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TAX POLICIES FOR THE 1990'S: PERSONAL SAVING, BUSINESS INVESTMENT, AND CORPORATE DEBT

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ABSTRACT

Although the tax reforms of the 1980s substantially lowered the excess burden caused by high marginal tax rates, there were also significant adverse effects on incentives to save and to invest in business plant and equipment.

Effective tax rates on real capital gains and real net interest income remain very high because the tax rules do not recognize the difference between real and nominal magnitudes. These high effective tax rates discourage personal saving. The paper discusses a number of ways in which the tax law could be modified to encourage more saving and less borrowing.

Existing tax rules bias corporate decisions in favor of debt finance relative to equity finance and in favor of investments in intangible assets (like advertising, consumer goodwill, and R and D) relative to investments in plant and equipment. The paper discusses the use of a cashflow corporate tax (with complete expensing of investment and no deduction for interest payments) as a way of remedying both of these biases in our current tax law.

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Tax Policy for the 1990s:

Personal Saving, Business Investment, and Corporate Debt

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The tax reforms of the 1980s achieved a remarkable reduction of personal income tax rates. Cutting the marginal tax rate from the 70 percent rate at the start of the decade to 28 percent on the investment income of the highest income taxpayers reduced the associated deadweight loss to less than one-sixth of its previous level. Even the smaller reduction of the top marginal tax rate on personal services income from 50 percent to 28 percent reduced the associated deadweight loss by nearly three-fourths.

The restructuring of the personal income tax in the 1980s is testimony to the power of economic ideas. Economists for decades have emphasized the adverse effects of high marginal tax rates and have advocated broader tax bases with lower marginal tax rates. In the end, this key idea came to have widespread bipartisan support in the Congress and in the Administration. While it took strong political leaders to persuade the public of the desirability of tax reform and imaginative staffs in the Administration and in the Congress to invent the technical gimmicks that made the final legislation acceptable to a Congressional majority, the driving force behind the reform was the basic economic insight that high marginal tax rates have disproportionately large burdens.

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I. Adverse Effects of the Tax Reform Act of 1986

As a result of political considerations, some provisions of the Tax Reform Act of 1986 contain serious harmful effects of the incentives to save and invest. Although the revenue effects of reducting high marginal tax rates were balanced in part by eliminating the opportunities for tax shelter investments and the deductibility of net nonmortgage interest, that still left some high income taxpayers with substantial tax reductions. Even though the total net revenue loss was relatively small and could easily have been offset by a small increase in all tax rates or other modifications of tax rules, there was strong political pressure to provide middle and lower income taxpayers with even larger proportional tax reductions than those received by high income taxpayers. The legislation was therefore expanded to include a massive increase in personal exemptions, an increase that cost approximately $25 billion a year in lost revenue with almost no effect on marginal tax rates. To keep the overall tax bill revenue neutral, this revenue loss had to be offset by an equally large increase in corporate taxes. This corporate tax increase was achieved by eliminating the investment tax credit and reducing depreciation allowances, changes that substantially reduced the incentive to invest in business plant and equipment.

Even with the enlarged personal exemptions, the distribution of the tax reductions appeared to favor higher income taxpayers. This appearance was an illusion because the Treasury and the Congressional Joint Committee on Taxation did not take the increased corporate tax into account in calculating the distributional consequences of the legislation. Doing so would have shown that the overall effect of the tax reform was to raise the tax burden on higher income taxpayers (Feldstein,1988). The tax bill was nevertheless modified to raise the tax burden of higher income taxpayers by eliminating their IRA deductions, capping pension contributions, imposing an extra tax on large pension payouts, and, most importantly, by taxing realized capital gains at the same tax rates as ordinary income.

Because capital gains realizations are very sensitive to tax rates (Feldstein, Slemrod and Yitzhaki, 1980; Lindsey, 1987), this last change may not in the end lead to any increased tax collections from higher income taxpayers. It will undoubtedly have the adverse effects of reducing the incentive to invest in equities, encouraging the corporate use of debt finance, and decreasing the overall efficiency of the capital market. Ironically, ignoring the actual increase in the tax burden on upper income taxpayers that resulted from the rise in the corporate tax led to an increase in the capital gains tax rate that will have serious adverse effects on the economy without necessarily raising the tax paid by those high income individuals.

The tax reforms of the 1980s have succeeded in reducing marginal tax rates and eliminating the personal tax shelters. The tax reforms of the 1990s are likely to focus on improving the taxation of capital income to increase saving, to improve the allocation of total capital formation and to reduce the current incentive for excess use of corporate debt.

II. Insufficient Saving

The United States has long had one of the lowest saving rates in the world and a rate that falls far short of equating the social rate of return on additional capital and the intertemporal discount rate that individuals apply to future consumption (Feldstein, 1977). The low rate of saving means that the United States has a lower level of income and possibly a substantially lower rate of income growth than would otherwise be possible.

The already low rate of saving fell precipitously in the 1980s. During the decade of the 1970s, the total net private saving rate in the United States, including the saving of households, businesses, pensions and state-local governments averaged 8.9 percent of GNP. By the first half of 1988, that saving rate had fallen to only 5.7 percent of GNP, lower than any other major industrial nation. The decline of private saving is a particularly serious problem because our chronically high budget deficits still absorb private saving equal to more than 3 percent of GNP.

The high effective tax rates on saving are not the only reason for the low rate of private saving in the United States. Private saving fell in the 1980s because of the rise in personal wealth (resulting from the increae in stock prices and home values), the increased availability of home equity loans and other forms of consumer credit, and the reduced number of underfunded private pensions. But taxes are clearly an important reason for our chronically low saving rate and one that can be reversed by changes in policy. While some skeptics express doubts about the potential effects of tax rules on private saving, the research of a large number of careful scholars [including Boskin (1978), Summers (1981), and Venti and Wise (1987)] confirms that personal saving does respond to changes in effective tax rates and after-tax rates of return.

Despite the sharp reductions in statutory tax rates, the effective tax rates on the return to saving remain very high because existing tax rules fail to distinguish real and nominal rates of return. Consider a taxpayer who earns a 9 percent nominal return on a bond and expects inflation to average 5 percent during the life of the bond. His expected pretax real return is thus 4 percent. If the taxpayer has a 28 percent marginal federal income tax rate and a 5 percent state income tax rate, he faces a combined marginal tax rate that takes one third of his nominal 9 percent return. His after tax nominal rate of return is therefore only 6 percent. With a 5 percent expected inflation, the real after tax return is only 1 percent.

Thus taxes reduce the real return to 1 percent from 4 percent because the tax law does not correctly distinguish between real interest income and the payments that just offset the inflationary erosion of the debt. Although the combined federal and state statutory rate is only 33 percent, the effective tax rate on real interest income is 75 percent. Although the situation today is substantially better than it was a few years ago when inflation and tax rates were both substantially higher, today's tax rules leave little incentive to save.

The situation is no better for individuals who invest their savings in common stock. Someone who bought a diversified portfolio of stocks like the Standard and Poor's 500 back in 1978 has enjoyed one of the great bull markets of the century. An investment of $10,000 would bring $28,000 if sold today. Even allowing for the fact that the rise in consumer prices since 1978 means that it takes $18,250 to buy today what $10,000 would buy in 1978, the real gain was $9,750 or 4.4 percent a year. Adding this to the current 3.6 percent dividend yield implies an 8 percent pretax real return, enough to compensate for risk and provide an incentive to save.

But that 8 percent return ignores the effect of taxes. Since the tax law does not distinguish between real and nominal capital gains, the investor who sold that portfolio in 1988 would have to pay tax on an $18,000 gain. With a 33 percent combined federal-state tax rate, the tax bill would be $6,000 or 62 percent of the real gain. The net-of-tax real rate of gain would be only 1.9 percent. Even when combined with a current net-of-tax dividend yield of 2.4 percent, the total return of 4.3 percent is hardly enough to compensate for the risks of equity market fluctuations, let alone to provide an incentive to save. It is not surprising that individuals have been net sellers of corporate equities.

The failure to distinguish real and nominal interest also reduces the net cost of mortgage borrowing and other consumer debt. An individual who borrows at 12 percent faces a 7 percent real cost of funds before tax but only a 3 percent net-of-tax cost of funds.

The most obvious remedy for these defects in the tax treatment of capital income is to adjust the measurement of capital gains and of interest, including interest on consumer borrowing and mortgage debt, to reflect the difference between nominal and real interest rates. Administrative complexity and the inability to adjust for inflation with complete precision do not result in as much economic loss as a tax system that grossly mismeasures real taxable income and dramatically reduces the net incentive to save. Moreover, if fully implemented, these adjustments for inflation would actually increase total tax revenue.

The current taxation of capital income would of course still reduce the incentive to save even if real capital income and expenses were measured perfectly. A consumption tax or consumed-income tax that excluded all savings from the tax base would eliminate this distortion. Although such a consumed-income tax might be chosen over an ordinary income tax in the initial design of a new national tax system, there are formidable problems of transition from the existing system to a consumption based tax. There are also substantial problems in a consumed-income tax associated with the purchase of homes and major consumer durables.

These difficulties may not be worth confronting since a piecemeal approach can achieve much of the reduction in the tax distortion against saving. Because of the Individual Retirement Accounts and private pension rules, most American taxpayers already face the equivalent of consumed-income tax rules for retirement saving. Moreover, most taxpayers do not itemize their deductions and therefore cannot deduct any interest expenses.

Further piecemeal progress toward a consumed-income tax framework and therefore a greater incentive to save could include six changes from current tax law: (1) increasing the income limits for IRA eligibility and indexing those limits to keep up with income growth in the future; (2) providing IRA-type tax treatment for long-term deposits that are withdrawn before retirement age, thus appealing to younger households; (3) introducing IRA-type accounts for other special purposes like home purchase or educational finance; (4) phasing out the remaining interest deductions for consumer interest financed by home equity loans; (5) indexing the cost basis in calculating taxable capital gains; and (6) excluding a fraction of taxable interest income and expenses based on the ratio of the inflation rate to the interest rate on government bonds.

III. Misallocated Investment and Excessive Debt

The current system of taxing corporate income leads to a misallocation of total investment and potentially destabilizing levels of corporate debt. Although the 1986 elimination of the investment tax credit and decrease in depreciation allowances were advocated as ways of "levelling the playing field" among different types of business investments, the net effect of these changes was to increase the tax bias against investments in business plant and equipment in favor of investments in owner occupied housing and in corporate intangible assets like advertising, customer goodwill, manpower training, and research and development that can be expensed at the time of investment. This tax distortion leads to a misallocation of capital that reduces the level of real income and the rate of economic growth.

Tax rules distort the composition of corporate finance as well as the composition of business investment. For many years economists were puzzled by the failure of corporations to respond to the strong tax incentives to use debt and to substitute share repurchases for dividend payments. Debt is a lower cost source of finance because interest payments are deductible in calculating taxable profits. Share repurchases involve a lower tax burden on shareholders because the cost of the stock is subtracted in calculating the taxable gain and, until recently, that gain was taxed at lower rates than dividend income. In recent years, practice has caught up with theory, helped in part by the new financial technology of junk bonds and the favorable initial experience of large leveraged buyout funds.

Now there is increasing concern that the tax distortion in favor of debt is creating an excessive volume of LBOs and an undesirably high level of debt. The Federal Reserve and others have indicated concern that high debt levels that may be privately optimal could cause substantial economy-wide problems if high interest rates or a severe recession caused widespread defaults. While it is difficult to assess these risks, there is no doubt that the current tax rules provide a strong bias in favor of debt finance.

The concern about excessive debt has recently led to proposals to limit the deduction of interest by highly leveraged corporations or on debt assumed in LBO transactions. There are clear practical difficulties in distinguishing LBOs from the ordinary acquisitions that are a constant part of corporate growth. Attempts to restrict interest deductibility is likely to transfer borrowing to companies that currently have low debt-equity ratios or to foreign companies. In the end, such restrictions are unlikely to limit the substitution of share repurchases for dividends and will do little or nothing to reduce overall debt finance.

One way to reduce the existing tax bias in favor of debt and the incentive for LBO share repurchases would be to replace the current corporate income tax with a cash-flow corporate income tax. The cash-flow corporate tax would also eliminate the tax bias that currently exists against investment in plant and equipment relative to outlays on advertising and other forms of "intangible capital" and to investments in owner-occupied housing.

The cash-flow corporate income tax can be implemented by two changes from the current corporate income tax: eliminating the deductibility of interest expenses (thus treating them like dividends) and permitting an immediate write-off of all investments in plant and equipment (thus treating such investments like all other business costs). As King (1988) notes, eliminating the deductibility of interest expenses is equivalent to continuing the interest deduction but including net borrowing as a taxable receipt. This establishes that the cash-flow corporate income tax is equivalent to taxing the difference between all cash receipts (other than from the sale of new equity) and all cash payments (other than the payment of dividends).

Because outlays on plant and equipment are expensed under a cash flow corporate tax in the same way as outlays for advertising, training and other current costs, the bias against investments in fixed capital is eliminated. The cash-flow corporate income tax simultaneously solves the problems of misallocated corporate investment and excess corporate debt. The revenue loss from permiting all investment to be expenses would be balanced by eliminating the deductibility of interest; any remaining revenue difference could be made up by a small change in the corporate tax rate.

IV. Conclusion

The new administration has the opportunity to focus on tax reform aimed at strengthening capital formation. If they are successful, the United States will have a higher level of saving, more investment in plant and equipment, and less reliance on corporate debt.

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