Taxes on Investment Income Remain Too High and Lead to Multiple Distortions

MARTIN FELDSTEIN

Thanks to recent tax reforms, the marginal tax rates on investment income in the United States are significantly lower today than in the past, which correspondingly reduces the economic losses *caused by the tax system.* That's the good news. But there is also bad news.

The first piece of bad news is that tax rates on the income from saving and investment remain much higher than they would be in any rational system of taxation. The second piece of bad news is that these taxes continue to seriously distort the economy with a large resulting loss of real income. The third piece of bad news is that many economists grossly underestimate the efficiency cost of our system of taxing capital income because they think that if the taxation of capital income does not cause a big reduction in saving, it is not a problem. They are wrong, as I will explain.

Martin Feldstein is the George F. Baker Professor of Economics at Harvard University and President and CEO of the National Bureau of Economic Research. From 1982 through 1984, Martin Feldstein was Chairman of the Council of Economic Advisers and President Reagan's chief economic adviser. He served as President of the American Economic Association in 2004.

A Little Tax History

Back in 1963 the highest marginal rate of personal income tax was 93 percent. A taxpayer in the top bracket got to keep only seven cents out of every extra dollar that he earned. I used to work for one of those taxpayers: Ronald Reagan. His experience of the adverse effects of such high tax rates on his decisions and on those of his Hollywood friends is an important reason that we have much lower marginal tax rates today.

Even as recently as 1980 the top income tax rate was 70 percent on interest and dividends, and 50 percent on wages and other personal services income. Today the top statutory federal marginal income tax rate is 35 percent, although the effective marginal tax rate for many high income taxpayers is over 40 percent when the Medicare payroll tax, the phase-out of deductions, and state tax systems are taken into account. In many well-off two-earner families, at least one of the two faces a marginal social security payroll tax as well, bringing that individual's total marginal tax rate above 50 percent.

Today's statutory tax rates on capital income consist of: a corporate tax rate that is down from 46 percent in 1980 to 35 percent now; a 15 percent maximum tax rate on capital gains (which in 1980 could reach more than 40 percent as a result of tax add-ons and offsets); a 15 percent tax rate on

dividend income; and a 35 percent maximum rate on interest income. Recent legislation extended the lower rates on dividends and capital gains until 2010, after which they could revert to 35-plus percent if Congress does not pass new legislation.

The decline in the rate of inflation since the 1970s has also lowered the effective tax rate on investment income. When inflation was at double-digit levels in the late 1970s, the taxation of nominal interest and nominal capital gains and the use of historic cost depreciation raised the effective tax rate substantially, to more than 100% in some years and for some types of investment income.

But it would be wrong to conclude from the recently reduced tax rates on dividends and capital gains and today's much more modest rate of inflation that the tax on capital income is now low. The full tax on capital income includes not only the taxes paid by the individual investors but also the corporate income tax. When these taxes are combined, the result is still a marginal tax rate that is high—albeit not as high as in the 60s and 70s—and that is thus capable of doing a great deal of economic harm.

Two kinds of efficiency losses result from our current taxation of capital income. First, the tax wedge that reduces the return to saving means that we consume too much now and in the near future and too little in the more distant future. The nature of this distortion and the magnitude of the resulting deadweight loss are still very badly understood.

Second, specific distortions are generated because of the structure of capital income taxation. We allocate too little capital to corporations and too much capital to noncorporate forms of business. Companies pay too little in dividends and retain too much of their earnings. Corporations take on too much debt and issue too little equity. Capital gains realizations are postponed excessively. Businesses that should be located in the United States place themselves abroad instead. The tax structure distorts each of these decisions in ways that cause deadweight losses.

The Tax on the Return to Saving and the Timing of Consumption

Let's look first at the effects of our capital income taxes that reduce the rate of return to savers—the combination of the corporate income tax, the taxes paid by individuals on dividends, interest, capital gains, and the estate tax. Despite the recent reductions in the tax rates on dividends and capital gains, the cumulative corporate and individual taxes still typically take one third or more of the real pretax return to capital, often as high as 50 percent.

Even saving that takes place in IRAs, 401(k) accounts, and other "tax-favored" vehicles is subject to a large tax wedge because of the combination of the corporate tax and the ultimate taxation of distributions at ordinary income tax rates. For those whose saving exceeds the maximum amount that can be deposited in IRAs and 401(k) accounts, the marginal distortion in the return to saving is as large as it would be without access to those tax-favored accounts.

The tax wedge that reduces the rate of return to savers does much more damage than is generally understood.

The large losses from diminished future consumption

It is natural (but wrong) to think about the deadweight efficiency cost of taxing the return to saving by asking how much that tax reduces the amount of saving. We think about the

deadweight efficiency cost of a tax on apples by asking how much that tax reduces the quantity of apples consumed. We think about the deadweight efficiency cost of a tax on labor income by asking how much that tax decreases people's willingness to work. So it's understandable, but incorrect, to think that the deadweight loss occurs only if the tax wedge reduces saving.

This error is compounded by the belief of many economists—an incorrect view in my judgment—that savings are not very responsive to the net after-tax rate of return. Because they combine this empirical view with the belief that you measure the efficiency loss by looking at how the tax affects the volume of saving they conclude that taxes that lower the return to saving create little deadweight loss. In their view, the tax on capital income is, from an efficiency point of view, a "good tax," like the standard textbook case of a tax on a commodity with inelastic demand: "Little change in the amount of saving implies little deadweight efficiency cost."

But that is wrong.

The deadweight loss of a tax on the return to saving depends on how the tax affects future consumption and not on how the tax affects current saving. Why? Because deadweight losses depend on how taxes affect the things that people care *directly* about. We don't really care *directly* about how much we save (though we may care about it as an indirect indicator of future consumption). We do care about how much we consume, both now and in the future. (This point is developed more formally in my 1978 article in the Journal of Political Economy.)

The right way to think about saving is that it is the amount that we "spend" today to buy future consumption. When we think about a tax on apples, we measure the deadweight loss by looking at the impact of the tax on the number of apples that are consumed. We don't conclude that the deadweight efficiency loss from a tax on apples is zero if total consumer spending on apples is unchanged. For example, if a tax that raises the price of apples by 10 percent causes a 10 percent reduction in the number of apples consumed there will be no change in spending on apples. But we still recognize that the reduction in the number of apples consumed causes a loss of efficiency, i.e., a deadweight loss. Similarly, a tax on capital income should be evaluated by looking at how it affects the level of future consumption bought by saving, not what happens to the amount of saving itself.

A capital income tax that does not change saving at all can still cause a very large deadweight efficiency loss.

An illustrative example: Assume that in the absence of all capital taxes, 10 percent is the real rate of return that individual savers would receive. If capital income taxes take half this return, the net return to the saver is 5 percent. Think about someone who saves at age 45 and dissaves 30 years later at age 75. With a 10 percent real rate of return, each dollar saved at age 45 grows to $17.45. In contrast with a 5 percent rate of return, a dollar saved at age 45 grows to only $4.32—a decline of 75 percent.

This example has two implications. First, it can be shown that the individual would be better off if the government collected the same amount of revenue by a lump sum tax or a tax on labor income at age 45 and allowed the individual to invest the remainder at the higher rate of return (see the appendix to my 2006 NBER working paper). This is because the deadweight loss depends on the distortion of consumption, not

on the change in saving. The large magnitude of the difference in future consumption means that this deadweight loss could be very large.

Second, the example reminds us that a tax on investment income is also a tax on extra work, since some of the income from that work would be saved and consumed during retirement years. If each extra dollar of earnings at age 45 buys $17.45 of age-75 retirement income, the individual has much more incentive to earn income than if those extra dollars only buy $4.32. So the tax that reduces the return to saving reduces labor supply broadly defined.

This effect occurs even if the tax on the return to saving does not alter the amount of saving. But my reading of the evidence on saving is that taxes that lower the return to saving do reduce saving. One example of such research is the studies of 401(k) plans by James Poterba, Steven Venti and David Wise that show that individuals who have access to 401(k) plans save substantially more than those who do not.

I will not pursue these issues further but turn instead to four ways in which our complex system of taxing capital income distorts the use of capital in the economy.

Distorting the Use of Capital

First, the relatively higher rate of tax on profits in the corporate sector—by the corporate income tax and then by the taxes on dividends and capital gains—drives capital out of the corporate sector and into other activities, particularly into foreign investment and real estate. Shifting capital abroad causes a real loss of income in the United States as tax revenue shifts from the U.S. Treasury to foreign governments. The shift of capital from corporate businesses to real estate creates a loss of efficiency because of the gap between the higher pretax return to capital in the corporate sector and the lower return to capital in the more lightly-taxed real estate sector. (The classic work on this was by Arnold Harberger in 1966; see more generally Alan Auerbach's 2002 chapter in the Handbook of Public Economics.

The reduction of the corporate tax rate from 46 percent to 35 percent reduced this deadweight loss. By keeping more of the capital in the corporate sector, it also caused the revenue loss to be less than conventional "static" revenue estimates that ignore behavioral responses. The lower tax rates on dividends and capital gains have also helped to keep capital in the corporate sector, and so reduced the revenue cost of those lower tax rates. Should the Congress fail to extend the current tax rates on capital gains and dividends, the higher rates would exacerbate the sectoral misallocation of capital, and would produce less revenue than static revenue estimates predict.

Second, the recent reduction in the tax rate on dividends has led many corporations to start paying dividends and many others to increase their dividend payout rates. (See my 1970 article in the Review of Economic Studies, for an early study of the effect of taxes on dividend payout rates. Raj Chetty and Emmanuel Saez present a recent study confirming that effect for the most recent reduction of dividend tax rates in a 2004 working paper.) This increase in dividends improves economic efficiency by making funds available to new and growing businesses, and by imposing greater discipline on corporate managements that must now seek outside funding more often. And, of course, the rise in dividend payouts means that the government collects more revenue than predicted by the traditional static analysis that

the Treasury and the Congressional Staff use to evaluate the revenue impact of tax changes.

Third, the current tax system encourages firms to use debt finance rather than equity finance because interest payments are deductible by borrowing firms, while dividend payouts are not. This makes firms more vulnerable to adverse business cycle conditions. It also causes firms to be more cautious in their investments, foregoing projects with more uncertain payoffs or with longer-term payoffs even if those would be more productive. In both of these ways, the tax induced bias toward debt finance is a source of economic inefficiency. Another of the advantages of the recent reduction in the tax on dividends is that it reduces this bias in favor of debt.

Fourth, consider the realization of capital gains. The capital gains tax is essentially a voluntary tax because individuals can postpone the realization of the capital gain and the payment of the resulting tax liability. (For early evidence on the effect of the capital gains tax rate on the selling of stock and the realization of gains, see Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki, 1980). They can even avoid the tax liability completely by using the appreciated property to make a charitable contribution or by holding it until they bequeath it at death. The extent to which the tax is voluntary can be seen by comparing the relatively small amount of taxable capital gains realized in each year with the full amount of the accrued gain in the same year.

An individual investor's decision not to sell appreciated property reduces the funds available for new and growing businesses. It also causes the investor to have a riskier portfolio because he retains appreciated stock rather than rebalancing. It discourages investors from shifting funds to companies in which they wish to invest by locking them into their old positions. Each of these causes a deadweight loss and also reduces tax revenue. Lowering the capital gains tax rate to 15 percent thus reduces efficiency losses and reduces revenue by less than a static forecast would predict.

Concluding Thoughts

The tax system today is more efficient than it was in the past. Tax rates are lower than they used to be on all forms of income. But marginal tax rates on capital income are still relatively high. And the efficiency costs of the resulting distortions are much greater than is generally understood. Taxes on capital income produce large deadweight losses even when the saving rate is not very sensitive to the net rate of return. Analysts who believe otherwise do so because they fail to understand that the right measure to use in their calculations of the deadweight losses from taxation is not *the amount saved* but rather *the amount of future consumption purchased by current saving*.

Taxes that reduce the net rate of return to saving also reduce the reward for working when the individual is young because each dollar earned translates into less consumption when old. The lower reward for working reduces labor supply broadly defined to include not only the number of hours worked but also the accumulation of human capital, the amount of effort, the choice of education, and so on.

Moreover, the combination of taxes on corporate profits, dividends and capital gains introduce further efficiency costs and depress tax revenue in a variety of ways.

It is thus important to retain the gains that

have been made by reducing tax rates in general and the taxes on dividends and capital gains in particular. The corporate tax system itself deserves a serious reexamination.

Much can also be done to improve the tax policy process. The revenue estimators need to recognize and report the extent to which taxes change behavior in both the short run and the longer term. And the measurement of economic efficiency and deadweight losses deserves to be a focus of the analysis alongside estimates of the effects on tax revenue.

My sense is that the need for these improvements is now better understood in both the academic world and in Washington. And that makes me optimistic about the future path of tax policy.

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Acknowledgments

This article draws on a talk to the National Association for Business Economics, March 14, 2006 that was subsequently published in Tax Notes, May 8, 2006 with the title "The Effect of Taxes on Efficiency and Growth."

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