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QUICK STUDY

Summary: *A significant problem of the U.S. tax code is that it discourages saving and investment critical to economic growth. Fundamental tax reform toward greater reliance on consumption taxes would increase national saving, reduce the cost of capital, and lead to higher levels of capital formation and GDP. Such a move would be an important policy lever for achieving stronger economic growth, higher living standards, and greater national security.*

THE ROAD MAP TO TAX REFORM™

U.S. Capital Formation:

How the U.S. Tax Code Discourages Investment

By Margo Thorning, Ph.D.

Introduction: The Link Between Saving and Investment

Saving matters primarily because it finances the investment that determines the growth of income and living standards in a country. United States domestic saving has declined from an average of 9.7 percent of GDP over the 1960–1980 period to only 4.9 percent from 1991 to 2001. Thus, an inflow of foreign saving has provided much of the wherewithal for the surge in investment during the latter half of the 1990s.

The U.S. tax code treats saving and investment very harshly and thus hampers our ability to maintain the strong economic base that will be needed in the coming years in the face of changing demographics and geopolitics. Our tax code hits saving and investment harder than those of many of our international competitors.

Tax reform can be carried out through a broad-based restructuring in which consumption, rather than income, becomes the tax base, or through incremental changes to the current income tax base that reduce the tax burden on various types of saving and investment. Either type of tax restructuring would enhance U.S. productivity and economic growth and promote the achievement of environmental goals.

Taxes on Business Investment

The price tags of durable goods do not reveal the whole cost of investments in a business. That is why economists talk about the "user cost of capital:" the pretax rate of return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, and other factors including inflation, risk, economic depreciation, and taxes.

In the United States, according to Professor John Shoven of Stanford University, one-third of the cost of capital is due to taxes. In other words, "hurdle rates," or the rate of return an investment must yield before a firm would be willing to start a new capital project, are 50 percent higher than otherwise because of high taxes on income produced by the investment.

International Comparison of Taxes on Domestic- and Foreign-Source Investment

Several measures show that the United States taxes new investment more heavily than most of our international competitors. For example, the marginal tax rate on domestic U.S. corporate investment is 37.5 percent, exceeding that of every country except Canada (see Figure 1) in a survey by the centrist Progressive Policy Institute (the research arm of the Democratic Leadership Council). In taxes on foreign-source investment, the U.S. rate is 43.2 percent versus an average of 36.7 percent in the other G-7 countries.

Furthermore, U.S. financial service firms face much higher tax rates on foreign-source income than do their international competitors: 35 percent compared to 14.3 percent for French-, Swiss-, or Belgian-owned firms. As a consequence of their more favorable tax codes, foreign financial service firms have a competitive advantage in world markets.

International Comparison of Depreciation Allowances

Prior to TRA '86, the United States had one of the best capital cost recovery systems in the world. But consider the change in the present value of the capital cost recovery allowance for computer chips after TRA '86: it effectively fell from 100 percent to 81 percent.

Capital cost recovery provisions for pollution-control equipment suffered almost identical losses under TRA '86. Slower capital cost recovery means that new technology and energy efficient equipment will not be put in place as rapidly as they could under a more favorable tax code.

Impact of U.S. Tax Code Changes on Effective Tax Rates

Dale Jorgenson and Kun-Young Yun document the significant increase in the effective tax rate faced by most assets after the passage of TRA '86. Passage of TRA '86 raised the effective tax rate from zero (the equivalent of a first-year write-off) to 32 percent. By 1996, the rate had risen to 36 percent due to income tax rate increases.

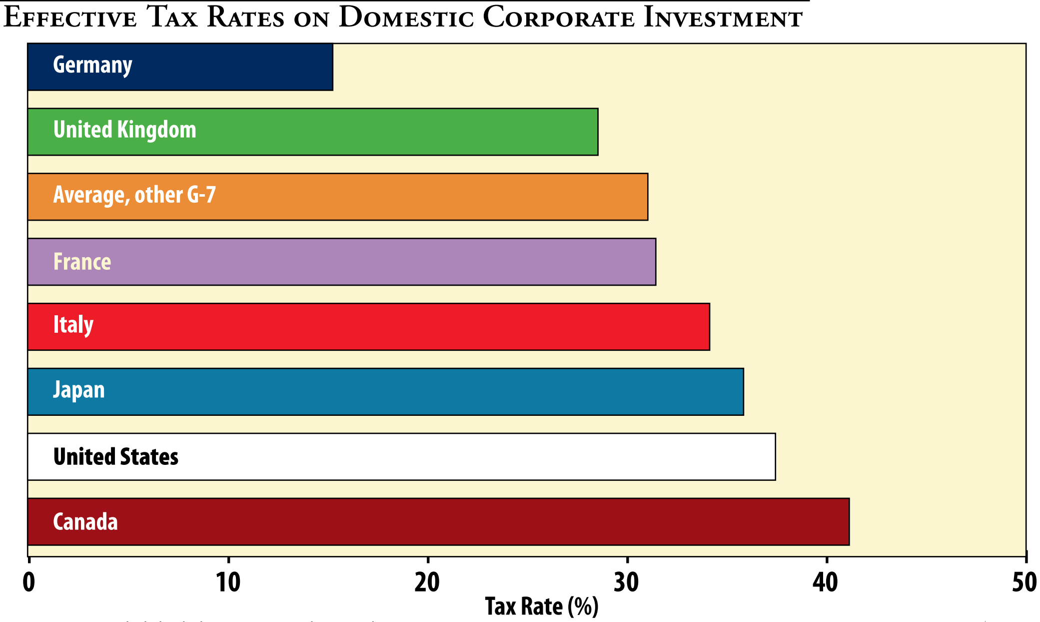
Capital Gains Taxes

As with its taxes on business investment, the United States has higher capital gains taxes than most countries. Long-term gains face a tax rate of 20 percent in the United States versus an average of 14.5 percent for 23 countries surveyed in one study. U.S. corporations face long-term capital gains tax rates 80 percent higher than those of all but one of the other countries surveyed.

Capital gains reductions would have a positive impact on capital costs. The Taxpayer Relief Act of 1997 reduced the individual capital gains tax from a top rate of 28 percent to 20 percent. The capital gains tax cut reduced the net cost of capital for new investment by about 3 percent, according to one analyst. Reducing capital costs will, other things being equal, raise business investment by 1.5 percent per year. Over a 10-year period, the capital stock will rise by 1.2 percent, and productivity and real GDP will increase by 0.4 percent relative to the baseline forecast.

Another study, by Dr. Allen Sinai of Primark Decision Economics, indicates that if further rate reductions (from 20 percent to 18 percent) in the Taxpayer Refund and Relief Act of 1999 (H.R. 2488) had been enacted, real GDP would be $64.6 billion higher, and employment, investment, new business formation, and national saving would

Figure 1 **Effective Tax Rates on Domestic Corporate Investment**



Note: Tax rates include both the corporate and personal income tax on investment.
Source: *Enterprise Economics and Tax Reform* (Washington, D.C.: Progressive Foundation, Progressive Policy Institute, October 1994).

be greater over the 2000–2004 period compared to the baseline forecast. In addition, U.S. capital costs would be slightly lower. He concludes that the capital gains tax cut would have produced significant returns.

Taxes at Death

Many top academic scholars and policy experts conclude that the U.S. federal estate tax should be repealed or reduced much faster than the new law provides because the death tax adds to the already heavy U.S. tax burden on saving and investment. For example, analysis by MIT's Professor James Poterba shows that the U.S. estate tax can raise the cost of capital by as much as 3 percent. The estate tax also makes it harder for family businesses, including farms, to survive the death of their founders.

A study by Dr. Douglas Holtz-Eakin (now chief economist of the President's Council of Economic Advisors) shows that the estate tax reduces the labor supply. He estimates that eliminating the estate tax would raise employment by 170,000 jobs and would increase saving by $800–$3,000 per person per year. Increased saving would permit higher levels of investment. For the results of another study of the effects of estate tax repeal/reform, see Table 1.

Taxes on Interest and Dividends

Interest and dividends received by individuals also are taxed more heavily in the United States than in many other countries. Other countries give special encouragement to small savers in the form of lower taxes or exemptions on a portion of the interest or dividends that they receive. High tax rates on dividends and interest, like the taxes discussed above, raise the cost of capital for new investment and slow U.S. economic growth.

The income tax hits saving more than once—first when income is earned, and again when interest and dividends on investment are received, or when capital gains from investment are realized. The playing field is tilted away from saving and investment because individuals and companies who save and invest pay more taxes over time than if they consumed all their income and no saving took place.

Recent Evidence on the Impact of Tax Policy on Economic Growth

Do we favor a truly level playing field over time to encourage saving and investing, stimulate economic growth, and create new and better jobs? If so, then we should not tax savings (including capital gains) at all. This view was held by top economists in the past and is held by many mainstream economists today.

Recent analyses by academic scholars and government policy experts suggest that substituting a broad-based consumption tax for the current federal income tax could have a positive impact on economic growth and living standards.

Alan Auerbach and Laurence Kotlikoff have compared five major tax reform plans according to their general equilibrium model. The reforms are a "clean" income tax and four types of consumption taxes. These consumption taxes are: a) a "clean" consumption tax; b) a Hall-Rabushka flat tax; c) a Hall-Rabushka flat tax with transition relief; and d) Princeton University Professor David Bradford's "X tax."

The clean income tax eliminates all personal exemptions and deductions, and taxes labor and capital income at a single rate. The clean consumption tax is a tax on wages with all saving exempt from tax at the household level, and as a cash-flow tax on business with expensing of new investment.

The Hall-Rabushka flat tax differs from the consumption tax by including a standard deduction against wage income and by not taxing the rental value of owner-occupied housing and the value of services provided by consumer durables. The flat tax with transition relief permits continued depreciation of capital in existence as of the reform. Finally, the Bradford X tax combines a progressive wage tax with a business cash-flow tax where the business cash-flow tax rate equals the highest tax rate applied to wage income.

Auerbach and Kotlikoff conclude that switching to a consumption tax can offer significant economic gains. The Bradford X tax, which the authors give the highest marks for its impact on equity, efficiency, and economic growth, raises long-term output by 7.5 percent and provides no

Table 1 Impact of Estate Tax Repeal/Reform on U.S. Economic Growth, 2001–2008

(Changes from baseline, cumulative except as otherwise noted)	Immediate Repeal, Loss of Step-up	Immediate Repeal, Step-up Retained	8-Year Phaseout	Lower Top Rate From 55% to 20%	Lower Top Rate From 55% to 39.6%
Real GDP					
(billions of 1996 dollars)	$131.60	$149.40	$103.20	$124.30	$88.20
Employment					
(average difference in levels per year)	164,761	132,443	94,311	113,647	80,521
New Business Incorporations					
(average difference in levels per year)	45,736	261,181	130,859	188,929	145,427
Total Federal Tax Receipts					
(fiscal years)	$54.30	($211.30)	($110.40)	($108.80)	($37.00)

Note: Assumes the saving in taxes paid is treated as an increase in disposable income as opposed to reinvesting in assets or paying down debt. Under different assumptions about how the tax savings is taken, the quantitative estimates might change but the direction of the results would not.

Source: "Macroeconomic Effects of the Elimination of the Estate Tax," by Allen Sinai, chief global economist and president, Decision Economics, Inc., preliminary report prepared for the American Council for Capital Formation Center for Policy Research, Washington, D.C., March, 2001.

transition relief from its expensing provisions. It also hits the rich with higher marginal tax rates than the poor. Still, under the X tax there are no long-run losers; even the rich are better off. Transition relief and adjustments that prevent adverse distributional effects lessen the positive impact of tax reform on the economy.

Another study, the Joint Committee on Taxation's "Tax Modeling Project and 1997 Tax Symposium Papers," brought together renowned economic scholars and public policy experts to compare the consequences of a broad-based unified income tax to those of a broad-based consumption tax The effects of the consumption tax on GDP are generally positive over the long term and greater than those of a unified income tax. The consensus seems to be that the economy would fare better under a "pure" consumption tax than under a "pure" income tax or under current law.

In another recent report, the Congresional Budget Office (CBO) shows that substituting a broad-based consumption tax for an income tax would increase the capital stock and raise the level of national output by between 1 percent and 10 percent, although CBO concludes that increases at the upper end of the range are unlikely.

According to Dr. Kevin Hassett of the American Enterprise Institute, if the United States adopted a consumption tax, the user cost of capital would fall from 0.234 to 0.205, which would lead to about a 10 percent increase in equipment investment.

Finally, a recent unpublished study by Dr. Allen Sinai shows that if the United States had switched in 1991 to a consumption tax system, in which all investment was expensed, all saving was deductible, and interest expense was not deductible, by 2004 real GDP would be 5 percent higher; business capital spending would be 35 percent higher; and saving, equities, and federal tax receipts would also be greater.

Unfinished Business in Tax Policy Reform: Long-Run Goals

Fundamental reform of the U.S. federal tax code remains a key goal for many policymakers. Many prominent members of Congress, including House Majority Leader Richard Armey (R-TX); Senator Richard Shelby (R-AL); Senator Pete Domenici (R-NM); and Representative Billy Tauzin (R-LA), have all introduced legislation in recent years to replace the federal income tax with a broad-based consumption tax. House Minority Leader Richard Gephardt (D-MO) has proposed broadening the current income tax base while lowering rates.

In addition to political factors such as voter discontent with the income tax, several factors contribute to the current interest in tax reform:

- The recognition that today's balanced federal budget is likely to be a relatively short-lived phenomenon.
- A growing awareness that the U.S. federal tax code is biased against the saving and investment that is crucial to improving U.S. economic growth.
- U.S. multinationals' goal of competing in the global marketplace.
- The need to raise rates of saving, investment, and output, and boost our ability to maintain military preparedness.

Conclusions

The conclusions of several new economic studies by academic and public-sector tax policy experts reveal the way to lasting tax reform. Switching to a consumption-based tax system would increase national saving, reduce the cost of capital, and lead to higher levels of capital formation and GDP. As the United States faces the economic challenges of the twenty-first century, including funding the retirement of the "baby boom" generation, fundamental tax reform that moves the U.S. tax system toward greater reliance on consumption taxes can be an important policy lever for achieving stronger economic growth, higher living standards, and military strength.

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