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FEDERAL BUDGET ISSUE:
Rethinking Tax Fairness

The recent debate in the House of Representatives pitted a House Republican economic plan against a plan proposed by the Democratic leadership.[1] The central feature of the Republican plan was a dramatic cut in the capital gains tax rate. The central feature of the House Democrats' plan was a tax cut for low- and middle-income wage earners, to be paid for by raising the tax rates for higher-income taxpayers.

"Higher taxes on investors are not fair if they lead to lower wages and fewer jobs."

The debate centered on "fairness," which is likely to be the theme of a similar debate in the Senate. House Democrats argued that redistributing income from the wealthy to the non-wealthy was "fair." House Republicans argued that the Democrats' plan would lead to less investment and fewer jobs — and thus would be "unfair."

In an election year, it is predictable that the fairness debate — both inside and outside Washington — would degenerate into name-calling and political rhetoric. Behind the rhetoric, however, is an important economic debate, the outcome of which will determine public policy in the United States for the foreseeable future.

Investors vs. Wage Earners

Although the debate has been couched in terms of "rich" versus "non-rich," the actual congressional proposals affect a very important economic relationship — that between investors and wage earners. Most of the income of the rich comes from investments. And most of the income of the non-rich comes from wages.

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Redistributing Income From Investors to Wage Earners. The House Democrats proposed a tax credit against 20 percent of the employee's share of Social Security (FICA) taxes up to a maximum of $400. To pay for this tax cut, they proposed raising the marginal tax rate 4 percentage points (from 31 percent to 35 percent) on annual taxable incomes above $85,000 for individuals and $145,000 for couples. In addition, they proposed a 10 percent millionaire surtax, increasing the tax rate on income in excess of $1 million to 38.5 percent.

Under this plan, people pay lower tax rates as wage earners. But they pay higher rates on investment income they receive. In general:

- About 60 percent of adjusted gross income in excess of $200,000 is investment income.[2]

- About 75 percent of the income of millionaires is investment income,[3] and income in excess of $1 million is almost all investment income.

On the surface, then, the House Democrats' plan is a plan to transfer income from investors to wage earners.

Why Workers Should Care About Investors. About one thing there is no debate among economists: Higher economic growth requires more capital and more capital requires more investment.[4]

"The House Democrats propose to redistribute income from investors to wage earners."

In a very real sense, the amount of capital in our economy determines how much wage income we earn, even if we do not personally own any capital. Workers' wages and the capital stock are inescapably linked. The only way that the real wages, and thus the well-being, of workers can rise is if there is more capital per worker. In general:[5]

- About 98 percent of the variation in real wages over the past 37 years can be explained by the capital-to-labor ratio alone, without reference to any other economic factor.

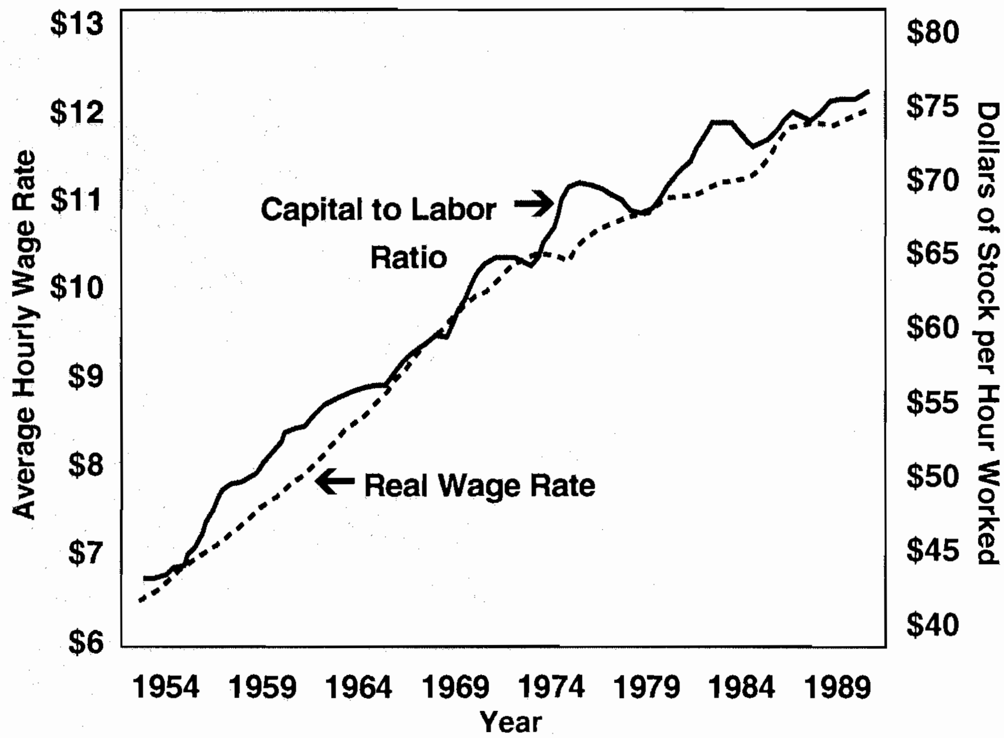
- For every 10 percent increase in the average amount of capital per worker, the real wage rate increases by 11.9 percent. [See Figure I.]

The Benefits of Investment. Many people believe that investors get most of the benefits which capital creates. That is not the case. One of the most surprising findings of the economics of capital is that the overwhelming bulk of the extra income generated by capital accumulation flows to people in their role as wage earners, rather than to the owners of capital. As Figure II shows:

- For every additional dollar of income produced by a larger capital stock, two-thirds goes to labor and only one-third to investors (owners of capital).

FIGURE I

Wages Depend on Capital



Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

"About 98 percent of the change in real wages is explained by the change in the amount of capital per worker."

- After taxes and depreciation, the discrepancy is even greater; labor receives 43.7 cents of each additional dollar of sales, while owners of capital receive only 3.7 cents.

- In other words, workers get to keep $12 in aftertax wages for every $1 of additional aftertax income to investors.

These facts have dramatic public policy implications. In general, public policies that promote capital accumulation primarily benefit wage earners, while policies that discourage capital accumulation primarily penalize wage earners.

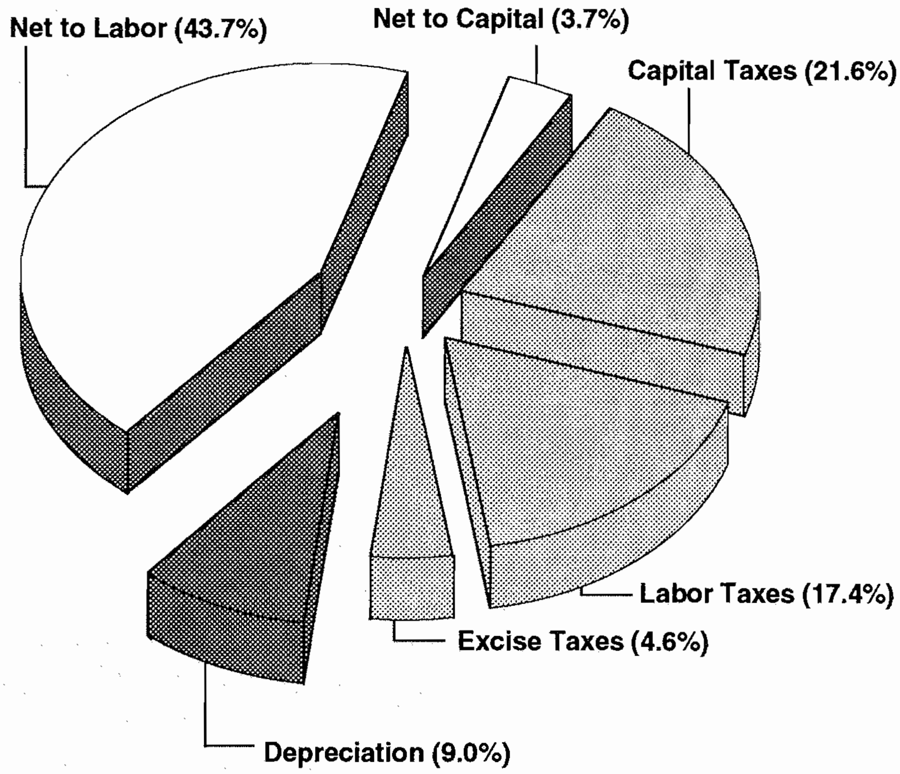
How Tax Fairness Proponents View the Economy

The idea behind most "tax fairness" proposals is a simple one: Government can redistribute income from investors to wage earners without any harmful side effects. (Note that if there are harmful side effects — such as a significant reduction in investment — the case for these proposals is significantly weakened.)

"*For every $1 of aftertax income received by investors, wage earners receive $12.*"

FIGURE II

Distribution of a Dollar of Sales



Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

Assumptions. Although they often accuse their opponents of believing in "trickle down economics," the tax fairness advocates are often unaware that their own arguments imply an economic theory — one that can readily be tested against reality. As Table I shows,

- If we believe that increased taxes on investors have no harmful side effects, we must also believe that taxes on investment income have no effect on the amount of investment.
- Since higher taxes on investment income lower the aftertax rate of return to investors, we are led to the conclusion that the amount of investment in the economy is independent of the rate of return investors receive.
- If a lower rate of return has no effect on the amount of investment, this implies that tax policy can permanently lower the rate of return on capital in the U.S. economy.

"Tax fairness proposals assume that investors will continue investing, regardless of how heavily they are taxed."

Another way of stating these assumptions is: Investors will continue doing whatever they are currently doing, regardless of economic incentives. This "static" view of the world adopts the sociological concept that people are creatures of habit and rejects the economic concept that behavior is determined by comparing the costs and benefits of alternative courses of action.

Additional Implications. If it is true that higher taxes on investment income do not cause less investment, then the converse must also be true: lower taxes on investment income do not cause more investment. Just as higher taxes on capital cause no harm, lower taxes on capital do no good. Thus proponents of tax fairness view almost all "pro-growth" proposals as a "giveaway" to the rich. Any attempt to create investment incentives is seen as nothing more than a tax cut for (higher-income) investors.

TABLE I

Two Competing Views of The Economy

ASSUMPTIONS BEHIND TAX FAIRNESS PROPOSALS	CONCLUSIONS OF THE OPPONENTS
1. Government can transfer income from investors to wage earners with no harmful side effects.	**1. The side effects of redistributing income from investors to wage earners are so large and harmful that wage earners will be worse off.**
⇩	⇧
2. Taxing investment income has no effect on the amount of investment.	**2. Taxes on investment income have a strong and permanent effect on the amount of investment.**
⇩	⇧
3. The amount of investment is independent of investors' aftertax rate of return.	**3. The amount of investment is almost totally determined by the aftertax rate of return.**
⇩	⇧
4. Tax policy can permanently lower the aftertax rate of return on capital.	**4. In the long run, the aftertax rate of return on capital is constant.**

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Sources of the Assumptions. The world view held by the proponents of tax fairness proposals has little support among economists outside of government. Within the Washington, DC. Beltway, however, this is the predominant point of view. It is endorsed by the economists at the Congressional Budget Office (CBO), the Joint Committee on Taxation (JCT) and even by some economists at the Office of Management and Budget (OMB) and the U.S. Treasury Department.

Consequences of Inside-the-Beltway Economics

Given the importance of the economic arguments, one might suppose that the tax-fairness economists have produced some evidence in support of their position. In fact, they have not.

- Although the tax-fairness economists have repeatedly asserted that federal tax policy can permanently change the aftertax rate of return on capital, we know of no instance where they have ever attempted to measure it.

- Although the tax-fairness economists have repeatedly asserted that taxes have no effect on investment, they have never been able to provide their own explanation of why investment spending changes over time.

Bad economic theories produce bad forecasts. Yet in the face of miserable forecasting records, the tax-fairness economists have not changed their forecasting techniques in more than two decades.

"The congressional forecasting agencies overestimated capital gains income by 50 percent."

Congressional Forecasting Errors. Despite a decade of overwhelming evidence that supply-side penalties and rewards affect economic behavior,[6] the economists employed by the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) routinely assume that supply-side incentives are irrelevant. Take capital gains taxes, for example:[7]

- Both the CBO and the JCT have repeatedly asserted that the 40 percent increase in the capital gains tax rate in 1986 would have no effect on investment and investment income.

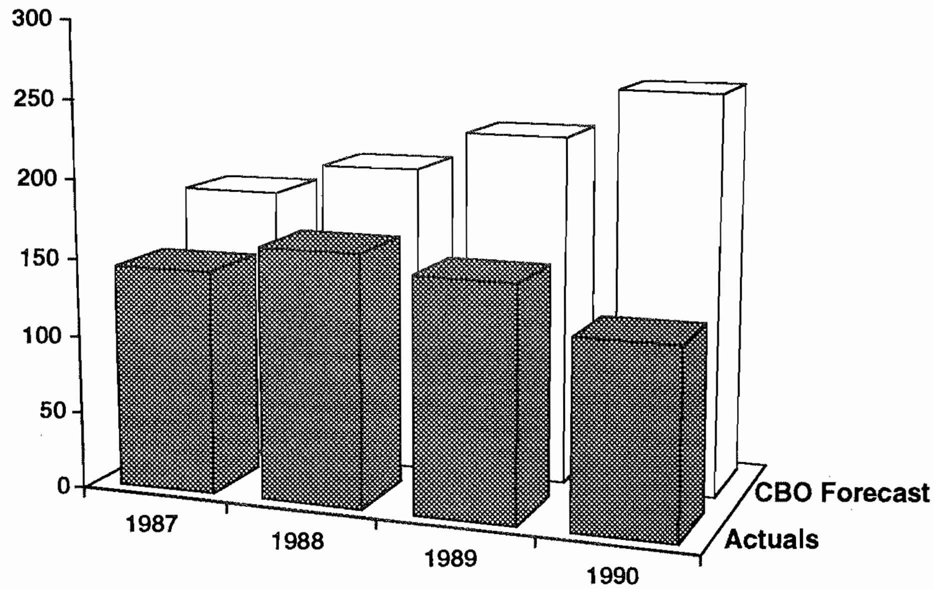
- As a result, both agencies originally predicted that capital gains income would be 50 percent higher than it actually was in 1989 and 100 percent higher than it actually was in 1990.[8] [See Figure III.]

"The Congressional Budget Office over-estimated 1990 capital gains income by 100%."

FIGURE IIIA

Capital Gains Income

($ billions)

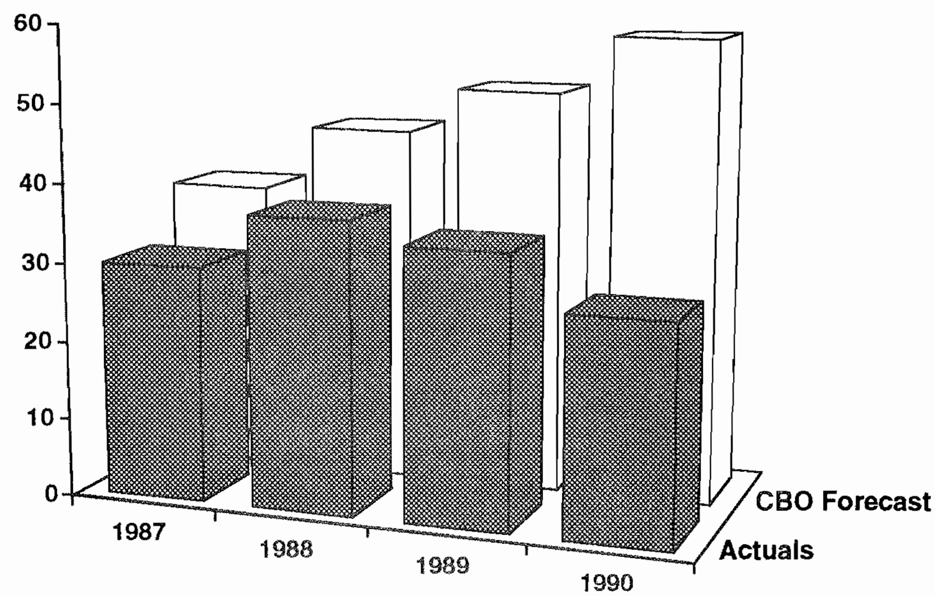


"In contrast to the CBO's prediction, increasing the tax rate did not increase government revenue."

FIGURE IIIB

Capital Gains Taxes

($ billions)



When forced to confront errors and contradictions in their analyses, the CBO and the JCT go to great lengths to deny there is anything wrong with their view of the world. For example:[9]

- The CBO recently admitted that a change in taxes on investment income would ultimately lead to an increase in the capital stock, but implied that the full adjustment would take more than 100 years, with annual increases being so small they could be safely ignored.

- The empirical evidence of the past 37 years, however, shows that the adjustment takes only five years and most of it occurs within two years.

"The Bush administration underestimated the five-year federal deficit by almost $1 trillion."

Administration Forecasting Errors. Similar faulty views are held by economists at the Office of Management and Budget (OMB) and the U.S. Department of the Treasury — despite the fact that the Bush Administration alleges to embrace the legacy of Ronald Reagan's supply-side vision. This explains why the administration's economists completely ignored the negative economic consequences of the increase in the capital gains tax rate and the limitation on IRA contributions passed in 1986 and, more recently, of the Clean Air Act, the Americans with Disabilities Act and 1990 budget summit tax increases. And just as the congressional agencies' forecasts have been wide of the mark, so have those of OMB. For example:[10]

- Between January 1990 and July 1991, the administration increased its forecast of the five-year federal deficit by almost $1 trillion.

- This trillion-dollar increase occurred despite a budget summit agreement that was touted as a deficit reduction measure and the fact that no major new spending program was adopted in the interim.

Legislation Based on Bad Forecasts. Many proponents of tax fairness proposals have argued that President Bush's 15.4 percent capital gains tax rate proposal would amount to a $16,000 transfer from the U.S. Treasury to the average high-income taxpayer. By implication, they believe that the government gained $16,000 or more when the capital gains tax rate was increased in 1986. Neither belief is consistent with the facts. For example:

- Based on past trends, the federal government would have collected $2 billion more in capital gains taxes between 1987 and 1990 at the old tax rate than it actually collected after the tax rate was increased from 20 percent to 28 percent in 1986.

- Contrary to the static view of the world, capital gains tax *rates* and capital gains tax *revenues* have always moved in opposite directions.[11]

The Current Political Debate. If supply-side penalties and rewards have no effect on the size of the economic pie, it follows that politicians can safely focus on how to divide the pie without worrying about the macroeconomic effects of their actions. In this way, inside-the-Washington Beltway economics has created a climate in which class warfare substitutes for pro-growth strategies in the national political debate. The congressional forecasting agencies have contributed to this shift of emphasis by publishing a steady stream of reports designed to pit class against class — focusing only on their estimates of how income is divided, not on what makes its production possible.[12]

How the Economy Really Works

"One side assumes the world is static; the other that it is dynamic."

As Table I shows, most advocates of "tax fairness" proposals begin with an assumption about what would be fair. Then, in order to support the assumption they back into an economic theory. By contrast, many of the opponents of tax fairness proposals begin with observations about how the economy actually works and base their conclusions about fairness on those observations.

One side proceeds from *assumption* to *theory.* The other side proceeds from *observation* to *conclusion.* One side assumes the world is *static.* The other side recognizes the world is *dynamic.* Which side is right?

Over the past several years, the National Center for Policy Analysis in conjunction with Fiscal Associates has produced forecasts of most major tax and spending bills before Congress. These forecasts contrast sharply with those of the official forecasting agencies. The most important difference in the two approaches is that we focus on how policy changes affect the nation's capital stock and how the amount of capital affects the wages of workers.

The approach we take is basically the analytic framework developed by Alfred Marshall, Irving Fisher and other 20th-century classical economists and extended in modern times by Dale Jorgenson, Robert Barro and others.[13] The theory is consistent with all relevant evidence about the role of capital in the U.S. economy. The following is a brief summary.

The Rate of Return to Investors in the U.S. Economy Tends to Be Constant. Despite the assertions of the CBO and the JCT, there is no evidence that tax policy (or any other policy for that matter) can fundamentally change the aftertax, real rate of return on real capital in the U.S. economy. To the contrary. As Figure IV shows:[14]

- Over the past 37 years, the rate of return on capital in the U.S. economy has tended to be remarkably stable — averaging about 3.3 percent per year.

- This stability has persisted despite radical changes in the structure of the economy, significant changes in technology and substantial changes in the taxation of income from capital.

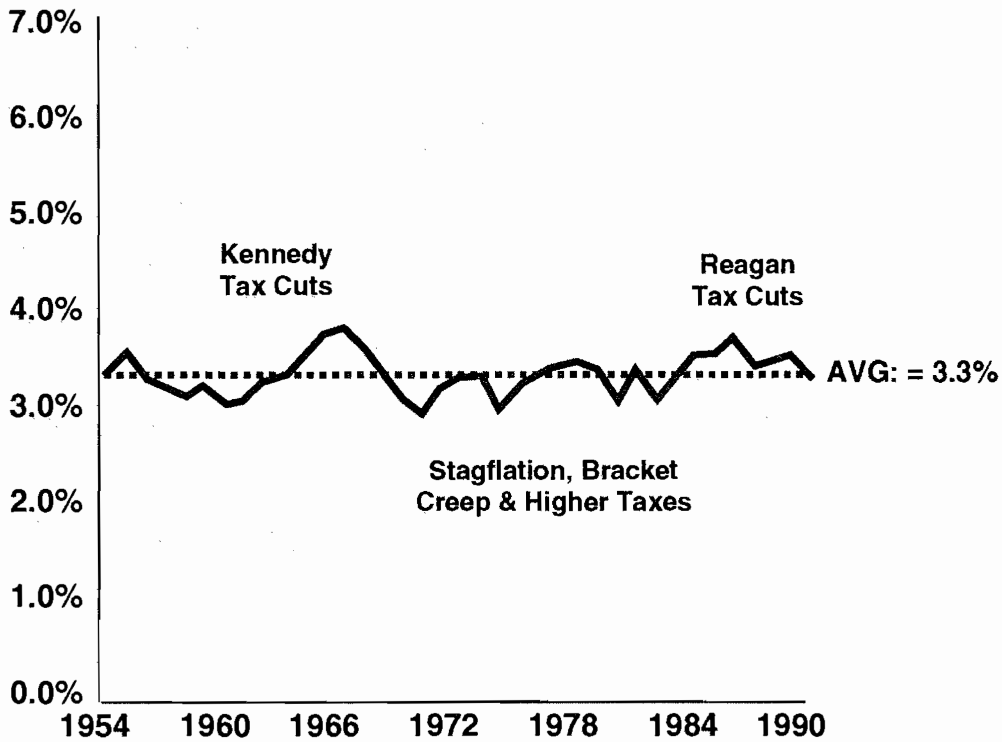
- Events which change the rate of return on capital (such as a change in the tax law) rarely cause variations of more than 1 percentage point above or below the long-term average.

- A return to the rate of 3.3 percent usually occurs within five years following a significant deflection, and 60 percent of the adjustment occurs within two years.

"The real aftertax rate of return on capital is remarkably stable — rarely varying a percentage point from its historic average."

FIGURE IV

The Real Aftertax Rate of Return on Capital in the United States



Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

Changes in Investment Spending Cause the Rate of Return to Investors to be Constant. Suppose something happens to cause the rate of return on capital to rise above its historic average. There will be an increase in investment, adding to the current stock of capital. As the capital stock expands, the rate of return on capital will fall. Conversely, when the rate of return on capital is below its historical level, there will be a decrease in investment. As the capital stock shrinks, the rate of return on capital will rise.[15] In this way, changes in investment spending tend to keep the rate of return on capital constant over time.

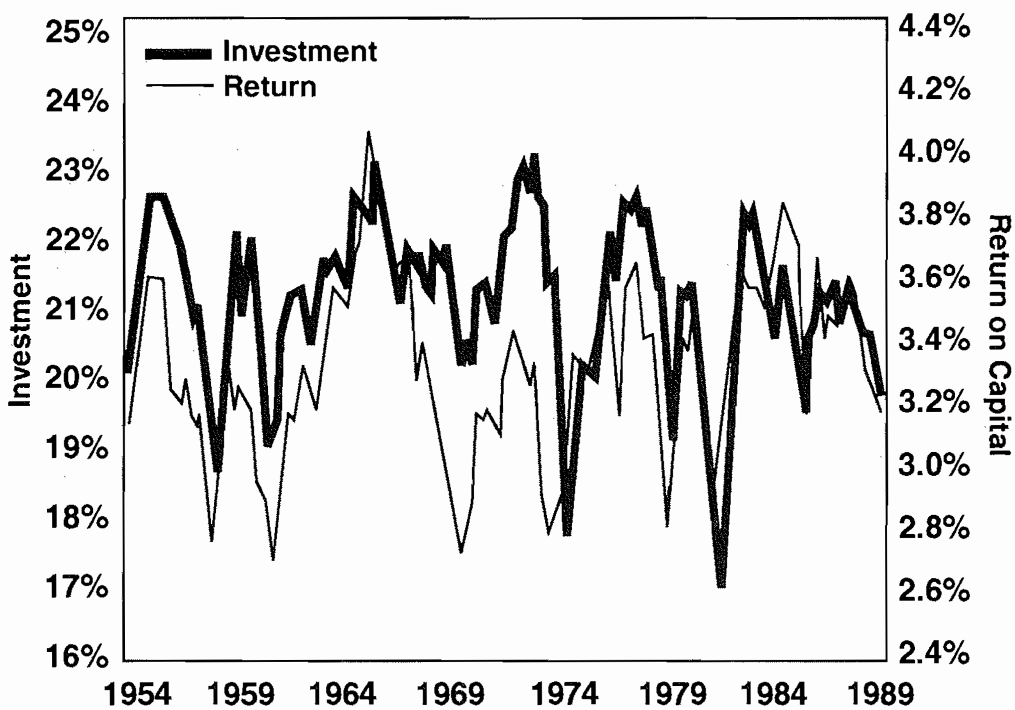
In Figure V, changes in the rate of return are magnified in order to facilitate visual comparison. As the figure shows,

- Changes in investment spending are very closely related to the rate of return on capital.
- In fact, a simple correlation can explain about 75 percent of the changes in investment spending in terms of changes in the return on capital alone.

"About 75 percent of the change in investment spending can be explained by changes in the aftertax rate of return."

FIGURE V

Investment as a Percent of Private GDP and the Real Aftertax Rate of Return on Capital



Source: Gary Robbins and Aldona Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

When Higher Taxes on Investment Income Reduce the Amount of Capital, 90 Percent of the Burden Falls on Wage Earners. Ultimately, taxes on investment income do not affect the aftertax rate of return on capital. Instead, they affect the amount of capital available. Although an increase in a tax on investment income causes a one-time reduction in wealth for owners of capital, it does not permanently affect the future aftertax rate of return. After such an increase, the aftertax rate of return dips below its historical average. Investors respond by lowering their rate of investment and the capital stock shrinks (relative to what it would have been) until the rate of return reaches 3.3 percent. After that adjustment takes place, the owners of capital receive the same aftertax rate of return they received before the tax increase.

This does not mean that owners of capital are indifferent to taxes on capital. Such taxes lower the aftertax future income stream on existing capital assets. Thus a tax on capital lowers the value of capital assets and makes current owners of capital less wealthy. For any new purchase of an asset, however, investors can expect the normal rate of return of 3.3 percent.

Just as wage earners are the primary beneficiaries of a larger capital stock [see Figure II], so they are the primary losers from a smaller capital stock.

Applying the Principles to the House Republican and House Democratic Economic Plans[16]

Viewing the world in purely static terms, the House Democrats propose to take an additional $64 billion from high-income taxpayers and give $46 billion in tax cuts to wage earners over the next five years. This would appear to be a good deal for low- and middle-income families. Viewed in static terms, the Republican proposal to cut the capital gains tax rate would appear to be a giveaway to high-income investors, with only modest benefit for middle-income families.

"The Democrats' attempt to raise take-home pay by $46 billion would actually cause a $26.3 billion decrease in take-home pay."

But because the world is not static, the actual results of these two plans would be much different. We calculate that the Republican plan would add $5.7 billion to the aftertax income of investors over the next five years. [See Table II.] By contrast, the Democrats' plan would lower the aftertax income of investors by $1.5 billion. Moreover:

- Whereas the Democratic plan attempts to increase the aftertax income of wage earners by $46 billion, aggregate take-home pay would actually decrease by $26.3 billion.

- Whereas the Republican plan initially rewards only those who have a capital gain, the net result is that aggregate take-home pay of wage earners would increase by $140.1 billion.

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"For every additional dollar investors get under the Republican plan, national income would grow by $43."

TABLE II

Total Gains and Losses

1992 - 1996

(Amounts in billions of nominal dollars)

	House Republicans	House Democrats
Labor Income Net of Tax	+$140.1	- $26.3
Government Revenue	+ 99.0	- 46.5
Capital Income Net of Tax	+ 5.7	- 1.5
Gross Domestic[1] Income	+$244.8	- $74.3

[1]Gross domestic product less depreciation.

Source: Aldona Robbins, Gary Robbins and John Goodman, "Reviving the Economy: Bush vs. The House Democrats," National Center for Policy Analysis, NCPA Media Backgrounder No. 113, February 1992.

Republican Fairness. Because the Republican plan allows investors to receive an additional $5.7 billion in aftertax income, investors would invest about $1.1 trillion in the economy. (For the most part, investors do not gain unless they make new investments.) This investment would expand the national income by $245 billion, creating $140 billion in new wages for workers and almost $100 billion in new tax revenue for government at all levels. As a result:

- For every $1 in additional income received by investors, workers would receive $25 in additional aftertax wages. [See Figure VI.]

- For every $1 in additional income received by investors, government would receive about $17 in new revenue.

Democratic Fairness. Because the Democrats' plan reduces the aftertax income of investors by $1.5 billion, the economy pays a heavy price. Total investment would be reduced by $150 billion, leading to a $74 billion contraction in national income. Moreover:

- For every $1 reduction in the income of investors, workers would lose $18 in wages. [See Figure VII.]

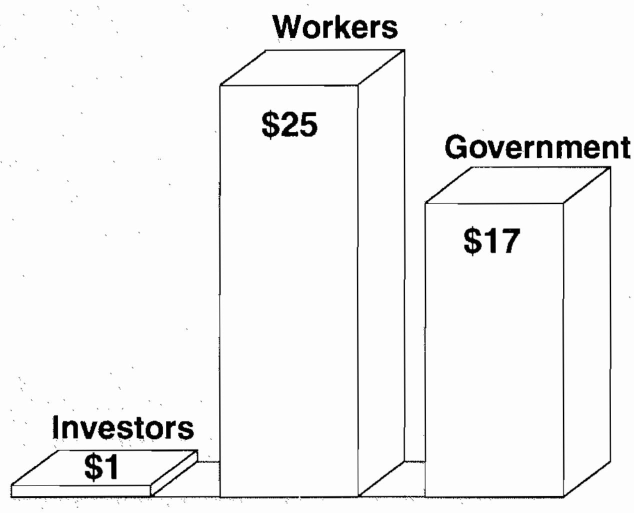
- For every $1 reduction in the income of investors, government at all levels would lose about $31 in revenue.

Under the Republican plan, investors would receive 2.3 percent of the increase in national income. Under the Democrats' plan, investors would lose 2.0 percent of the decrease in national income. What is most astonishing about the "fairness" debate is that it focuses on these almost trivial changes in the fortunes of a few and ignores the huge impact of the two plans on everyone else.

"Under the Republican plan, workers get $25 in additional aftertax wages for every $1 of additional aftertax income for investors."

FIGURE VI

Relative Gains Under The House Republican Plan

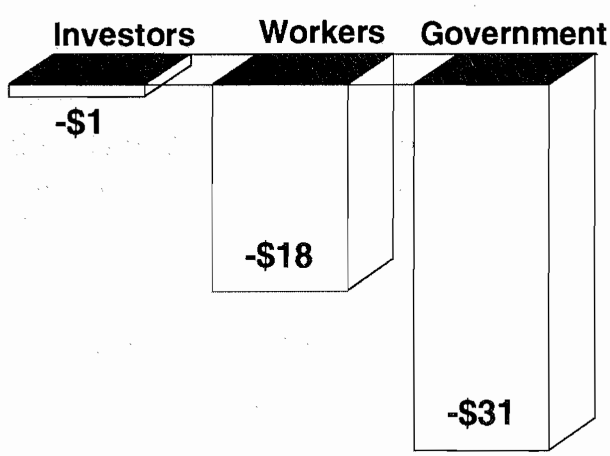


Source: Table II.

"Under the Democrats' plan, workers would lose $18 in take-home pay for every $1 reduction in aftertax income for investors."

FIGURE VII

Relative Losses Under The House Democrats' Plan



Source: Table II.

"Special victims of the House Democrats' fairness proposal would be minorities, women and elderly workers."

People Especially Affected by the Two Plans. Between 1992 and 1996, we estimate that the Republican plan would create 479,000 new jobs. The Democratic plan, by contrast, would cause a loss of 80,000 jobs. Thus in the first five years the difference between the two plans would be a swing of almost 560,000 jobs.

Although the difference in the two plans would affect workers in virtually every industry, and families at almost every income level, some people are more likely to be affected than others. In general, the marginal work force — those most likely to be hired when times are good and fired when times are bad — are racial minorities, women and the elderly. These are the people who have the greatest stake in the choice of economic policies.

Conclusion

Proposals to make taxes "fair" often harm the very people they purport to help. This is especially true when they attempt to tax investment income in order to give a tax cut to wage earners. Careful examination of the role of capital in the U.S. economy clearly shows that it is in the self-interest of wage earners to promote lower, rather than higher, taxes on income from investment.

Gary Robbins
Aldona Robbins
John Goodman

Footnotes

[1] See Aldona Robbins, Gary Robbins and John Goodman, "Reviving the Economy: Bush vs. The House Democrats," National Center for Policy Analysis, NCPA Media Backgrounder No. 113, February 28, 1992.

[2] Internal Revenue Service, *SOI Bulletin,* Spring 1991, p. 17.

[3] Ibid.

[4] See Aldona Robbins and Gary Robbins, "Capital, Taxes and Growth," National Center for Policy Analysis, NCPA Policy Report No. 169, January 1992.

[5] This estimate is based upon the following ordinary least squares regression for the period 1954 to 1990:

$$\log W = \underset{(-92.1)}{-2.66107} + \underset{(41.6)}{1.186851} \log K/L \quad R^2 = 0.98$$

where W is the real hourly U.S. wage rate, K/L is the real capital stock divided by the number of hours worked and t-statistics are in parentheses. For an explanation of how the capital stock is measured, see "Capital, Taxes and Growth."

[6] The best analysis of the economic effects of supply-side policies is in Lawrence Lindsey, *The Growth Experiment : How the New Tax Policy Is Transforming the U.S. Economy* (New York: Basic Books, 1990). Lindsey began his research convinced that supply-side responses were negligible. After examining the evidence, he became one of the strongest proponents of supply-side policies. See also the analysis of tax rates and investment spending for specific types of investment in "Capital, Taxes and Growth."

[7] See Congressional Budget Office, "Effect of Lower Capital Gains Taxes on Economic Growth," *CBO Papers,* August 1990; and Joint Committee on Taxation, "Explanation of the Methodology Used To Estimate Proposals Affecting the Taxation of Income From Capital Gains," Washington, DC: U.S. Government Printing Office, March 27, 1990.

[8] Rep. Dick Armey (R-TX), Ranking Republican, Joint Economic Committee, letter to colleagues, February 7, 1992; and Chris Frenze, JEC Republican Staff, Memorandum to Republican Members, February 24, 1992.

[9] See the analysis in Appendix C of "Capital, Taxes and Growth."

[10] Aldona Robbins and Gary Robbins, "If the Budget Summit Was a Success, Why Is the Five-Year Deficit Heading Toward $1 Trillion?," National Center for Policy Analysis, NCPA Policy Backgrounder No. 109, March 11, 1991.

[11] See the literature review in John C. Goodman, Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990, pp. 22-23.

[12] Methods used by congressional agencies to estimate income distribution are coming under criticism. See JEC Republican Staff, "Income Mobility and the U.S. Economy: Open Society or Caste System?", released by Rep. Dick Armey, January 1992; JEC Republican Staff, "Distorting the Data Base: CBO and the Politics of Income Redistribution," released by Rep. Dick Armey, April 1991; and Aldona Robbins and Gary Robbins, "Tax Fairness: Myths and Reality," National Center for Policy Analysis, NCPA Policy Report No. 90, March 11, 1991.

[13] The structure of the investment decision follows in the long tradition of neoclassical capital theory. The general outline and justification for the approach are shown in Dale W. Jorgenson, "Anticipations and Investment Behavior" in J.S. Duesenberry, G. Fromm, L.R. Klein and E. Kuh, eds., *The Brookings Quarterly Econometric Model of the United States* (Washington, DC: Brookings Institution, 1965). The Brookings effort was the first of the large-scale econometric models and has provided the general structure for many subsequent models of the U.S. economy.

Investment is modeled as being determined by the productivity of capital in the production process and the "rental" cost of using it. The rental cost is determined by the cost of economic depreciation (deterioration of the assets' value), taxes to be paid from capital's income and a normal rate of return. For a nontechnical description of the investment process, see Robert J. Barro, *Macroeconomics* (New York: John Wiley & Sons, 1987), ch. 9.

The major difference in our approach and that of others is in determining the "normal rate of return." In the conventional applications, an interest rate is selected as the proxy for the rate of return. We go to great lengths to solve for the actual, economy-wide internal rate of return. As Figure IV shows, investment is closely related to the internal rate of return. By contrast, there is very little relationship between investment and interest rates. The appropriate formulation of the model of investment is generally not in question. Rather, the question is how to measure the "price" of capital.

[14] For an explanation of how the rate of return on capital is calculated and measured, see Robbins and Robbins, "Capital, Taxes and Growth."

[15] In technical terms, the marginal value product (MVP) of capital decreases with the amount of capital. The MVP is the amount of revenue generated by the additional output produced by one more unit of capital.

[16] For a more complete analysis of the two plans, see Robbins, Robbins and Goodman, "Reviving the Economy."