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The Bush Tax Cuts Never Went Far Enough

A permanent reduction in capital taxes would increase productivity and wages. Postwar Britain shows how higher capital tax rates reduce investment and damage economic growth.
Article

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The Obama administration has announced its willingness to compromise on a temporary extension of the Bush tax cuts for all income levels. But the Bush tax cuts never went far enough in providing sufficient incentives to promote higher rates of savings and investment. Temporary solutions like this one or the administration's proposed investment tax credit for businesses will not solve our problem of low capital accumulation. What matters is how the income from capital is taxed over its lifetime.

Economists agree that a large capital stock is a key ingredient for prosperity, as it expands our productive capacity and raises worker productivity, which in turn increases wages and consumer purchasing power. Our capital stock is comparatively much smaller today than it was before the Great Depression. The ratio of business-sector capital to output is about 30% smaller today than it was in 1929. This shortfall reflects the fact that recent investment rates have been lower and consumption rates have been higher compared to earlier in our history.

One important reason that our economy has less capital is because tax rates on capital gains, dividends and other forms of capital income have increased substantially. Prof. Douglas Joines of the University of Southern California has estimated that the average marginal tax rate on capital income, which includes all forms of taxable capital, was around 20% in 1929. In contrast, this rate is estimated to have averaged about 37% between 1990 and 2003, the most recent period for which estimates are available.

Higher tax rates on capital income reduce the incentive to save and invest, which in turn reduces investment and ultimately the capital stock. Capital can easily escape taxation by going abroad, and when that happens, the burden of capital income taxation falls on domestic workers in the form of higher unemployment and lower wages.

The most striking evidence for the impact of higher capital taxes comes from Britain, which increased tax rates on capital income (net of depreciation) to more than 90% in the 1940s, and continued to tax capital income at relatively high rates through the 1960s. Not surprisingly, per capita GNP growth in Britain was abysmal, averaging less than 1% per year between 1940 and 1960, and capital accumulation during this period was among the lowest of all developed economies.

Britain's tax policy was implemented on the advice of British economist John Maynard Keynes. Keynes was a British Treasury adviser who developed a plan to finance Britain's World War II efforts by substantially increasing capital income taxation. Keynes not only advocated higher capital taxation to pay for the war, but he also advocated permanently higher capital taxes in order to redistribute wealth. He wrote about this in his 1940 book "How to Pay for the War": "I have endeavored to snatch from the exigency of war positive social improvements. The complete scheme now proposed . . . embodies an advance toward economic equality greater than any which we have made."

Keynes gave little credence to the view that higher capital tax rates would sharply reduce investment and damage economic growth. John Hicks, another British economist, wrote to Keynes that his tax proposals would stifle savings and growth, as investors and business would respond to the changes in incentives. But Keynes dismissed Hicks's concerns, writing back, "I doubt if people are often as actuarially minded as your calculation makes them."

The history of capital income taxation offers important lessons. Specifically, we should pursue the reforms recommended by many bipartisan tax commissions that have focused on increasing the incentives to save and invest. There is no better way to do this than to permanently cut tax rates on savings and investment.

Taxing capital income at a permanent average rate of 20% instead of the current average of 37% would yield substantial benefits. After several years of higher investment, we estimate that output would increase by about 8%, that employment would increase by about 3%, and that wages would increase by about 5%. Moreover, most of these increases would be realized within the first 10 years following such a reform.

Our estimate of the benefits of lower capital taxes is conservative, as we consider only the impact of lower capital taxes on the accumulation of physical capital. It is likely that lower taxes would also stimulate increases in research and development and other inventive activities, increase entrepreneurship, increase the accumulation of human capital, lead to more immigration of high-skilled workers, and encourage foreign firms to locate in the United States.

How would shifting to a 20% capital income tax rate affect the deficit? The significantly higher tax base that would result under lower capital income taxes means that such a reform would be deficit-neutral, provided that either transfer payments were reduced by less than 2% of GDP or a national consumption tax of less than 3% were adopted. And there is the possibility that even much smaller tax increases would be required after accounting for the broader set of benefits associated with lower taxes noted above.

Permanently cutting capital income taxes is the closest thing to an economic free lunch that policy makers can offer. And with unemployment stubbornly stuck near 10%, there is no better time than now to relieve domestic workers from the burden of capital income taxation.

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