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Taxing Capital in a Supply-Chain World

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The post-election wrangle over extending the Bush tax cuts will take place in the worst possible environment for making good policy: A lame-duck Congress facing an artificial deadline to deal with a highly contentious issue after a nasty election. Even from a substantive policy perspective alone, the debate is a bad one, because there's no consensus among reputable economists about the impact of lower marginal tax rates—the empirical literature is murky, at best.

The fundamental problem underlying this debate is that the U.S. tax code is an outdated and overgrown morass of bad policy. Our current tax system was designed for a primarily domestic economy. But now we live in a world where the unit of economic value creation is now the supply chain, which crosses multiple national borders and cannot be easily divided into domestic and foreign components. And the whole tax system is increasingly perceived as unfair and complicated, with more and more preferences and loopholes added in. What we really need is a sweeping tax reform aimed at promoting growth and innovation, designed for today's supply-chain economy and simplified for the benefit of all taxpayers. But we're not going to get this in the 2010 lame-duck session.

So how can we think about the upcoming tax debate in constructive terms that focus on fostering the kind of meaningful growth and innovation that lead to good jobs and long-term prosperity? We can start by identifying broad principles of what our tax system should look like in order to encourage growth, innovation and jobs, and attempt to apply those principles to the choices Congress must make about extending the Bush tax cuts. In doing so, we can hopefully encourage Congress to take steps that will move us closer to the kind of tax system we need, rather than farther away.

One such principle is the idea that the rates on income from capital investment should be kept low, because it is an important element of the kind of broader tax system we need: one that attracts and encourages capital investment, rather than reducing investment options by raising the cost of capital.

About the author

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Taxing Capital Under a Bush Tax Cut Extension

The background to the current tax debate is well known. The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum tax rates on both qualified dividends and long-term capital gains to 15 percent. The legislation included a provision that the lower rates would 'sunset' at the end of 2010. As a result, without new legislation, corporate dividends will be taxed as ordinary income starting on January 1, 2011, while the maximum marginal rate on capital gains would increase to 20 percent. For high-income households, that could mean that the maximum marginal tax rate on dividends could jump from 15 percent to nearly 40 percent.

The modest rise in the rates on capital gains is not an optimal choice for encouraging growth, but the dramatic spike in the dividend tax to nearly double the rate on capital gains would be a particularly bad policy outcome. In the short run, it's difficult to understand why we would want to raise taxes on capital while the economy is still weak. Most macroeconomic theories would imply that raising taxes while the economy is struggling is a bad idea. If you believe in Keynesian economics, the economy needs more fiscal stimulus, not less. If you hold to supply-side economics, any increase in taxes is a bad idea, especially in a downturn.

The other issue is the impact of raising the taxes on capital during an investment drought. Despite the collapse of the housing market and the talk of households cutting back, the biggest hole in the economy is nonresidential investment (See Figure 1). It's not the best plan to raise taxes on capital when business investment is still struggling.

Which companies are most likely to be affected by a dividend tax increase? Today, the list of corporations with high dividend yields includes a heavy representation from innovative industries such as telecom and pharmaceuticals (the dividend yield is the ratio of the dividend payout per share to the price per share). The top 50 companies with high dividend yields include Verizon, AT&T, Eli Lilly, Bristol-Myers Squibb and Merck.[1]

FIGURE 1: THE BUSINESS INVESTMENT DROUGHT

	Change in outlays, 07Q4-10Q3 Billions of dollars, at annual rates
Personal consumption expenditures*	388.3
Government	280.7
Net exports	134.2
Residential investment	-235.9
Nonresidential investment	-246.1

**Includes government transfer payments such as Medicare and Medicaid*
Data: BEA

Given the importance of innovation for U.S. competitiveness and growth, it seems self-defeating to raise the cost of capital for telecom and pharmaceutical companies. These are the sectors we hope will lead the economy forward.

Some economists have argued that the level of dividend taxes doesn't have much impact on corporate investment because companies can finance their spending through retained earnings, or by raising money from foreign and domestic investors, or pension funds, who don't pay dividend taxes. However, the empirical research on the subject is highly ambiguous. And given the critical need to encourage investment in the current economic environment, do we really want to reduce the options available to businesses for financing new capital projects? That's exactly what raising the dividend rate would do for companies that pay high dividends.

All things being equal, keeping taxes on capital low is an important element of the kind of pro-growth tax policy we need. But I am not arguing that it is sufficient on its own to produce significant growth. In fact, the data suggests that when low rates on capital were included in the larger supply-side package in 2003, the combination of these cuts did not have an obvious positive impact on the economy. The performance of the U.S. economy in the five years after the 2003 legislation is summarized in the table below (the numbers from 2008 and 2009, of course, are distorted by the downturn). As predicted, it looks like companies paid out a bigger share of their profits as dividends after the tax rate was reduced. However, there's little sign of a positive impact of lower tax rates on business investment and savings, at least in the short run. In the five-year period 2003-2007, nonresidential investment averaged 10.9 percent of gross domestic product (GDP), down from 11.9 percent in the previous five years. Similarly, national savings averaged 14.7 percent of national income from 2003 to 2007, down from the earlier periods.

So the empirical evidence we have leads to the conclusion that low taxes on dividends and capital gains by themselves are not enough to spur the economy; a broader program for growth is needed. But encouraging capital investment is a critical piece of that broader program, so it would be a mistake for Congress to move us in the opposite direction by letting rates on most dividend income rise to double the rate on capital gains.

Conclusion

Having acknowledged the difficulty of making good tax policy in today's political environment, it's clear that allowing the tax rate on dividends and capital gains to rise would be a step in the wrong direction.

It doesn't make sense to raise the tax rate on corporate dividends and capital gains in the middle of a U.S. investment drought. That's true, whether you believe in Keynesian economics, supply-side economics or anything in between.

Taxing capital at too high a rate impairs the environment for innovation, especially in this world of permeable borders and mobile money. In particular, raising the tax rates on dividends is likely to hurt innovative industries such as telecommunications and pharmaceuticals, which tend to pay out dividends at a higher level than other industries.

Rather than making the tax laws more and more complicated in an attempt to capture revenue that keeps slipping overseas, Congress should act more strategically to keep the system simple and globally competitive for attracting capital investment.

Comprehensive tax reform is an essential part of a progressive new growth agenda, and future policy briefs will directly address the elements of such an agenda. But for now, with respect to the Bush tax cuts, the best we can hope for may be small steps in the right direction. One such step would be to unbundle the rate on corporate dividends from the current line-drawing debate over which marginal rates should be kept low, and set the dividend rate equal to the rate on capital gains for all taxpayers, either at a rate of 20 percent, as the administration has proposed, or at the current rate of 15 percent. Keeping these rates at parity will avoid unwanted complications and biases in the tax system that would discourage investment in the innovative sectors that should be driving our economy.

FIGURE 2: THE BUSINESS INVESTMENT DROUGHT

	1988-1992	1993-1997	1998-2002	2003-2007
Dividends (share of corporate value-added)	4.1%	5.2%	5.6%	6.8%
Nonresidential investment (share of GDP)	10.5%	10.9%	11.9%	10.9%
National savings (share of national income)	16.2%	16.5%	17.0%	14.7%

Data: Bureau of Economic Analysis

Endnotes

1. http://moneycentral.msn.com/investor/finder/deluxestockscreen.aspx?query=Highest-Yielding+S%26P+500+Stocks . Downloaded on November 4, 2010.

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