beneficial to capital, important secondary, longer-run effects, often overlooked or deemphasized, are highlighted here. In particular, several bodies of economic literature suggest that important, substantial benefits of lower capital taxation are likely to accrue to labor and workers. Thus, the interests of labor and capital owners are importantly harmonious, not antagonistic, as much present-day analysis suggests.

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Reducing Tax Impediments to Capital Formation

Introduction and Summary

Recent tax reductions on income, dividends, and capital gains, together with expanded depreciation allowances, lowered taxation on savings and investment and hence on capital.[1] These cuts improved the structure of capital taxation. Nonetheless, the existence of a mostly income-tax base continues to impose a bias against savings, investment, and hence capital formation. This anti-capital bias of income taxation has long been understood by prominent economists (including John Stuart Mill, Alfred Marshall, A.C. Pigou, Irving Fisher, and Nicholas Kaldor) who explicitly recognized that bias and preferred expenditure taxation.[2]. A host of more contemporary economists also recognize this bias and support an expenditure tax base.

Remedies for this bias in the form of wholesale restructuring of the tax code have been proposed in recent years: i.e., a flat tax, national sales tax, or consumed-income tax. All have advocates. But public choice theory suggests that there are important political obstacles to such sweeping reform. Consequently, instead of a one-time sweeping overhaul, an incremental approach to removing the tax bias against saving may prove to be more feasible politically. This paper delineates such an approach and examines the short-and long-run economic effects of reducing capital taxation. While the initial, short-term effects are straightforward and beneficial to capital, important secondary, longer-run effects, often overlooked and misunderstood are highlighted. In particular, several bodies of economic literature suggest that over time, important, substantial benefits of lower capital taxation are likely to accrue to labor and workers. In other words, over the long run, recent empirical evidence suggests that the benefit of reducing capital taxation may accrue to workers. Analogously, raising taxation of capital increases the burden on labor and, hence, hurts workers.

Indeed, Lawrence Summers (1981) emphasized this point. He noted that:

> "…shifting to consumption taxation would raise the lifetime utility of the representative consumer by the equivalent of about six year's income in the new steady state. These estimates dwarf estimates of the static welfare cost of taxation, and significantly exceed even extreme previous estimates of the dynamic loss."[3]

This implies that important economic interests of labor and capital are harmonious, not antagonistic, as much present-day opinion suggests.

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[1] Most analysts or researchers refer to savings, investment, and capital accumulation in discussing analogous concepts. In this paper, we will refer to capital or rather capital accumulation as identifying savings and investment.

[2] See Appendix.

[3] Lawrence H. Summers "Capital Taxation and Accumulation in a Life Cycle Growth Model," **The American Economic Review**, vol. 71, No. 4 (September 1981), 533-544.

The Existing Tax Structure

Currently, the taxation of capital in the U.S. takes many different forms, making it difficult to measure, analyze, or assess capital taxation in the aggregate or policies dealing with such an aggregate. For example, since federal taxation, for the most part, has an income base, a host of capital income sources are taxed, all of which add layers of taxation on capital. Federal taxation of dividend income, interest income, capital gains, corporate income, and gift and estate transfers serve as illustrations. The tax treatment of depreciation is also relevant. All of these different taxes are forms of taxation on savings, investment, and thus on capital. State and local governments also add property and state income taxes to the list.

Implications

A key implication of the current hybrid tax structure is that the income tax base is necessarily biased against saving, investment, and hence, capital formation. An income tax that includes levies on various sources of capital income effectively taxes savings several times. In this structure, taxes are levied not only on current saving but also on the future returns to that saving. This structure, in effect, creates multiple layers of taxation on various forms of saving, whereas income consumed is only taxed once. As the late Norman Ture (1977) eloquently put it:

> "The bias against saving in the present tax system results from the fact that, with few exceptions, taxes are imposed both on the amount of current saving and on the future returns to such saving, whereas the tax falls only once on income used for consumption. Since the amount one saves today is the capitalized value of income one will receive in the future, the same future income stream is taxed at least twice. More realistically, it is taxed over and over again: the tax on capital gains, the corporation income tax, State and local income taxes, property taxes, estate, gift and inheritance taxes – all substantially add to the aggregate tax burden on saving. Saving uses of income are taxed far more heavily than anything else. The tax system, thereby, greatly increases the cost of saving and capital formation relative to the cost of consumption."[4]

Recognition of this bias of income taxation suggests that the base for taxation should be changed to expenditure from income.

Some Historical Background

The recognition that income taxation is necessarily biased against saving, investment, and capital formation and that taxation may be better based on consumption rather than income is not novel. This important observation has been recognized by generations of economists. Well known influential economists explicitly recognizing

[4] Norman B. Ture and Kenneth Sanden, The Effects of Tax Policy on Capital Formation, Financial Executives Research Foundation, N.Y., 1977, p.60.

these points include John Stuart Mill, Alfred Marshall, A.C. Pigou, Irving Fisher, Nicholas Kaldor, and others. A brief summary and documentation of their thought along these lines is presented in the Appendix. This summary demonstrates that these influential economists explicitly recognized the bias of income taxation against saving, investment, and capital formation and that these arguments critical of income taxation have a remarkably respectable ancestry dating from at least the mid-1800s.

Historical support for these ideas, however, runs much deeper than suggested by this brief summary or the documentation presented in the Appendix. Notably, the view outlined here is consistent with several important constructs of classical economic thought. First, for example, classical economists for the most part supported indirect rather than direct taxation.[5] Indirect taxation, mostly tariffs and excise taxes, is largely consumption- or expenditure-based taxation that does not materially adversely impact savings, investment, or capital formation. Direct taxation, on the other hand, is made up largely of income or wage taxation, which adversely affects savings, investment, and economic growth. Thus, classical economists for the most part preferred expenditure rather than income taxation, analogous to the view spelled out above.

Second, classical economists always emphasized economic growth and the primacy of aggregate supply and production as epitmomized in Say's Law, the cornerstone of classical economic thinking. The central theme of Say's Law is the primacy of aggregate supply: it is production and aggregate supply and not aggregate demand that creates wealth and economic growth. Capital formation was always seen as a critical factor in the growth process. These views were popularly summarized in phrases such as "people produce in order to consume," or "supply creates its own demand."

There are several relevant tax policy implications of Say's Law. The law, for example, implies that consumption is an effect and not a cause of production. Accordingly, while taxation of consumption doesn't materially affect production, taxation of production does adversely affect consumption. Thus, according to classical economists, expenditure taxation is preferable to taxes on production. Since Say's Law maintains that production and aggregate supply create wealth and economic growth rather than demand or expenditure, tax policies supportive of this view foster aggregate supply (rather than aggregate demand) and do not discourage production and capital formation by double taxation of savings. As Say himself argued:

> "The encouragement of mere consumption is no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen, that production alone, furnishes those means. Thus it is the aim of good government to stimulate production, of bad government to encourage consumption…It is impossible to deny the conclusion, that the best taxes, or rather those that are least bad, are …such as are least injurious to reproduction."[6]

[5] See, for example, D.P. O'Brien, The Classical Economists, Clarendon Press, Oxford, 1975, pp. 245-259.
[6] Jean Baptiste Say, A Treatise on Political Economy, Book III, Wells and Lilly, Boston, 1824, pp. 92, 196 (emphasis added).

Say's Law, then, is consistent with both the view expressed above, and the contention that taxes should tax people on the basis of "what they take out of the common pool (consumption), rather than what they put into it (savings, investment, and capital formation)."

The Support of Contemporary Economists

In addition to these prominent, earlier economists, a number of contemporary economists have embraced the view that income-based taxation is inherently biased against saving and associated with multiple taxation of saving resulting in lower capital formation and slower growth than would otherwise be the case. These economists for the most part support tax reform involving various forms of consumption-based taxation. A partial, incomplete list of these supporters have included, for example, Norman Ture, David Bradford, Glen Hubbard, Michael Boskin, Martin Feldstein, flat tax advocates such as Alvin Rabushka, Robert Hall, as well as many others.

These economists have supported and clarified the above-mentioned arguments and have added insights of their own. One notes, for example, that income taxation "skews relative prices in favor of consumption and against saving… and makes consumption more attractive than it should be and saving less attractive…(this) anti-saving bias (is) inherent in the use of income as a tax base." [7]

Several of these economists analyzed the current "segregated" corporate and individual tax systems and described several alternative ways these systems could be integrated, thereby eliminating forms of double (and multiple) taxation. [8] Others developed tax reform proposals involving movement toward consumption-based from income-based taxation. In the process of developing such proposals, it was established that minimizing the economic distortion associated with multiple taxation of saving was a centerpiece of any such tax reform program.[9]

Over the years, several of these alternative, sweeping, wholesale tax reform proposals have evolved or emerged and differentiated themselves from competing alternatives. Each alternative has positive elements supporting it. These proposals and their various pros and cons have been thoroughly assessed by a number of authors. [10] Each of the key proposals has distinguished supporters as well as political sponsors. In general, the most popular alternatives are some variant of a flat tax, a national sales tax, and a consumed-income tax. Each of these tax systems would improve the performance

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[7] Michael Schuyler, Consumption Taxes: Promises and Problems, Institute for Research on the Economics of Taxation, Washington, D.C., 1984, pp. 7, 11, 38 (parenthesis added).
[8] See, for example, David Bradford, Untangling the Income Tax, Harvard University Press, London 1986; and U.S. Treasury Department, Integration of the Individual and Corporate Tax Systems, USGPO, Washington, D.C., 1992.
[9] See Steve Entin, "Update from Washington on Fundamental Tax Restructuring," Institute for Research on the Economics of Taxation, July 18, 1995.
[10] See, for example, Entin, ibid., and the National Commission on Economic Growth and Tax Reform, January 1996.

of the economy **so long as it replaced but was not added to the existing tax structure**.[11]

While these sweeping reform proposals are commendable and would work to improve economic performance, wholesale tax reform rarely, if ever, occurs. There are several reasons why major tax reform is so unusual and the status quo is so well-entrenched. Several of these explanations are provided by public choice analyses:

- **The opposition of various special interest groups:** Sweeping tax reform often involves the removal of special deductions, of exemptions, or of certain privileges (the product of years of lobbying efforts) that benefit important and well organized special interest groups. The costs of tax reform are often concentrated among special interests and the benefits often widely dispersed among the population. Accordingly, incentives are created that work to lower the probability of sweeping reform. In particular, special interests have incentives to organize, to lobby, to become well-informed, and generally to oppose sweeping reform: i.e., organized political opposition to reform is usually quite strong.[12] On the other hand, benefits are often widely dispersed. Many groups and general interests who stand to benefit from lower taxes on capital and saving are unorganized and diffuse. Sometimes they don't realize they benefit because the benefits are neither obvious nor transparent. The general population often has little incentive to become well-informed, to lobby, to organize, and generally to muster support for tax reform. Thus, political support for tax reform is sometimes relatively weak. In short, support for tax reform is difficult to organize whereas opposition is easier to muster.

- **The Absence of a Strong Consensus:** In situations where majority control is less than overwhelming, consensus (and bipartisan support) may be essential for passage of sweeping tax reform legislation. Such consensus may be especially difficult to muster in situations as fractious as today's. Further, while trade-offs are inevitable when significantly altering the tax code, in practice tax changes to ensure popular support should have significantly more beneficiaries than losers. This requirement may be especially difficult to muster in situations where a sizable portion of the public pays no income tax.

- **The System of Government in the U.S. is Institutionally "Conservative":** Another factor explaining why sweeping tax reform is unlikely to occur is that institutionally, the form of government in the U.S. is resistant to change and prone to support the status quo; in this sense, the system is "conservative". The non-parliamentary form of government, for example, is characterized by an elaborate system of checks and balances, two legislative houses, three branches of government, and decentralized powers, all of which serve as obstacles to rapid

[11] See Entin, op.cit., p.5.
[12] Several flat tax proposals, for example, remove the mortgage deduction, which elicits strong opposition from the mortgage and real estate industries.

wholesale, dramatic change. Congress can be a cumbersome institution and its organization often requires super-majorities or a strong consensus to complete legislation. Consequently, Congress often ends up supporting only piecemeal, incremental change.

In sum, a number of reasons explain why sweeping tax reform is unlikely to occur. As a consequence, instead of one-time wholesale sweeping reform, an incremental approach to lowering taxation on capital may be more politically feasible and in practice more likely to be successful. As Conlan et. al. remarked, "incremental decisions are normally the path of least resistance where there is a pluralistic distribution of power." [13]

An Incremental Approach

Many economists and activists concur that an incremental approach to lowering taxation on capital would likely be more viable politically than any grand attempt at one-time sweeping, wholesale reform.[14] An incremental approach, however, needs to have clear objectives so that continual movement toward these goals is maintained over time. An incremental approach, for example, should focus on minimizing the most egregious economic distortions of the existing tax structure. The greatest economic benefit is provided by lowering taxes in those areas where taxes are most distortive. Currently, this would involve lowering taxation on those activities that are taxed highest because of double – or multiple – taxation on capital: ie., lowering taxes on those activities with the highest rates and the narrowest base. Economic activity, after all, should be taxed as evenly and equally as possible. Since saving, investment, and capital formation are often taxed multiple times, these tax-rates are generally higher than those on other economic activity such as consumption. Thus, saving, investment, and capital formation are prime candidates for further tax reduction.

More specifically, our system is hybrid in nature; some saving is taxed once, some twice, others three or four times. While the cost of capital may be low for some individual forms of capital, it is not low for the aggregate. Accordingly, an incremental approach to tax reduction would involve reducing or eliminating those forms of taxation comprising the multiple layers of taxation on saving, investment, and capital described above. Incrementally lowering taxation on capital would involve "peeling off" those layers of multiple taxation on saving, investment, and capital, thereby lowering the aggregate cost of capital.

Some incremental tax reduction, for example, might involve lowering taxation on any or all of the following: personal income, corporate income, interest income, dividend income, capital gains, gift and/or estate transfers. It might involve enhanced depreciation allowances and/or lower taxation on saving. It would, however, produce lower capital taxation in the aggregate. Given recent tax reduction on personal income, dividends,

[13] Timothy J. Conlan, Margaret T. Wrightson, and David R. Beam, Taxing Choices: The Politics of Tax Reform, Congressional Quarterly Press, Washington, D.C., 1990, p. 231.
[14] See, for example, Entin, op. cit., p.3, where he suggests that an incremental approach could make significant gains by dismantling multiple layers of taxation on capital.

capital gains, depreciation allowances, together with the historic low saving rate in the U.S., direct tax relief for saving seems an especially appropriate choice at this time.

Directly reducing taxation on saving can take a number of forms. Over the years, a number of tax-deferred saving vehicles have been established, including for example, IRAs, Roth IRAs, 401k's, Keough accounts, as well as more specialized saving plans.[15] These saving vehicles can be expanded in several ways. In addition to expanding allowable contributions, age and income eligibility limits can be liberalized as a way of lowering taxes on saving and capital.

In recent years, the administration has proposed an expansion of tax exempt savings vehicles.[16] This proposal would consolidate, simplify, and expand the tax exempt treatment of saving, while encouraging saving. More specifically, the administration's proposal would replace the many current forms of tax exempt savings accounts with three types:

> (1) Lifetime saving accounts (LSAs), (2) Retirement savings accounts (RSAs), and (3) Employer Retirement Savings Accounts (ERSAs). These newly consolidated vehicles would operate like Roth IRAs: i.e., they would be "back loaded," so contributions would not be deductible but distributions and earnings would be. Interest and investment income would accumulate tax free and withdrawals would be tax free. Contribution limits for accounts would be increased substantially, exempting sizable portions of savings from taxation for most households. According to the original proposal, for example, the new LSAs, would allow annual contributions of $7,500 per person or $15,000 per family. Income caps for eligibility would be eliminated. The other new vehicles would allow for similar contributions so that overall, incentives to save would be bolstered considerably, while capital taxation would be significantly reduced. Given "the new investor class" whereby workers are savers and investors, owning IRA's, stocks, and pension funds, such tax reduction would to some extent directly benefit labor.

Effects of Reduced Taxation on Capital

Because taxation on saving, investment, and capital formation takes a number of different forms, it is often difficult to precisely quantify the aggregate macro effects of lower capital taxation. Analysis of the macro effects of lowering capital taxation often borrows from several related bodies of literature, including the tax incidence, optimal taxation, and the growth literature.

[15] See, for example, James R. Storey, Paul J. Graney, "Retirement Plans with Individual Accounts: Federal Rules and Limits," Report for Congress, Congressional Research Service, Feb 17, 2003.
[16] See, for example, "Principles of Tax Reform," testimony of Michael J. Boskin before the Joint Economic Committee of the U.S. Congress, November 5, 2003, pp. 15-6, for a discussion of the Administration's tax proposals.

Initial Effects

Most popular analyses of tax cuts on capital tend to focus on the initial, first-round effects that benefit capital, after-tax returns to capital, and capital owners. Today, capital owners increasingly are workers with pensions, IRAs, and or stocks in their portfolios. That is, more and more middle-class households own stocks, bonds, real estate and other assets in their pension funds, IRAs, and mutual funds. It is estimated, for example, that more than 50 percent of U.S. households own equities.[17] Many of these individuals are entrepreneurs or small business owners. In short, there is an emerging "investor class" that increasingly includes middle-end even some lower-income households.

Accordingly, "labor" and "capital" theoretically cannot be stereotypically categorized into distinct "air tight" compartments. Sharp distinctions between these categories is increasingly suspect. Instead, the categories are increasingly becoming "blurred"; labor and capital are gradually merging into one entity. As a consequence, the effects of taxes on capital no longer are confined to wealthy or upper-income households. Rather, reductions of taxation on capital increasingly impact middle-class investors or the entire "investor class."

In spite of these observations, however, the distinction between capital and labor remains appropriate for analytical purposes as in studies of the effects of capital taxation.

The initial effect of lower capital taxation, for example, is to increase the after-tax rate of return received by owners of capital. Higher rates of return on capital will improve incentives to save, invest, and accumulate capital. Conventional economic analysis maintains that lowering taxation on capital promotes capital formation, and helps both the stock market and owners of capital, some of whom may be wealthy. It is these initial effects that are highlighted and emphasized by the media and political pundits. Their analysis is often accompanied by assertions that the benefits of capital tax cuts go largely to a small sliver of the population, and come at the expense of labor and the working class. The interests of capital and labor are antagonistic in this view. Far from promoting growth, tax cuts on capital are often depicted as zero-sum in nature, allowing the rich to accumulate wealth relative to workers.[18]

A More Complete Picture

These initial, first-round effects are partial and incomplete. They are misleading since they represent only part of the story and overlook important secondary effects. They are what the French political economist Bastiat referred to as "what is seen" as

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[17] See, for example, **Equity Ownership in America 2005**, Investment Company Institute and the Securities Industry Association, pp. 1,7,8.

[18] Proponents of this view contend that lowering Capital Taxation brings about shifts of funds out of taxable funds and into now lower-taxed capital. No new capital is created, only shifts in distributions occur.

opposed to "what is not seen." As Bastiat argued, an acceptance of only these partial, first-round effects is a common error of economists.[19]

A more complete, comprehensive assessment is more general, taking into account the "not so obvious," indirect, secondary and longer-term effects impacting all groups. These effects were emphasized by classical economists but are often overlooked by recent analysis. The secondary effects of lower capital taxation can be very important, as they involve impacts on labor, productivity, wages, living standards, and economic growth.

As mentioned above, initial effects of capital taxation cuts raise the rate of return to capital, benefiting capital and its owners. With higher rates of return on capital, incentives to save and invest improve, fostering more capital formation. These effects, however, are only the initial effects of cuts in capital taxation. In particular, the increased formation of capital eventually bolsters the earnings of labor, as labor becomes more productive when it is combined with larger a stock of capital.[20]

The effects of changes in the capital stock on labor, productivity, and other factors are explained by a fundamental principle of economics: namely, the law of variable proportions (or the law of diminishing returns). This law maintains that the greater the amount of capital combined with a given amount of labor, the greater is the marginal product of that labor. Similarly, the larger the capital-labor ratio, the lower is the marginal product of capital. Some important insights are illustrated by this important principle. Increasing the capital-labor ratio, for example, results in an increased demand for now more productive labor. In an efficient market system, the increased demand for labor services results in increases in both employment and real wage rates: i.e., higher standards of living for labor. While other factors influence labor productivity, there is a strong consensus that one of the most important determinants of labor productivity over time is the size of the capital stock with which people work.

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[19] Henry Hazlitt's paraphrasing of Bastiat is noteworthy:

> "(A key fallacy) is the persistent tendency of men to see only the immediate effects of a given policy, or its effects only on a special group, and to neglect to inquire what the long-run effects of that policy will be not only on that special group but on all groups. It is the fallacy of overlooking secondary consequences.
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> In this lies the whole difference between good economics and bad. The bad economist sees only what immediately strikes the eye; the good economist also looks beyond. The bad economist sees only the direct consequences of a proposed course; the good economist looks also at the longer and indirect consequences. The bad economist sees only what the effect of a given policy has been or will be on one particular group; the good economist inquires also what the effect of the policy will be on all groups."

Henry Hazlitt, Economies in One Lesson, Arlington House, N.Y., 1979, pp. 15-6 (parenthesis added).

[20] See Richard E. Wagner, Federal Transfer Taxation: A Study in Social Cost, Institute for Research on the Economics of Taxation, 1993, pp. 10-11. The following paragraph follows the argument therein.

So, in contrast to the analysts who focus exclusively on the initial effects of reductions in capital taxation and who contend that capital tax reduction benefits only the wealthy capital owners, more complete analysis suggests the benefits of reduction in capital taxation are more widespread. Cuts in taxation on capital can benefit labor in important ways. In particular, over time, a reduction in capital taxation fostering capital formation can importantly improve labor productivity, labor's wages, employment and thus labor income, living standards, and economic growth. Countries that are capital rich tend to have high living standards. More general analysis suggests that labor and capital are complements: that the economic interests of labor and capital are harmonious, not antagonistic, as suggested by the partial analysis described above. Policies that promote capital formation, therefore, likely will benefit labor. Indeed, even though workers may not own capital, they still can benefit (sometimes significantly) from its increase. In effect, benefits of reduced capital taxation shift over time from supplies of capital to supplies of labor. [21]

Corroboration

The above-described secondary effects which underscore the benefits of lower capital taxation accruing to labor are corroborated in several bodies of economic literature. This literature tends to support the view that the principal beneficiaries of tax reduction on capital are not only capital owners as maintained by much contemporary analysis.

Tax Incidence Literature

Studies of tax incidence determine how the burden of a tax is allocated among consumers, workers, and other factors of production. In so doing, the tax incidence literature provides a number of illustrations of the benefits of lowered capital taxation shifting to labor. As Kotlikoff and Summers contend in their survey of the tax incidence literature:

> "The distinctive contribution of economic analysis to the study of tax incidence has been the recognition that the burden of taxes is not necessarily borne by those upon whom they are levied…Economics is at its best when it offers important insights that contradict initial, casual impressions. The theory of tax incidence provides a rich assortment of such insights. Tax incidence's basis lesson that…taxes on capital may be born by workers…(is an example)." [22]

Similarly, Fullerton and Metcalf show in their survey that tax incidence analysis "begins with the very basic insight that the person who has the legal obligation to make a tax payment may not be the person whose welfare is reduced by the presence

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[21] See Gary Becker, "The Dividend Tax Cut Will Get Better with Time," Business Week, February 10, 2003, p.2 of 3.

[22] Lawrence J. Kotlikoff and Lawrence H. Summers, "Tax Incidence," Chapter 16, Handbook of Public Economics, Volume II, edited by Alan Auerbach and Martin Feldstein, North Holland, N.Y., 1987, pp.1043, 1088. (parenthesis added).

of the tax.”[23] In short, this literature demonstrates that economic incidence is distinctly different from statutory incidence because changes in behavior alter the tax burden.

Further, this literature concedes that lower capital taxation may improve the welfare of labor. Indeed, this literature provides a number of examples of reduced capital taxation which is shifted so as to significantly benefit labor. These results are the product of a variety of methods, models, and differing assumptions or conditions. The results often depend, for example, on assumptions about factor elasticities, about economic openness, or about factor mobility. Similarly, the type of model employed (e.g., static, dynamic, general equilibrium, life-cycle, etc) may significantly affect the results.[24] In addition to this literature, surveyed professional economists indicated they supported the view that a significant portion of the tax burden of corporate income taxation is shifted away from capital.[25]

Other Literature

Additional economic literature corroborates the view that secondary effects of capital tax cuts are important and often largely accrue to labor. In particular, some authors contributing to the optimal taxation literature find that it is suboptimal for the economy to tax capital income in the long run.[26] This suggests that capital taxation should be reduced in order to benefit the macroeconomy, economic growth, and labor in the long run. Other researchers, notably Feldstein, find large welfare costs and deadweight losses associated with capital taxation. For example, Feldstein calculates “an enormous welfare cost associated with the taxation of capital income” as well as “a significant gain in welfare from a shift away from a capital income tax toward a wage tax.”[27] Generally, “the more recent work on the welfare cost of capital income taxation carried out in the 1980s…tended to indicate that the welfare cost of capital income taxation was significant.”[28] Researchers, notably Lucas, showed that lowering the capital income tax rate could permanently raise the economy’s growth rate.[29]

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[23] See Fullerton, Don and Gilbert E. Metcalf, “Tax Incidence,” National Bureau of Economic Research (NBER) Working Paper 8829, NBER, March 2002, p.1.

[24]See Kotlikoff and Summers, op. cit, pp 1060, 1066, 1067, 1073. See also Fullerton and Metcalf, op.cit (e.g., See citations about Feldstein. (1974), Judd (1985a), and Mutti and Grubert ((1985).)

[25]See Fullerton and Metcaff, op. cit., p.29 (footnote).

[26] See, for example, Raymond G. Batina and Toshihiro Ihori, Consumption Tax Policy and the Taxation of Capital Income, Oxford University Press, Oxford, 2000, p.23. See, for example, citations for Arrow and Kurz (1970), Judd (1985), Chamley (1986), and later Lucas (1990).

[27]See Batina and Ihori, op. cit., pp. 22,53.

[28]See Batina, and Ihori op.cit., pp. 87,105.

[29]See ibid, p.93. Eliminating capital income taxation would significantly boost the per capita capital stock according to Lucas (see Batina and Ihori, ibid, p.105).

Growth literature shows that capital accumulation promotes growth and higher income per capita. It suggests that lowering the income tax rate on capital would not only boost growth, but also advance welfare, thereby ultimately benefiting workers. Some researchers also argue that capital taxation is suboptimal if capital is mobile internationally (and the economy open). [30] In this case, lowering the tax on the more mobile factor (capital) works to relieve the accumulated burden on the more immobile factor (labor) and thus works to benefit labor. And the literature is peppered with models which suggest that the benefits from lowering interest income taxation may be shifted substantially to workers: that a lowered capital taxation will foster capital accumulation which, when combined with labor, raises the wages received by workers. [31]

In sum, major categories of economic literature – the literature on tax incidence, on optimal taxation, and on economic growth – all strongly suggest that lowering taxation on capital may well have significant secondary effects that accrue to the benefit of labor or workers rather than exclusively to capital. Additionally, the movement toward reduced capital taxation can remain fully consistent with any desired degree of tax progressivity; adoption of consumption taxation does not in any way consign consumers to a more regressive tax system.[32]

Summary and Conclusions

Recent tax reductions on income, dividends, and capital gains, together with expanded depreciation allowances, lowered taxation on capital. These cuts improved the current structure of capital taxation. Nonetheless, the existence of an income-tax base continues to impose a bias against savings, investment, and hence capital formation. This anti-capital bias of income taxation has long been understood by prominent economists (including John Stuart Mill, Alfred Marshall, A.C. Pigou, Irving Fisher, and Nicholas Kaldor) who explicitly recognized that bias and preferred expenditure taxation. A host of more contemporary economists also recognize this bias and support an expenditure tax base.

Remedies for this bias in the form of wholesale restructuring of the tax code have been proposed in recent years; e.g., a flat tax, national sales tax, or consumed-income taxation. All have advocates. But public choice theory suggests that there are well-known political obstacles to such sweeping reform. Consequently, instead of a one-time sweeping overhaul, an incremental approach to removing the tax bias against saving may prove to be more feasible politically. This paper delineates such an approach and examines the short-and long-run economic effects of reducing capital taxation. While the initial, short-term effects are relatively straightforward and beneficial to capital, important secondary, longer-run effects, often "unseen" and misunderstood, are highlighted. In particular, several bodies of economic literature suggest that important, substantial benefits of lower capital taxation are likely to accrue to labor and workers.

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[30] Ibid,, p. 301.
[31] Ibid,,p.100.
[32] The tax rate structure determines the degree of progressivity.

This implies that important interests of labor and capital are importantly harmonious, not antagonistic, as much present-day opinion suggests. These mutual benefits often go unrecognized. For all of the reasons highlighted in this paper, there is strong support for making permanent recent reductions in capital taxation.

Appendix

Earlier Writers

This appendix documents the historical recognition of the anti-saving bias of income taxation. The view that taxation should be based on an individual's expenditures or consumption rather than his income or earnings was voiced by Thomas Hobbes. [33] The essential idea he supported was that "an expenditure base would tax people accordingly to the amount which they take out of the common pool, and not according to what they put into it." [34]

John Stuart Mill clearly spelled out important arguments against income-based taxation. He explicitly recognized that income taxation is biased against saving (and hence investment and capital formation) because of the multiple taxation of saving. Mill's support of consumption-based taxation was important because he and his principles were so influential. As Blaug emphasized:

> "All through the second half of the 19th century Mill's Principles of Political Economy was the undisputed bible of economists…as late as 1900 Mill's work was still the basic textbook in elementary courses in both British and American universities." [35]

In making the case for consumption-based taxation in this book, Mill clearly spelled out the biased nature of income taxation:

> "…the proper mode of assessing an income tax would be to tax only the part of income devoted to expenditure, exempting that which is saved. For when saved and invested ….it thenceforth pays income tax on the interest or profit which it brings, notwithstanding that it has already been taxed on the principal. Unless, therefore, savings are exempted from income tax, the contributors are twice taxed on what they save, and only once on what they spend… [36] The difference thus created to the disadvantage of prudence and economy is not only impolitic but unjust. To tax the sum invested, and afterwards to tax also the proceeds of the investment, is to tax the same portion of the contributors means twice over….No income tax is really just from which savings are not exempted; and no income tax ought to be voted without that provision…"

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[33] Thomas Hobbes, Leviathan, chapter XXX. Cited in Nicholas Kaldor, An Expenditure Tax, Unwin University Books, London, 1965.
[34] Nicholas Kaldor, An Expenditure Tax, Unwin University Books, London, 1965, p.11.
[35] Mark Blaug, Economic Theory in Retrospect, R.D. Irwin, Homewood, Ill., 1968, p. 180.
[36] John Stuart Mill, Principles of Political Economy, Augustus M. Kelley, Fairfield, 1909, p.813.

> "…all sums saved from income and invested, should be exempt from the (income) tax."[37]

Alfred Marshall also supported consumption-based taxation and actually proposed a post-World War I expenditure tax.[38] Another well-known economist, A.C. Pigou, contended that an income tax can be shown to be biased against saving and investment; accordingly, he argued that an expenditure tax is preferable to an income tax.[39]

Irving Fisher was another prominent economist who recognized that income taxation is biased against saving, investment, and capital formation, since savings is taxed multiple times. Echoing the arguments presented by Hobbes, Mill, and Marshall, Fisher stated that saving should be exempt from income taxation and that expenditure-based taxation is preferred. Fisher (1942) explicitly took note of earlier economists supporting this view in his book's extensive bibliography.[40]

In making his argument, Fisher noted that income taxation is flawed in several ways:

> "[income taxes] are unfair…because they impose double taxation (by taxing savings and their fruits)… they thus tax the producers of the nation's wealth more heavily than those who merely spend, especially the "idle rich"…By taxing the increase of capital, they kill the most important geese which lay the most important golden eggs…if a tax on the savings is added to a tax on the fruit of the savings, essentially the same thing is taxed twice."[41]

Fisher took note of several forms of multiple taxation on capital. For example, he stated:

> "…to tax the corporation on the profits which it distributes and, at the same time, to tax the stockholders personally on their dividends is to tax the same thing twice – it is double taxation."[42]

Fisher's book and his many other publications addressing this topic show the broadness and depth of his knowledge on this subject.[43]

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[37] Mill, ibid., pp. 814-15, 829 (parenthesis added).
[38] See Alfred Marshall, "The Equitable Distribution of Taxation (1917)," in Memorials of Alfred Marshall edited by A.C. Pigou, Augustus M. Kelley, N.Y., 1966, pp. 345-352.
[39] A. C. Pigou, A Study in Public Finance, London, MacMillen & Co. 1947 (Third edition), chapter X.
Ibid, p.3, p.56. [brackets added].
[40] Irving Fisher and Herbert Fisher, Constructive Income Taxation, Harper & Bros., New York, 1942.
[41] Ibid, p.3, p.56. [brackets added].
[42] Ibid, pp. 28-29.
[43] See his bibliography, ibid., pp. 249-260.

Recognizing the biased nature of income taxation, Nicholas Kaldor also made the case for expenditure-based taxation in a study stemming from his work at the Royal Commission on the Taxation of Profits and Income in the early 1950s. His arguments included all the points outlined above, but also highlighted several additional ones. Kaldor emphasized, for example, that "an expenditure base would tax people according to the amount which they take out of the common pool and not according to what they put into it."[44] Kaldor also argued that income taxation is biased against risk bearing and, further, that:

> "The primary economic objective of the financial policy of the Government in a modern state… is…the maintenance of… an adequate rate of capital accumulation for steadily rising standards of living."[45]

In sum, the idea that income taxation is biased against saving, investment, and capital formation is not novel, but rather, has a remarkably respectable ancestry dating from at least the mid-1800s.

[44]Kaldor, op.cit., p. 53.
[45]Ibid., pp. 173-4.