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Capital Income Taxation: Reframing the Debate

By Alan D. Viard

Although capital income taxes penalize saving and slow long-run growth, the federal tax system imposes multiple such taxes. Seven increases in capital income taxes took effect at the beginning of 2013, and President Obama's 2014 budget plan proposes further increases. In upcoming decades, rising revenue needs fueled by entitlement growth will create pressure to further expand capital income taxation despite its negative economic effects. Opponents of capital income taxation must reframe the policy debate by explaining the economic disadvantages of capital income taxes and proposing alternative budgetary measures that maintain tax fairness.

The appropriate tax treatment of capital income, or the income earned on savings, has been a major source of political controversy in recent years. Unfortunately, the political debate has often ignored or downplayed the economic effects of this type of taxation. To properly evaluate capital income taxes, we must understand how they affect saving and economic growth.

Capital Income Taxes Penalize Saving

Some commentators argue that any tax system that taxes labor income should, as a matter of fairness and economic neutrality, also tax capital income. That view misunderstands the actual consequences of capital income taxation.

The saving penalty embedded in an income tax that applies to both labor and capital income can be illustrated with an example involving two individuals, Patient and Impatient, each of whom earns \$100 of wages today.¹ Impatient wishes to consume only today; Patient wishes to consume only at some point decades in the future.

In a world with no taxes, Impatient goes to the mall and consumes \$100 today. Patient lends her \$100 of wages to a firm that buys a machine that yields a 100 percent rate of return (which is also the rate of return firms must pay savers) and therefore provides a \$200 future payoff. The firm pays Patient back her \$100 loan with \$100 interest, allowing her to eventually consume \$200.

What happens in a world with a 20 percent income tax? Impatient pays \$20 of tax on his wages and consumes the remaining \$80, which is 20 percent less than he consumed in the no-tax world. Patient also pays \$20 of tax on her wages and lends the remaining \$80 to the firm. On her \$80 loan, she earns \$80 of interest and is therefore repaid \$160 by the firm. However, a \$16 tax is imposed on the \$80 of interest. Patient is left with \$144, which is 28 percent less than the \$200 she consumed in the no-tax world, compared to a 20 percent reduction for Impatient.

Taxing labor and capital income at the same 20 percent rate is not neutral. Instead, it penalizes saving, assigning Patient a higher percentage tax burden than Impatient solely because she saves for future consumption

rather than consuming today. After being taxed on her wage income, Patient is taxed again when she saves that income and earns a return on her savings. Stated differently, the income tax reduces the after-tax rate of return on saving. Because Patient sacrifices \$80 of consumption today to obtain \$144 tomorrow, her after-tax return is only 80 percent, well below the 100 percent before-tax return.

Taxing labor and capital income at the same 20 percent rate is not neutral.

Either a wage tax or a consumption tax can achieve neutrality between Patient and Impatient. A 20 percent wage tax reduces both workers' consumption by 20 percent. Consumption taxation is neutral if the tax rate remains constant over time. Consider a tax with a 20 percent tax-inclusive rate so that the tax is 20 percent of the sum of consumption and the tax itself. After earning \$100 of wages, Impatient consumes \$80 and pays a \$20 tax, as he did under the income tax. Patient lends her entire \$100 to the firm and owes no tax because she has not yet consumed. On her \$100 loan, she earns \$100 interest, accumulating \$200. She consumes \$160 in the future and pays \$40 tax.

Relative to the no-tax world, the consumption tax reduces each worker's consumption by 20 percent. Also, Patient's after-tax rate of return is 100 percent, the same as the before-tax rate of return. By making her \$100 investment, Patient gives up \$80 of consumption today (without the investment, she would have paid \$20 tax and consumed \$80) in exchange for \$160 of consumption tomorrow, a 100 percent rate of return.

Consequences of the Saving Penalty

As you can see from this example, the income tax's saving penalty distorts the timing of consumption by favoring consumption today over consumption in the future. The penalty therefore artificially leads taxpayers to do more spending early in life and less late in life. A number of statistical studies have found that, when the after-tax rate of return on saving is lower, individuals' consumption grows at a slower rate, which confirms that their early consumption is greater and their later consumption is less.²

By driving a wedge between the before-tax rate of return (which measures the benefits that the savings can

offer in the economy) and the after-tax return that savers can receive, the income tax artificially discourages mutually beneficial saving. In the Patient-Impatient example, anyone who is willing to save in exchange for a 100 percent payoff should do so; such saving is mutually beneficial for the saver and the business firm, which can invest those savings in machines that generate a 100 percent return. With the income tax in place, however, savers clear only an 80 percent rate of return, so taxpayers who would be willing to save in exchange for a 100 percent payoff but who are unwilling to do so for an 80 percent payoff are deterred from saving.

The saving penalty is also likely to slow long-run economic growth. Although some business investment in the United States is financed by foreigners' savings and some Americans' savings are used to finance investment abroad, the level of business investment in the United States is still linked to the amount Americans save. A reduction in the amount of Americans' saving is therefore likely to shrink the US capital stock, reducing the long-run levels of output and wages.

Prominent economists' simulation models indicate eliminating capital income taxes through a move to consumption taxation would increase long-run output by 2 to 9 percent. A significant part of the long-run gains come at the expense of short-run consumption. The size of the gains depends on economic assumptions, which are subject to considerable uncertainty, and on the design of the consumption tax reform. For example, long-run gains tend to be smaller if the consumption tax adopts the sensible and politically essential policy of offering some tax relief for consumption financed by assets accumulated before the consumption tax was adopted. The models also generally assume a closed economy, which magnifies the impact of Americans' saving on domestic investment. Despite these limitations, the models usefully illustrate the potential gains from reducing or eliminating capital income taxes.³

Capital Income Taxation in the Federal Tax System

The federal government's largest revenue source is the individual income tax, which has the built-in saving penalty I have described. Some commentators downplay the saving penalty, claiming it is mitigated by such measures as tax-preferred savings accounts and the preferential individual income tax rate on long-term capital gains

(gains from the sale of capital assets held longer than one year) and qualified dividends. In reality, however, these measures have only limited effects and are outweighed by other measures that enhance the penalty on saving.

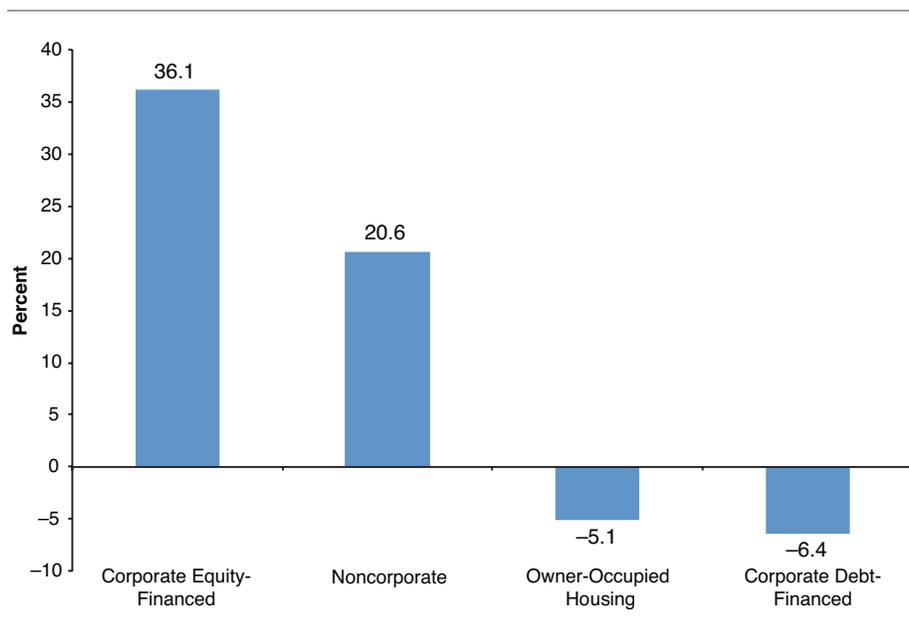
For example, although tax-preferred accounts shield about one-third of household financial assets from taxes, they do less to promote saving than would an across-the-board one-third reduction in tax rates on saving. The accounts offer no marginal incentive to save for households that reach the maximum contribution limits, and they enable taxpayers to reduce their tax liabilities by shifting money from taxable to tax-preferred accounts without additional saving. Also, the withdrawal restrictions on the accounts make them less useful to taxpayers who plan to use their savings before retirement.

In addition to the individual income tax, other parts of the federal tax system impose tax burdens on capital income. Notably, the corporate income tax imposes an additional tax burden on equity-financed investment through C corporations; the preferential individual income tax rates for long-term capital gains (as applied to gains on corporate stock) and qualified dividends only partially offset this extra tax burden. Estate and gift taxes also impose a tax burden on saving to pass wealth on to the next generation and can therefore be viewed as capital income taxes.

Also, the current tax system does not correct for inflation in its measurement of the income from saving; a taxpayer who receives 5 percent nominal interest when inflation is 2 percent is taxed on the full 5 percent rather than on her real interest income of only 3 percent. The tax system similarly fails to correct for inflation in the measurement of taxable capital gains and depreciation allowances.

To determine the net impact of the various provisions, we must look at the total tax burden on capital income. That burden can be measured by the effective marginal tax rate (EMTR), the percentage by which the after-tax return falls short of the before-tax return. In the Patient-Impatient example, the income tax imposed a 20 percent EMTR because the 80 percent after-tax rate of return was

FIGURE 1
EFFECTIVE MARGINAL TAX RATES ON CAPITAL INCOME



Source: Congressional Budget Office, *Taxing Capital Income: Effective Rates and Approaches to Reform*, October 2005, 8, www.cbo.gov/sites/default/files/cbofiles/ftpdocs/67xx/doc6792/10-18-tax.pdf.

20 percent lower than the 100 percent before-tax return. The consumption tax imposed a zero EMTR because the 100 percent after-tax rate of return was equal to the before-tax rate of return. The EMTR includes taxes imposed at both the firm level and the individual level and accounts for depreciation deductions and any tax credits that can be claimed on investments.

Figure 1 shows EMTRs computed by the Congressional Budget Office (CBO) in 2005. Because the current tax system does not treat all investments uniformly, CBO computed separate EMTRs for different investments.

CBO's calculations reveal that the current system imposes substantial tax burdens on corporate equity-financed investment and noncorporate investment while providing much more favorable treatment to owner-occupied housing and corporate debt-financed investment. Unlike other investments, equity-financed investment is subject to both the individual and corporate income taxes. Noncorporate investment, which refers to investments by sole proprietorships, partnerships, and S corporations, is exempt from the corporate income tax but bears a significant tax burden at the individual level. Debt-financed corporate investment escapes the corporate income tax because corporations may deduct interest paid on debt. The services provided by owner-occupied housing are not taxed by either individual or corporate taxes.

In summary, although some features of the current tax system offer some tax relief for capital income, major categories of capital income still face substantial tax burdens. Moreover, the effective tax rates in figure 1 understate current tax burdens because they do not reflect recent increases in capital income taxation.

Capital Income Tax Increases in 2013

Seven increases in capital income taxation took effect on January 1, 2013. Five of the increases—two individual income tax rate increases, two stealth tax increases, and an estate tax rate increase—occurred because of the partial expiration of the 2001 and 2003 tax cuts. Those tax cuts were scheduled to expire at the end of 2010 but were extended for two years by legislation adopted in December 2010. In legislation adopted in January 2013, Congress allowed part of the tax cuts to expire for high-income taxpayers at the end of 2012 while making the tax cuts permanent for other taxpayers. The remaining two tax increases were adopted as part of the 2010 Patient Protection and Affordable Care Act.

Some of the tax increases apply only to capital income while others apply to both capital and labor income. All of the tax increases apply only to high-income households, but because that group accounts for much of the saving in the United States, taxing their savings inflicts significant economic damage.

Two Individual Income Tax Rate Increases.

Individual income tax rates increased in two ways because of the partial expiration of the 2001 and 2003 tax cuts. Both rate increases apply to taxable incomes greater than \$400,000 for single taxpayers, \$425,000 for heads of household, and \$450,000 for couples in 2013; these thresholds will be adjusted for inflation in future years.

First, the top ordinary individual income tax rate, which applies to interest income, noncorporate business profits, short-term capital gains, and nonqualified dividends⁴ (as well as to wages and other noncapital income), rose from 35 to 39.6 percent. Second, the top individual income tax rate that applies to long-term capital gains and qualified dividends rose from 15 to 20 percent.

The new 39.6 percent top rate on ordinary income is the same as in 2000 before the adoption of the 2001 and 2003 tax cuts. Similarly, the 20 percent top rate on long-term capital gains is the same as in 2000. In

contrast, the new 20 percent top tax rate on qualified dividends is much lower than the corresponding rate in 2000. Because dividends were taxed as ordinary income before the 2003 tax cut, they faced a top tax rate of 39.6 percent in 2000. The January 2013 legislation preserves the 2003 tax cut's policy of taxing qualified dividends at the same rate as long-term capital gains. As I have mentioned, the lower individual income tax rate on dividends partially offsets the corporate tax burden on equity-financed investment.

Two Stealth Tax Increases. The Pease provision and the personal exemption phase-out (PEP) are stealth tax provisions not reflected in the tax rate tables. Both provisions first took effect in 1991. Under the 2001 tax cut, they were reduced in 2006 through 2009 and eliminated in 2010. The December 2010 legislation blocked the two provisions from returning in 2011 and 2012. The two provisions returned in 2013 because of the partial expiration of the 2001 tax cut, although Congress raised the income thresholds at which the provisions start to apply. Both provisions now apply to adjusted gross incomes in excess of \$250,000 for single taxpayers, \$275,000 for heads of household, and \$300,000 for couples in 2013; these thresholds will be adjusted for inflation in future years.

Seven increases in capital income taxation took effect on January 1, 2013.

Although the Pease provision is officially labeled as a reduction in itemized deductions, it does not reduce the marginal payoff of itemized deductions for most affected taxpayers.⁵ Instead, it is effectively an additional tax on adjusted gross income. For each additional dollar of income (ordinary income, capital gains, or dividends) above the threshold, an affected taxpayer generally must pay tax not only on the dollar but also on an extra three cents. Under PEP, when an affected taxpayer earns an additional \$2,500 of income (ordinary, capital gains, or dividends), an additional 2 percent of all personal exemptions claimed by the taxpayer is lost.

The Pease provision typically increases marginal tax rates by 0.99 to 1.19 percentage points for the affected taxpayers. Receiving \$100 of additional income results

in an extra \$3 being taxed, which gives rise to a tax liability of \$0.99, \$1.05, or \$1.19, depending on whether the taxpayer is in the 33 percent, 35 percent, or 39.6 percent bracket.⁶

The marginal-rate increase caused by PEP depends on the number of personal exemptions the taxpayer claims. In 2013, the personal exemption amount is \$3,900 per person. With PEP, receiving \$2,500 of additional income results in an extra \$78 per person in taxable income, which gives rise to \$25.74 of tax liability per person if the taxpayer is in the 33 percent bracket. PEP therefore typically increases marginal tax rates by 1.03 percentage points per person, or 3.09 percentage points for a three-person household.

Although the marginal-rate increase caused by PEP can be greater than that because of Pease, it does not apply at the highest income levels. Because 2 percent of the taxpayer's personal exemptions are phased out for each \$2,500 of additional income above the threshold, the phase-out is complete once income is roughly \$125,000 above the thresholds at which PEP begins to apply.⁷ At higher income levels, PEP has no impact on marginal tax rates.

Estate Tax Increase. Because of the partial expiration of the 2001 tax cut, the maximum estate tax rate rose from 35 to 40 percent, effective for persons dying in or after 2013. The increase applies to estates with taxable values in excess of \$5.25 million in 2013; this threshold will be adjusted for inflation in future years.

Under the 2001 tax cut, the maximum estate tax rate was gradually reduced from its previous value of 55 percent, reaching 45 percent in 2007 through 2009, and then eliminated for persons dying in 2010. The December 2010 legislation set the maximum rate at 35 percent for persons dying in 2011 and 2012. Congress allowed the rate to rise to 40 percent starting in 2013.

Self-Employment Tax Increase and UIMC.

The 2010 Affordable Care Act included two increases in taxes on capital income, both of which took effect as scheduled at the beginning of 2013.

First, the law increased the top Medicare payroll and self-employment tax rate from 2.9 to 3.8 percent. Although the payroll tax applies only to labor income, the self-employment tax is, in part, a tax on capital income. It applies to the business income of general partners and sole proprietors, some of which is capital income attributable to their investments in the business.⁸ The extra 0.9 percent tax applies if the sum of wages and

self-employment income exceeds \$200,000 for unmarried taxpayers and \$250,000 for couples.

Because these thresholds will not be adjusted for inflation in future years, this tax increase will gradually spread to more people. As I will explain, the effective rate of the self-employment tax is somewhat lower than the stated tax rate.

Second, the law introduced a new 3.8 percent unearned income Medicare contribution (UIMC) tax on certain kinds of income received by high-income households. This tax is specifically targeted to apply only to capital income, which Congress referred to as "unearned income" in naming the new tax. The UIMC is imposed on interest, dividends, capital gains, and some passive business income that is not subject to self-employment tax. The tax applies if adjusted gross income exceeds \$200,000 for unmarried taxpayers and \$250,000 for couples. Like the thresholds for the self-employment tax increase, these thresholds will not be adjusted for inflation in future years.

The revenue from the increase in the Medicare payroll and self-employment tax, like the other revenue raised by that tax, is earmarked to the Medicare Part A trust fund. In contrast, the revenue from the UIMC is paid into the general treasury. Although Congress labeled the tax as a "Medicare contribution," it has no financial link to the Medicare program.

The Bottom Line. Figure 2 summarizes how the 2013 tax increases affect five categories of capital income, comparing the new tax rates to the tax rates in 2000 (before the adoption of the 2001 and 2003 tax cuts) and 2012. The tax rates are those that apply at the highest income levels and therefore do not include any effects from PEP. The tax rates do not include the burden of the corporate income tax, the estate tax, or state and local taxes.

Passive business income, interest income, short-term capital gains, and nonqualified dividends were subject to an official income tax rate of 39.6 percent in 2000, to which the Pease provision added 1.2 percentage points. In 2012, these types of income were taxed at 35 percent, and Pease was gone. Now, the income tax rate and Pease are the same as in 2000, but the UIMC adds another 3.8 percentage points.

Self-employment income faced a 39.6 percent income tax rate in 2000, to which Pease added 1.2 percentage points, and the Medicare self-employment tax had an effective rate of 2.1 percent (somewhat less than the official 2.9 percent rate).⁹ In 2012, the income tax rate was

35 percent, Pease was gone, and the effective self-employment tax rate was 2.2 percent. Now, the income tax rate is 39.6 percent, to which Pease adds 1.2 percentage points, and the effective self-employment tax rate is 2.8 percent (somewhat less than the official 3.8 percent rate), for a combined 43.6 percent tax rate.

Qualified dividends faced a 39.6 percent income tax rate in 2000, to which Pease added 1.2 percentage points. In 2012, they faced a 15 percent income tax rate, and Pease was gone. Now, the income tax rate is 20 percent, to which Pease adds 1.2 percentage points and the UIMC adds another 3.8 percentage points.

Long-term capital gains faced a 20 percent income tax rate in 2000, to which Pease added 1.2 percentage points. In 2012 and 2013, they are taxed the same as qualified dividends.

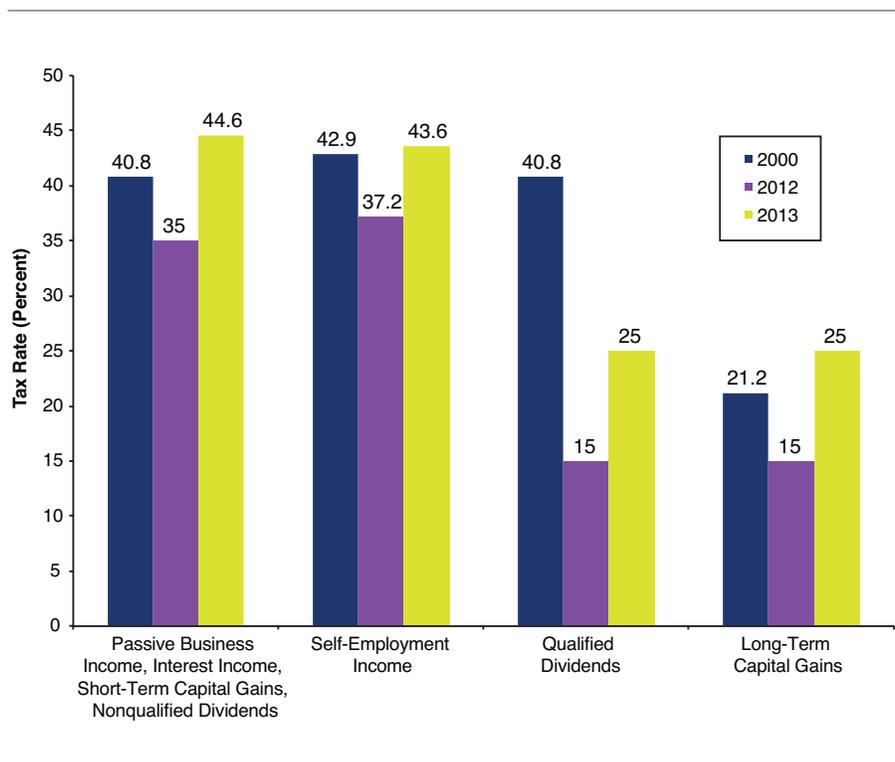
With the exception of qualified dividends, all of these categories of capital income are taxed more heavily now than in 2000. Self-employment income is taxed at a rate 0.7 percentage points higher than in 2000 because of the Medicare self-employment tax increase. Passive business income, interest income, capital gains, and nonqualified dividends are taxed 3.8 percentage points more heavily than in 2000 because of the UIMC. Qualified dividends also face a new tax burden from the UIMC but nonetheless face much lower tax burdens than in 2000 because they now receive the same income tax treatment as long-term capital gains.

These capital income tax increases may not be the end of the story, as still more increases have been proposed.

Proposed Capital Income Tax Increases

President Barack Obama proposed further capital income tax increases in his fiscal 2014 budget plan, including another increase in the estate tax and a new minimum income tax that would primarily apply to long-term capital gains and qualified dividends.

FIGURE 2
INDIVIDUAL TAX RATES ON CAPITAL INCOME



Note: Tax rates applicable at highest income levels.
Source: Author's calculations.

Effective for persons dying in and after 2018, the president's plan would boost the top estate tax rate from 40 to 45 percent and reduce the exemption amount, which could be around \$5.7 million in 2018 under current law, to \$3.5 million. Because the new exemption amount would not be adjusted for inflation, the estate tax would gradually spread to more people.

Starting in 2014, the president's plan also calls for a new minimum tax, often referred to as a Buffett tax or fair share tax. The tax would fully apply to taxpayers with adjusted gross incomes greater than \$2 million in 2014 and partially to those with somewhat lower incomes. This threshold would be adjusted for inflation after 2014. The affected taxpayers would be required to pay minimum individual income tax equal to 30 percent of their adjusted gross income (after a partial deduction for charitable contributions), minus any amounts paid in self-employment and employee payroll taxes and UIMC tax. No credits would be allowed against the minimum tax, except the credit for foreign income taxes.

Millionaires with a significant amount of ordinary income would not be subject to the minimum tax because they already pay more than 30 percent under the regular tax system. But the minimum tax would apply to millionaires

whose income is primarily from long-term capital gains and qualified dividends, because that income is taxed more lightly under the regular income tax.

The president's proposals are unlikely to be adopted by the current Congress. But proposals to increase capital income taxes will remain on the table for some time to come.

Long-Run Prospects

The long-run future of capital income taxation is likely to depend on the interplay of several factors. Although the international competition for capital will put downward pressure on the corporate income tax, the challenging fiscal environment will put upward pressure on other capital income taxes. The final outcome is likely to depend on the manner in which the policy debate is framed.

The International Competition for Capital. The relatively high US corporate income tax rate is likely to be vulnerable in the face of international competition for capital. Because the US corporate income tax primarily applies to investments inside the United States, it creates an incentive for savers, both American and foreign, to invest their savings abroad.¹⁰ As a large country with many attributes that make it a desirable place to invest, the United States has some latitude to attract capital even with a high corporate tax rate. Nevertheless, it faces the risk of losing capital if it continues to impose corporate taxes significantly higher than those levied abroad.

The corporate income tax is particularly unattractive in a world in which capital is mobile across countries. To begin, a significant part of the economic burden of the corporate tax is likely to be shifted to workers as the tax shrinks the domestic capital stock, reducing the productivity of labor and driving down wages. Some statistical studies support this prediction.¹¹ Moreover, the revenue yield from corporate tax increases is diminished by the resulting reduction in the capital stock, a prediction that some statistical studies also confirm.¹²

All countries, including the United States, therefore have an incentive to reduce their corporate taxes as capital becomes more mobile. And many countries have done so in recent decades. From 1993 to 2012, the average federal corporate tax rate in Organisation for Economic Co-operation and Development countries fell from 34.3 to 26.2 percent while the US federal corporate tax rate remained at 35 percent.¹³ Competitive

pressures may force the United States to cut its corporate rate in upcoming years.

The likely decline of the corporate income tax does not necessarily mean a shift away from capital income taxation. Because individual income taxes apply to the capital income of Americans, regardless of where those savings are invested, they cannot be legally avoided by investing abroad. These taxes are therefore less vulnerable to international competitive pressures and are likely to prove more durable than the corporate income tax. Indeed, the stringent budgetary climate will surely prompt proposals for increased capital income taxation.

Challenging Fiscal Environment. Unless current policies are changed, entitlement spending is projected to grow rapidly in upcoming decades. Under the alternative fiscal scenario in CBO's June 2012 long-run budget outlook, noninterest federal spending will rise from 21.5 percent of GDP in 2013 to 26.3 percent in 2038 and 29.6 percent in 2063. The spending growth will be driven by health programs and Social Security, which are slated to grow from 10.6 percent of GDP in 2013 to 16.6 percent in 2038 and 20.8 percent in 2063.¹⁴

Proposals to increase capital income taxes will remain on the table for some time to come.

The relentless pressure of spending increases will force Congress to make difficult budgetary choices. Capital income tax increases will undoubtedly be among the choices considered. The proposed increases could take the form of further hikes in the top individual income tax rates and in capital gains and dividend rates or of new levies like the UIMC. Or they could look entirely different. On the distant horizon, the specter of wealth taxation looms.

Professors Bruce Ackerman and Anne Alstott of Yale Law School have proposed a tax of 2 percent per year on wealth in excess of \$7.2 million; other commentators have also called for wealth taxation.¹⁵ Wealth taxes, used by a number of European countries, can impose significant burdens on capital income even at deceptively low annual tax rates. For example, with a before-tax rate of return of 5 percent per year, a 2 percent per year wealth tax is equivalent to a 40 percent tax on capital income.

A wealth tax will not be adopted in the near future because of its unfamiliarity and constitutional difficulties.¹⁶

Further down the road, though, such a tax may appeal to a Congress and president seeking to pay for entitlement growth, prompting a search for ways around the constitutional problems. Tyler Cowen of George Mason University recently predicted that wealth taxation will be the next major economic struggle in American policy debates and warned that the “coming battles over wealth taxation may prove especially bitter and polarizing.”¹⁷

A particularly insidious danger is that Congress will impose a “one-time” wealth tax, seeking to soak up past savings while avoiding disincentives for future saving with a promise not to repeat the levy. Such a promise is unlikely to be credible; on the contrary, any imposition of a wealth tax is likely to create long-lasting uncertainty about its possible repetition, casting a chill on saving and investment. In what may be a harbinger of things to come, former Office of Management and Budget director David Stockman has already proposed a one-time wealth tax, with a staggering 30 percent tax rate.¹⁸

If lawmakers are to be dissuaded from imposing capital income tax increases during a prolonged period of severe budgetary pressures, they must be informed of the fundamental flaws of capital income taxation and offered acceptable budgetary alternatives.

Reframing the Debate

Unfortunately, opponents of capital income tax increases employed a severely misdirected strategy during the debate over the extension of the 2001 and 2003 tax cuts. Rather than making the economic case against higher marginal tax rates on saving and investment, they argued that tax rate increases would harm small businesses and have adverse Keynesian impacts on aggregate demand. Of course, these arguments have some validity. Capital income tax increases impede investment by small (as well as large) businesses, and any tax increase (or spending cut) can have harmful Keynesian demand effects if it is imposed while the economy is weak.¹⁹

But these arguments did not offer a firm basis to resist capital income tax increases because alternative policy measures could address the concerns they raised. If the problem with capital income taxation is that it burdens small businesses, then the seemingly obvious solution is to raise capital income taxes while offering targeted relief for small businesses. Indeed, President Obama and other supporters of higher capital income taxation have been eager to support complex and narrowly targeted

tax breaks for small businesses, such as the small-business stock exclusion set forth in section 1202 of the Internal Revenue Code.²⁰

Similarly, if the problem with capital income taxation is that it reduces aggregate demand, then an obvious solution is to raise capital income taxes while providing Keynesian stimulus through spending increases and consumption-oriented tax cuts that may well have stronger effects on demand in any event. Another obvious solution is to simply delay capital income tax increases until the economy is strong and no longer needs Keynesian demand stimulus.

**Over the long haul, capital income tax increases
can be blocked only if opponents make the case
that they penalize saving and impede growth.**

In view of this misdirected strategy, the final outcome of the debate should not be surprising. Capital income tax cuts expired even as other tax cuts that had less impact on long-run economic growth were made permanent.

Over the long haul, capital income tax increases can be blocked only if opponents make the case that they penalize saving and impede growth. Opponents of such increases must challenge the philosophical basis for capital income taxation by asking why Patient should pay more taxes than Impatient merely because she chooses to save for the future. And they must spell out the economic importance of capital accumulation, emphasizing that long-run growth depends on the capital and other productive resources available to the economy rather than the aggregate demand factors that drive short-run business cycle fluctuations.

Opponents of capital income tax increases must also outline acceptable budgetary alternatives. One approach is to restrain entitlement spending by slowing the growth of Social Security and Medicare benefits. While entitlement restraint is a necessary part of the solution, the degree of restraint required to fully address the long-term fiscal imbalance is likely to be politically infeasible.

We must also consider other measures, such as moving toward consumption taxation. Completely replacing the income tax with a retail sales tax or value-added tax (VAT) would allow revenue to be raised without taxing capital income, but such a replacement would shift the tax burden to less-well-off households in a manner that

would be undesirable and politically infeasible. Adopting a VAT alongside a scaled-back income tax system would be more feasible, but it would not fully eliminate tax burdens on capital income and might lessen pressures to reduce spending by giving the government an additional revenue source.

A more attractive approach is to completely replace the income tax with a *progressive* consumption tax such as a Bradford X tax or a personal expenditure tax. The X tax is a graduated-rate version of the flat tax advocated by Robert Hall and Alvin Rabushka. Businesses are taxed at a high flat rate on their business cash flow, and households are taxed at graduated rates on their wages, with exemptions and refundable credits for low-wage households. The personal expenditure tax imposes taxes at graduated rates on households' consumer spending, which they compute on annual tax returns as income minus net saving.²¹ Although it may be difficult to win support for either of these unfamiliar tax systems, they have the compelling policy advantage of keeping the tax burden on those who have the greatest ability to pay, without penalizing saving.

About the Author

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Notes

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1. For further discussion of this example, see Robert Carroll and Alan D. Viard, *Progressive Consumption Taxation: The X Tax Revisited* (Washington, DC: AEI Press, 2012), 7–9, 30–32.

2. For a survey of the statistical evidence, see Timothy S. Gunning, John W. Diamond, and George R. Zodrow, "Selecting Parameter Values for General Equilibrium Model Simulations," *National Tax Association Proceedings of the 100th Annual Conference on Taxation*, 2008, 43–49, at 43–44. The relevant parameter is the elasticity of intertemporal substitution, which measures the percentage increase in the growth rate of consumption for each increase of 1 percentage point in the after-tax rate of return on savings.

3. For further discussion and references to the models, see Carroll and Viard, *Progressive Consumption Taxation*, 179–80.

4. In general, nonqualified dividends are paid by foreign companies based in countries with which the United States has not entered into tax treaties.

5. For further discussion, see Alan D. Viard, "The Myth of the Limits on Itemized Deductions," *The American*, January 9, 2013, www.aei.org/article/economics/fiscal-policy/taxes/the-myth-of-the-limits-on-itemized-deductions/.

6. Unless nearly all of the taxpayer's income is from long-term capital gains and qualified dividends, the extra \$3 will normally be taxed at ordinary income rates, regardless of the tax rate that applies to the \$100.

7. More precisely, 2 percent of personal exemptions are phased out for each \$2,500 or portion thereof above the threshold so that the phase-out is complete once income is \$122,501 above the threshold.

8. The Medicare tax is the only payroll and self-employment tax that applies on the margin at high income levels because the 12.4 percent Social Security self-employment tax ceases to apply once self-employment income plus wages reach a specified ceiling (\$113,700 in 2013).

9. The self-employment tax's effective rate is lower than its stated rate for two reasons. First, the tax is imposed on only 92.35 percent of self-employment income. Second, half of self-employment taxes can be deducted under the income tax, yielding tax savings equal to the self-employment tax times half of the income tax rate (including the Pease surcharge). The first factor lowered the 2.9 percent tax in effect in 2000 to 2.68 percent. Deducting half of the 2.68 percent tax at a 40.8 percent income tax rate yields tax savings of 0.55 percent, reducing the net tax to 2.13 percent.

10. A commonly proposed, but misguided, remedy for the corporate income tax's incentive to invest abroad is to increase taxes on investments made abroad by the subsidiaries of US-chartered corporations. (Such investments bear some US corporate income tax burden today, but the tax is deferred until profits are repatriated to the United States and credit is provided for foreign income taxes.) Such a tax increase would undoubtedly reduce the amount of investment abroad by the subsidiaries of US-chartered corporations. Investments made abroad by the subsidiaries of foreign-chartered corporations would continue to be exempt from US corporate income tax; however, the forgone investment abroad by subsidiaries of US-chartered corporations would probably lead to greater investment abroad by subsidiaries of foreign-chartered corporations, with little or no increase in investment in the United States.

11. For an analysis of the relevant studies, see Matthew H. Jensen and Aparna Mathur, "Corporate Tax Burden on Labor: Theory and Empirical Evidence," *Tax Notes*, June 6, 2011,

1083–89, www.aei.org/article/economics/fiscal-policy/taxes/corporate-tax-burden-on-labor-theory-and-empirical-evidence.

12. See Alex Brill, “Corporate Tax Rates: Receipts and Distortions,” *Tax Notes*, December 22, 2008, 1421–25, www.aei.org/article/economics/fiscal-policy/corporate-tax-rates/.

13. Kevin A. Hassett, “The Stubbornest Tax: Why the U.S. Hasn’t Cut Corporate Tax Rates, and Why It Really Should,” *National Review*, April 30, 2012, www.aei.org/article/economics/fiscal-policy/taxes/the-stubbornest-tax/.

14. Congressional Budget Office, *The 2012 Long-Term Budget Outlook*, June 2012, supplemental data spreadsheet, www.cbo.gov/publication/43288. CBO’s forthcoming 2013 long-term budget outlook may be slightly less dire, but the basic picture will not change.

15. Bruce Ackerman and Anne Alstott, “Why (and How) to Tax the Super-Rich,” *Los Angeles Times*, September 20, 2011, <http://articles.latimes.com/2011/sep/20/opinion/la-oe-ackerman-wealth-tax-20110920>. Former labor secretary Robert B. Reich has endorsed the Ackerman-Alstott proposal; see “The Myth of Living Beyond Our Means,” Robert Reich (blog), January 24, 2013, <http://robertreich.org/post/41395861898>. For other proposals, see Ronald McKinnon, “The Conservative Case for a Wealth Tax,” *Wall Street Journal*, January 9, 2012; Daniel Altman, “To Reduce Inequality, Tax Wealth, Not Income,” *New York Times*, November 18, 2012; and Anna

Bernasek, “Looking Beyond Income, Toward a Tax on Wealth Itself,” *New York Times*, February 10, 2013.

16. The Constitution requires that direct taxes, other than income taxes, be apportioned so that each state faces the same per capita burden, a requirement that would be impractical to meet. It is widely accepted that wealth taxes are direct taxes.

17. Tyler Cowen, “Wealth Taxes: A Future Battleground,” *New York Times*, July 20, 2013.

18. David A. Stockman, *The Great Deformation: The Corruption of Capitalism in America* (New York: Public Affairs, 2013), 710–11.

19. For further discussion, see Alan D. Viard, “The High-Income Rate Reductions: The Neglected Stepchild of the Bush Tax Cuts,” *AEI Tax Policy Outlook* (September 2010), www.aei.org/files/2010/09/13/TPO-2010-9-no-3-g.pdf.

20. For further discussion, see Alan D. Viard, “The Misdirected [Tax] Debate and the Small Business Stock Exclusion,” *Tax Notes*, February 6, 2012, www.aei.org/article/economics/fiscal-policy/taxes/the-misdirected-tax-debate-and-the-small-business-stock-exclusion/.

21. For further discussion of the X tax, see Carroll and Viard, *Progressive Consumption Taxation*. For further discussion of the personal expenditure tax, see Laurence A. Seidman, *The USA Tax: A Progressive Consumption Tax* (Cambridge: MIT Press, 1997).