When Is It Best to Tax the Wealthy? (Part 1 of 2)

The process of the creation of new wealth is beneficial to the whole community. The process of squatting on old wealth though valuable is a far less lively agent.

— Winston Churchill

The fight over taxing those with capital — in particular, those with significant amounts of wealth — has raged almost as long as civilization has existed. Or at least as long as taxes have been collected to support civilization. Those with property were expected to help pay for the cost of king and state. Even William the Conqueror decided that his English conquest required the gathering of information on property ownership in the Domesday Book so he could begin to assess taxes in his new realm. In the modern era, we have become used to unending debates over land and income taxation, estate and inheritance taxes, and the ability of progressive taxes to collect from the rich. Throughout most of the industrial world the income tax itself started as a tax on corporations or big business rather than on individuals, largely because it was perceived as a tax on power, whether on those rich enough to own stock in a corporation or on the corporation itself.

More recently, the fight has switched back to estate taxation while the ever-continuing prospect for tax reform has drawn attention once again to consumption taxation as an alternative to income taxation. In the United States, the 2005 Tax Reform Panel couldn’t make up its mind about consumption taxation and presented both an income and a consumption tax option, and then at the end added an income tax component to its consumption tax as well. Similarly, based on considerations partly of progressivity and partly of compliance, many U.S. tax experts expressed considerable ambivalence about consumption taxation as a replacement for income taxation at a 2005 Tax Policy Center/American Tax Policy Institute/Tax Analysts conference.

I want to suggest that the civilizations-old debate is not going to go away, nor are we going to resolve it through some one-time victory by consumption or income tax advocates, nor by the lobbies against and for the estate tax — any more than it was resolved by advocates for and against land or corporate taxation generations ago. But I do suggest a way that the debate can proceed more rationally and intelligently.

The means I propose is simple. For many, though not all, purposes, it involves using the basic but elegant device of recognizing trade-offs at a given level of revenue. In particular, I suggest that some taxes will always be assessed on those holding wealth because they are the ones with the considerable means to pay tax. We can debate how high their taxes and their share of taxes should be, but we still need to decide how those taxes should be assessed.

In this column and the succeeding one, I will examine five of the distinctions already made by the tax code in the way that it taxes capital income and that must be explored in some depth whenever tax reform is being considered. Those distinctions form part of, but are not confined to, the consumption versus income tax debate. I will also at times indicate some advantages or disadvantages of making each of those types of distinction.

The distinctions I will examine are:

1. new capital (new purchases of plant and equipment) versus old capital (existing plant and equipment);
2. newer versus older business establishments;
3. small businesses versus large business;
4. winners in the capital market (those with above-average rates of return) versus losers (those with below-average rates of return); and
5. entrepreneurs versus inheritors.

This week’s focus is on the first two of those five items: new versus old capital and newer versus older business.

New Capital Versus Old Capital

When the consumption tax debate was first resurrected in the mid-1970s, some economic modelers claimed that there would be large efficiency gains from such a switch. Those gains depended on a significant number of assumptions, most of which I will not address here. Later analysis made clear that many of those gains came not from taxing consumption instead of income, but from the ways that a sudden switch would assess a very large tax on old capital. Economists stress that inefficiency is related to changed behavior, hence it is on new decisions that we must focus our attention when trying to minimize the distorting aspects of taxation. Some then take an additional leap and suggest that it would be efficient to assess a windfall tax on old capital (the decisions surrounding which have already been made) and use the revenues to lower taxes on new investments in capital (in which decisions are yet to be made).

Put another way, the modern consumption tax debate has raised the question of whether it is possible to discriminate one time only against old depreciable capital (buildings and machines already made or purchased) by requiring those investments to continue to be depreciated over time but then allowing new investments to be written off or deducted immediately. In effect, old wealth, having been purchased one day or at any other time before enactment of the new consumption tax, would be denied the benefits provided for all later
investment. Moreover, the value of old capital would be reduced because required rates of return on all capital would fall with the reduction in tax on new purchases of capital.

Many real-world tax policy analysts simply don't believe that such a windfall tax can be fully assessed. It's not simply that it might be unfair to zap owners of old capital. Nor is the issue simply that the treatment is unlikely to be enacted, fair or not. Even if enacted, the basic theory is off-base and depends on a questionable leap of faith. That basic theory and its supporting models essentially assume away a dynamic economy with any future policymaking once the new consumption tax or windfall tax is adopted. But think about it: Why would capital owners trust that the government wouldn't zap old wealth once again? For that matter, the corporate tax, when first assessed, was a tax on old wealth (as well as new wealth). There are many ways to make quick unannounced assessments on wealth, including direct confiscation.

As a consequence, the gains from surprises tend to dissipate once it is recognized that they may be indicators of future actions as well. Having suffered once or more, people have no reason to trust that the zapping of old capital (say, in 2010) would not be followed by some zapping of later investments (say, in 2015, when old capital now includes investments made between 2010 and 2015). Thus, there is substantial reason to discount the model's implicit assumption that the Ways and Means Committee will fold up shop and disband.

Don't think that dynamic issue is just a matter of theory. In 2002 legislation, new physical capital investment, if made by the year-end 2004, was provided a one-time tax break in the form of a quick write-off for a large portion of the expense. A one-time tax on old capital that enhanced the value of the incentive? That's what the simple theory claims. But think about it: Now investors are constantly encouraged to hold off their new investment until Congress again enacts or extends that one-time only (!) incentive yet one more time.

That is not to suggest that the idea of taxing old capital is without merit. But trickery has its limits.

Newer Versus Older Business Establishments

Taxes on capital income can also be assessed differently on newer business establishments than on older ones. Here the tax differential is not based as much on the vintage of capital as on the business itself. This issue arises in one context whenever a new tax break for new capital investment is offered in lieu of a lower direct tax rate, such as a lower corporate rate.

In helping coordinate Treasury's 1984 tax reform study that led to the Tax Reform Act of 1986, I successfully maintained that investment incentives as then structured discriminated against new business. They mainly subsidized or lowered taxes on older businesses that already had significant profits. For new businesses, the allowed deductions were too large to offset the taxable income generated by the new investments and/or the credit was too large to offset the tax due on any taxable income. Thus, the incentives mainly went to offset taxable income arising from old wealth even though new capital investments were required. Firms that were already successful could use the incentives simply to offset taxes due to their past success simply by replacing their capital as it aged, or adding modestly to that stock of capital.

Consider in the simplest example an established business that bought a new piece of equipment every five years as the old one depreciated to zero. The capital incentive helped it lower the cost of its new purchase. However, when the same type of equipment was purchased by a new business, it often didn't yield enough income to allow the business to make full use of the tax break. Some carryover of benefits to future years lessened the discrimination, but it didn't help with cash flow problems, and no interest was provided on the deferred deductions. Hence, the cost of capital was made higher for newer business, giving a competitive advantage to older business establishments that already generated profits.

The issue has not gone away. A similar case applies against the types of accelerated deductions and the partial expensing items temporarily made available through legislation in 2002. New companies were put at a competitive disadvantage by those devices — at least when it came to returns on assets, they couldn't come close to generating enough income to fully use the tax breaks. Even if their assets generated a normal rate of return, it would be years before that return was sufficient to make use of deductions that in the first year or two typically exceeded 60 percent of costs. Unless one thinks that competition doesn't matter or comes about automatically as some deus ex machina, those tax provisions were in many ways anticompetitive, whatever their other macroeconomic effects.