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# Is Heavy Taxation of Capital Socially Desirable?

By Michael J. Boskin

The life cycle theory of saving and consumption has occupied a central role in the scientific analysis of consumption at least since the 1950's, yet the implications of the theory, and supporting empirical evidence, have only slowly worked their way into an understanding of the central issues of tax policy. As a result, a variety of generally fallacious propositions continue to command attention, not only from the general public, but from policy-makers and even professional economists.

I shall bring together several pieces of information and analysis to help nudge one such proposition off center stage: that heavy taxation of capital relative to labor is exclusively at the expense of the extremely wealthy and enormously beneficial to the mass of the working population. However accurate or inaccurate this view once may have been, it is now outmoded for several reasons: the changing ownership of the capital stock, the new understanding of the incidence of capital income taxes, and the rigorous analysis of the optimal life cycle pattern of taxation.

In my opinion, the most important *long-run* structural problem with the U.S. economy is that *we undersave*. We have not accumulated enough capital, and our current saving rate is grossly inadequate.

This is *not* a short-run problem tied to the serious recession/inflation we are now experiencing. It is a fundamental, pervasive problem which involves enormous waste of resources. While several solutions are conceptually possible, my preferred solution involves a major change in our tax system: replacing taxes on income with taxes on spending; i.e, removing saving from the tax base.

## Fallacies about Capital, Its Ownership And Its Taxation

> **FALLACY 1:** Capital accumulation is important only to big business; reducing capital income taxes is a giveaway to business and would not benefit ordinary citizens.

What is saving (capital accumulation) and why is it so important? Saving is the withholding of resources from

### *This Issue in Brief*

"The most important *long-run* structural problem with the U.S. economy is that *we undersave*," writes economist Michael J. Boskin in this issue of Tax Foundation's *Tax Review*.

Professor Boskin maintains that current U.S. tax policy is preventing the nation from accumulating enough capital and that the current saving rate is grossly inadequate.

Professor Boskin argues that our lack of saving "is a fundamental, pervasive problem, which involves an enormous waste of resources." The best solution, he maintains, involves "a major change in our tax system: replacing taxes on income with taxes on spending; i.e., removing saving from the tax base."

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current consumption in order to add to future productive capacity. It is the single most important determinant of economic growth.

The decision as to how much of our productive potential to devote to current consumption and how much to save is one of the most basic we make as a nation. The essential part is that in order to have greater consumption in the future we must accumulate more capital; to accumulate more capital, we must sacrifice current consumption. On an individual level, such a decision involves deciding how much of our income to devote to current consumption and how much to save for future needs, including retirement when income declines substantially. The issue may be stated quite simply: Are the social benefits from increased saving (and hence increased future consumption) worth the cost incurred from decreased current consumption? I believe the answer is clearly yes.

**FALLACY 2:** Most capital is owned by people who inherited it rather than accumulated it themselves.

The first issue we must confront in determining the extent of capital ownership due to inheritance is to distinguish between direct and indirect inheritance. A variety of types of inheritance may be termed indirect inheritance, or the general trust fund passed from one generation to the next: such items as government capital, general knowledge, and technical change, etc. Each of these may have indirect effects on private capital accumulation. This article will focus on the direct inheritance passed from parents to children.

The only direct data on inheritances and bequests of capital come from estate and gift tax returns. Because of exclusions and deductions, Federal estate tax returns are filed for only seven to nine percent of decedents. It is, however, generally acknowledged that these wealthiest decedents account for the bulk of total capital bequests. I have calculated net bequests by subtracting various deductions and estate taxes from gross bequests.[1] To these totals we add similarly calculated net gifts. This produces a rather startling result: total annual transfers thus reported amount to only one-half of one percent of the capital stock! With about 25 years per generation, perhaps 10 to 15 percent of the capital stock is inherited in this way. Of course, some intergenerational capital transfers will not be reported, so perhaps we should use as a rough guide a number closer to 20 percent or so. In any event, these data suggest that a very large fraction of the capital stock is attributable to lifetime accumulation rather than inheritance. A similar estimate can be obtained from examining the growth of the aggregate capital stock. Further, the recent growth of private pension plans, which now own one-third of corporate capital by one estimate, suggests a spreading of the ownership of non-inherited capital to the middle and lower-middle income classes.

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With the possible exception of the few extremely large fortunes, it appears plausible, then, to discuss issues of the taxation of income from capital in the context of the desirable life-cycle taxation of consumption.

**FALLACY 3:** Most capital income accrues to the extremely wealthy.

It is true that capital income is less equally distributed than labor income and that it accrues disproportionately to the wealthy. This is due partly to the correlation between age and accrued savings, and income, respectively. However, three-fourths of capital income accrued to families with incomes below $50,000 (in 1972). While inclusion of capital gains would reduce this share somewhat, inclusion of the imputed income to housing and consumer durables would increase it; *it is clear that even if capital income taxes are borne exclusively by capital, heavy taxes on capital income will not be borne primarily by the extremely rich.*[2]

**FALLACY 4:** Heavy taxes on capital do not affect capital accumulation.

Suppose we analyze substituting an equal (current) yield capital income tax for a labor income tax. This will affect saving behavior in two ways. To the extent the propensity to save out of capital income exceeds the propensity to save out of labor income, saving will decrease initially by the amount of the tax revenue times the difference in the marginal propensities to save.

1. There are two slight problems here. First, the marital deduction may include more intergenerational transfers; and net bequests may include some transfers with the elderly generation. Second, the recipients may have paid for a small part of these bequests by reverse intergenerational transfers during their lifetime.

2. Of course, we would want to adjust these data to correspond to permanent income, as opposed to current income; however, I do not believe that such a correction would alter the basic conclusions.

Probably more important, the capital income tax reduces the real net-of-tax rate of return to saving. If private saving has a positive interest elasticity, substituting a capital income tax for a labor income tax will decrease saving. There is now considerable evidence that the taxation of capital income, by reducing sharply the after-tax rate of return, substantially decreases saving.

I have estimated a substantial positive impact of real after-tax rates of return on private saving.[3] My estimated interest elasticities cluster around 0.4 This implies that a 10 percent increase in the after-tax rate of return, say from 3 to 3.3 percent (occasioned, for example, by cutting capital income taxes slightly) would increase private saving by 4 percent, holding other things constant. Present heavy taxes on capital (estimates range from about 40 percent to 60 percent) have substantially impeded the accumulation of capital in the U.S. economy, the implied reduction in the capital/labor ratio being 30 to 40 percent. This tax-induced distortion of the consumption/saving choice leads to an enormous inefficiency, or dead weight loss of $50 to $60 billion annually!

**FALLACY 5:** Taxes on income from capital are borne exclusively by owners of capital.

Since these taxes have sharply retarded capital accumulation, they have decreased the capital available per worker in the U.S. economy; i.e., they retard the productivity of labor, and hence wage rates. Elsewhere I and others have estimated that perhaps one-half of all such taxes are ultimately shifted to labor via reduced wages. Workers have a huge stake in capital accumulation. While in the very short run (say a year), collective bargaining might be seen as how a given income is divided between capital and labor, in the long run wages are tied to productivity, which in turn reflects the available capital per worker.

**FALLACY 6:** The U.S. is saving enough today.

This is one of the least well understood issues in contemporary economic affairs. Proponents and opponents of this view have employed at least three fallacies in this argument. The first is hidden in the use of the conventional measure of saving for comparison of the U.S. saving rate with that of other countries. Our rate is much lower than that of Japan and Western Europe, and many persons have used this evidence to conclude that our relatively slow rate of economic growth is due to too low a rate of saving. They ignore the fact that those two areas came out of the war with their capital stocks depleted, thus requiring substantial saving to replenish them, and that they ended up with a newer capital stock and all its advantages. Further, such comparisons ignore the important fact that *forms* of saving differ among countries; e.g., we devote a much higher fraction of income to education, a sort of investment in humans, than do most other countries.

The second fallacy is is in the comparison of the current U.S. saving rate with our historical rate. We cannot conclude that the 1978 saving rate is desirable merely because we had the same rate in 1950 or 1960 unless we conclude that what we did then was correct. Further, the changes in the age structure of the population, increased life expectancy, earlier retirement, and other factors should have led to an increase in the rate of saving.

The third fallacy is an *exclusive* focus on business capital formation, ignoring household capital formation. Historically, there have been substantial shifts between direct personal saving and saving through corporations. As tax rates change, people have found it more advantageous to save by having earnings retained by corporations in which they have investments, electing to pay a capital gains tax later rather than a high income tax now. *Our basic problem is with the total saving rate, not with one of its components.* If we conclude that we should save more as a nation, there is no reason to argue that the increased saving should be done exclusively, or even mainly, through the corporate sector.

How then, should we think about whether we are saving enough; i.e., accumulating enough capital? As usual, we must compare the benefits with the costs.

The benefits from increased saving may be approximated by the social rate of return on private investment, the rate at which future consumption is produced from private investment. While this is not easy to estimate, most economists would accept a figure of about 10 percent, after accounting for inflation. Stated simply, if we put an extra $1,000 into private investment, it will produce an additional income flow of $100 per year. This extra income in the future will finance increased consumption.

For most goods and services, private markets automatically equate the incremental benefits and costs of the good in question. Unfortunately, in the case of saving, personal and corporate income taxes drive a wedge between the benefits, or social rate of return to saving, and the costs, or opportunities foregone in saving.[4] For example, if you invest in the corporate sector and your investment earns a 12 percent return, the corporation income tax will reduce your return by approximately 50 percent, or down to 6

3. See M. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, April 1978.

4. This example refers to corporate earnings financed by equity and paid out as dividends. Debt finance and/or retention can reduce the size of this wedge at the margin.

percent. This is not the end of the story. As *you* receive that 6 percent, you pay personal income taxes, Federal and state, on it. If your income is around $25,000 per year, you may well pay one-third of additional income in taxes. Hence, your 1,000 investment produces an income flow of $120 per year; after corporate taxes you get $60 per year; after personal taxes you may get only $40 per year! *Your* return on the investment is only one-third of the total return, 4 percent; the government takes two-thirds of the benefit. It is this divergence between the private return to the saver and the total, or social, return that leads us to save too little.

Our undersaving thus leads to an enormous waste of resources. It also has an adverse effect on future wages. Just as a farmer is more productive when he uses a tractor than when he tills the soil by hand, or an accountant is more productive with a computer than with a slide rule, so workers in general are more productive when they have more capital per worker. Since the primary determinant of wage rates is productivity, an increase in the rate of saving would increase future wages.

### Implications for Tax Policy Concerning Capital Income

Perhaps a useful way to summarize the discussion above is to return to a central tax policy focus of the debate over the desirability of heavy taxation of capital income: the choice between income and consumption as a tax base. Proponents of heavy capital income taxation argue that expenditure taxation, which deletes saving from the tax base, is less "equitable" that income taxation. I believe this view is inaccurate for a variety of reasons. First, the rate schedule in an expenditure tax is subject to choice. For instance, it can be made as progressive as in the income tax. Second, current income is a poor measure of economic well-being. Incomes fluctuate substantially over an individual's lifetime; indeed, current consumption is probably a much better measure of *permanent* income than is current income. Third, a substantial share of capital income taxes is ultimately shifted. Fourth, the ownership of the capital stock is more diffuse than commonly supposed and is diffusing throughout the general population. Finally, *a consumption tax is a wealth tax*. This simple point is not commonly understood. From the household's lifetime budget constraint, we know that each household's wealth is the present value of its expected future earnings and capital income. Over its lifetime, the household's consumption[5] will equal the present value of its future income stream. Thus, a tax on consumption is a tax on wealth.

For all these reasons, and more, I find the case against expenditure taxation unconvincing, and heavy taxation of capital quite likely to worsen the welfare of the general population.

I therefore propose gradually abolishing all taxes on income and replacing them with taxes on expenditure. As a practical matter, this would involve (1) *abolishing the corporate income tax, and* (2) *removing saving from the personal income tax base*.

These two policies would leave us substantially with a tax on consumption (expenditures); such a tax, relative to our current heavy taxation of capital income, would increase the return to saving, and thus increase capital accumulation, future wages, and future consumption and income.

There is now considerable support for the view that such a tax system, relative to the current one, would not only be more efficient as regards capital accumulation but would also be easier to administer. Further, under a consumption tax, all would pay taxes commensurate with their standard of living.

Reduction of taxes on income from capital should not be thought of primarily as a way to "give business a break." Capital in whatever form is an intermediary in the lifetime consumption process of citizens. We should reduce capital income taxes to improve the efficiency of the allocation of resources of all of our citizens between present and future consumption, especially between working years and retirement.

If we continue to discourage private saving by our heavy taxation of its return, we will face the awkward prospect of a huge increase in the number of elderly persons dependent upon Social Security for a substantial share of their retirement income, and of an enormous increase in taxes on future workers to finance these benefits. We must begin to deal with the undersaving problem soon, or see the already damaging consequences worsen in the years ahead. *The best place to start is with the abolition of income taxation, corporate and personal, in favor of consumption taxation.*

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5. Including bequests in consumption.