by Gene Steuerle

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

This week I conclude a two-part series on taxing wealth and income from wealth. The presumption of the series is that the wealthy will pay some tax; I also examine various ways that distinctions can be and are being made among capital owners. Here we turn to small business versus large business, winners versus losers, and entrepreneurs versus inheritors.

Small Business Versus Large Business

One of the most confusing of all distinctions in taxation derives from taxing small business differently than large business. The confusion comes in defining just what is ''small.'' Generally speaking, tax preferences for small business are not really used by ''new'' business. The latter is usually disfavored by the way that investment incentives are applied so that only firms with well-established profits can make use of them. Small business preferences usually are not based on the income of the owner, either. A billionaire might own several small businesses and get tax breaks for each of them. A poor person, on the other hand, might own shares of corporate stock through a retirement plan, yet pay capital tax on the returns. Quite often the business itself need not be small to make use of some tax incentive. Noncorporate businesses, no matter what their size or income or income of their owners, for instance, can avoid corporate tax.

A debate over tax subsidies for oil and gas industries benefiting from higher prices highlights some of those distinctions. Many of those subsidies are used by independent drillers, often partnerships, rather than the large corporations that buy the oil and gas from the independent drillers. Are the partnerships small relative to other corporations? Based on the size of the firm, often. Based on the average income of their owners, often not.

The best case that can be made for favoring small businesses is that they face unjustified disadvantages that tend to reduce competition. The complexity of the legal and tax systems represents one disadvantage. In other cases, however, small businesses may be less, not more, efficient at some activities, as when there are substantial economies of scale that can only be exploited by larger businesseses. In those latter cases, public policy favoring small businesses could create, not reduce, distortions.

When it comes to competition, attention to new businesses often may be more appropriate than over small businesses. Of course, a small business trying to newly take on a larger business may raise some of the same issues, so the distinction is not entirely pure. Still, existing businesses, small or large, can hardly be expected to lobby on behalf of potential new competitors. Finally, even if new or small business needed to be favored, it is not clear why those preferences should be run through the tax code.

Winners Versus Losers in the Capital Markets

Under some very simplifying assumptions, taxing consumption is equivalent to exempting capital income from taxation. That has led some to suggest that one can produce the same result in taxation either way. However, that is dead wrong. Among the misleading assumptions is that everyone gets the same return from capital.

Take two individuals, each of whom invests $10,000. One invests and achieves a real return of 7 percent (roughly the average return from stock investment) and the other gets 2 percent real (roughly the average return from bonds). Let's call the household of the first investor the ''winner'' (relatively speaking) in the capital markets and the second the ''loser.'' Differences might be due to luck, planning, or differential risk preferences. Suppose the money is left to accumulate for 70 years. The winner earns more than $1.1 million; the loser gets an extra $30,000 over his original $10,000 investment.

With a pure consumption tax, the winner pays tax on more than $1.1 million if it is consumed then; with a pure income tax, the tax is collected over time and might be even higher on a present value basis (with borrowing and capital gains deferral, the result is less clear). Regardless of whether a pure consumption tax or an income tax is in place, the winner will pay much, much more tax than the loser. In a sense, the government shares in the gains and losses of the investors.

When the tax is forgiven on the capital income, as in the case of Roth IRAs, the millionaire winner pays no more tax than the loser. (There is an academic-style exception that I won't elaborate on much here, but it abstracts from the notion of winners and losers, assumes that the winner can't borrow, and, finally, that the winner loses the opportunity to invest initially taxed dollars at the same higher rate of return as implied by her winnings. Obviously this academic-style argument doesn't work when one taxpayer invests in General Motors and one in Microsoft in 1970 and they both cash out in 2005.)

Entrepreneurs Versus Inheritors

The new versus old wealth debate applies not simply across individuals but across time for the same individual. In other words, when is the best time to tax individuals accumulating wealth? Suppose that $100,000 in tax (in present value terms) is to be assessed against a top wealth holder with high income over his life. Is it better to collect that tax as the income is earned or later, such as at death or the time of transfer to heirs? I suggest that a case can be made to tax later, that those who are showing entrepreneurial success at a point in time are more likely to be investing well in the capital stock of the nation than are any random set of inheritors. One simple reason is regression toward the mean; skill does not always pass on from generation to generation.

Isn't that one of the arguments made by consumption tax advocates? Yes and no. They do suggest deferring tax while income is accumulating, at least until the time of consumption. Most of those advocates, however, don't make any distinction between the new entrepreneur and those receiving inherited wealth. And many want to eliminate the estate tax. On the other hand, some analysts have suggested that the government might be able to collect the same lifetime value of taxes by assessing taxes on consumption and estates or on wages and inheritances, in place of taxes on annual income. In that case, we would have a tax on lifetime income, rather than on annual, income.

My purpose in this column and the previous one has been to focus on some of the issues at the heart of much of the debate over taxation of the wealthy: Assuming some level of tax on the wealthy, how do we want to assess it? I have only begun to tap many of the relevant issues. The distinctions I address deserve attention because they have already been made in the income tax debate at various points in time, not just because they relate to some hypothetical tax regime in the future. This approach provides a disciplined way to deal with the trade-offs inherent in any choice of tax systems.