Capital Income Taxation: Good Ideas and Other Ideas

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This paper is based on my presidential address to the National Tax Association, Boston, November 19, 2015.
I have been studying capital income taxation for a long time, dating from my dissertation work (Auerbach, 1983). Notwithstanding some of the developments in the literature since them, I am not against capital income taxation. But it is an area where the tax system can do, and does, a lot of damage, so the aim of my presentation is to review some ideas, based on my own research and the research of others, regarding how – and how not – to implement taxes on capital income and wealth. A key thing to keep in mind is that it’s not what we call a tax, or on whom the statutory incidence of a tax falls, but rather the tax’s economic effects, that matter. I will focus on several examples and the lessons one should draw from them.

**Taxes on Wealth versus Wealth Taxes**

It is by now well understood, I hope, and certainly among those in this audience and the NTA, that a consumption tax equals a labor income tax plus a tax on existing wealth, including future above-normal returns. This is a point developed in my book with Larry Kotlikoff (1987), where we emphasized how important the difference between consumption taxes and labor income taxes were as a consequence, with respect to both efficiency and incidence. Consumption taxes fall more on existing wealth and, to the extent not fully anticipated, are more efficient.

Note that the burden of this tax on existing wealth is felt immediately, via a change in real asset values – before consumption actually occurs – and that the imposition of the capital levy doesn’t require the measurement of wealth or capital income. It does require that consumption be identified and taxed, but that is likely to be a much less significant problem than measuring and taxing wealth and capital income, particularly if tax rates are high. Indeed, this has been one of the main advantages cited over the years for those arguing in favor of consumption taxes (e.g., Andrews, 1974; Bradford, 1986). Under a consumption tax, we do give up taxing the normal return to wealth, and there are arguments in the literature against doing so. But can this be what all the shouting is about by those who want to implement large wealth taxes to address inequality? This seems particularly puzzling given the very low safe rates of return we have experienced now for many years.

Also note that capital levies come in other forms through the tax system. This is one of the implications of the (no longer) “new view” of dividend taxation, developed in the 1970s and, to my knowledge, first referred to in print that way in my initial presentation at this annual conference (Auerbach, 1981). In that paper, I argued that integration of the corporate and individual income taxes via dividend relief (at the corporate or shareholder level), a standard policy prescription, may not make a lot of sense for the earnings already accumulated within the corporate sector, whose owners would receive what is basically a lump-sum transfer with the adoption of such a policy. The same argument applies to policies that pay for corporate rate
reductions by getting rid of investment incentives. As I discussed in connection with the Tax Reform Act of 1986 (Auerbach, 1989), such a switch amounts to raising the cost of capital without raising any revenue, while increasing asset values. Since then, some have argued that, to compete internationally, we must have a lower corporate tax rate. As discussed below, though, our tax system doesn’t need a lower corporate tax rate to allow us to compete with other countries.

“Death and Taxes” versus “Death or Taxes”?

A common lesson of tax planning is that death is the ultimate tax avoidance technology. But this doesn’t have to be the case. Repealing §1014 of the Internal Revenue Code – which allows a step-up in the bases of appreciated assets at death – and instead taxing gains at death (and not just providing for a carryover of asset bases, as was attempted in the United States in the 1970s and again briefly during the temporary disappearance of the estate tax in 2010), would get rid of the biggest part of the lock-in effect now present under the capital gains tax, and would be progressive at the same time. Even if such a reform had no net impact on tax revenue (for example, if it were offset with a reduction in the capital gains tax rate), it would be a major improvement because of its efficiency gains. There are many improvements possible with respect to wealth transfer taxes as well, where we can and should do much better than we do now.

No Taxation without Realization?\(^1\)

The realization doctrine is a cornerstone of income taxation. It also may have made some sense at some point, but it really doesn’t any longer. However, the tax planning and other behavioral distortions to which the realization doctrine gives rise can be made much less significant, even if we do not completely get rid of the realization approach. One improvement is that just mentioned: elimination of basis step-up at death. Others moving in the direction of accrual taxation include taxing on realization but with an adjustment to eliminate the lock-in effect, as developed in Auerbach (1991) and further refined in Auerbach and Bradford (2004). A less ambitious but also simpler approach would be to charge interest on accrued gains, assuming some smooth rate of asset appreciation. Note that, under any of these approaches, the tax rate on gains effectively rises with holding period, to offset the deferral advantage of the realization-based system. While the intuition for doing this is straightforward, it has not stopped the periodic generation of proposals to do just the opposite, i.e., to offer more favorable tax rates on gains held for longer periods.

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\(^1\) This seems an appropriate title for a talk given in Boston, with apologies to my former colleague David Shakow, whose well known article on this topic (1986) bears a similar title.
The Tortoise and the Haven

Which moves faster: People or electrons? This is not intended as a trick question, but the practice of tax policy has not yet adapted to the obvious answer.

The taxation of multinational enterprises is a challenging issue. In thinking about what we should do to adapt our tax systems to face reality in the international context, there are two basic approaches:

(1) Try to keep plugging the dikes of source-based systems, coming up with more and more complicated approaches to determining the location of intangible assets. You can declare success, even if your actions make distortions of real activity worse and even if tax incidence falls in the wrong place; and perhaps you will win a trip to Brussels or Paris if your plan is sufficiently complicated; or, alternatively,

(2) Try something else.

As an adopted son of Massachusetts, Mitt Romney, suggested (to considerable derision) during his unsuccessful 2012 presidential campaign, corporations are people. One may assume that he was not referring to the fact that corporations are “persons” in the legal sense, but rather that the impact of taxes on corporations matters only to the extent of the effects on the people associated with them – their workers, owners, customers, creditors, etc. This is really just a statement of one of the first principles of tax incidence analysis – that only people can bear taxes.

So, if our aim is to impose a tax burden on resident owners of corporations, for example, why not tax the owners directly, rather than the corporations? The owners relocate a lot less often. Even better, why not impose a destination-based corporate tax (as laid out in Auerbach, Devereux and Simpson, 2010, and Auerbach, 2010), which can be shown to be equivalent to a residence-based tax on shareholders (Auerbach and Devereux, 2015) and doesn’t require information beyond our own borders on holdings abroad. This scheme also taxes owners at the corporate rate, which may be desirable given the declining share of ownership by taxable shareholders (Rosenthal and Austin, 2016); and the corporate rate would no longer have any impact on the location of profits and production, and so would not need to be reduced to respond to the pressure for international competitiveness. Indeed, with the elimination of a source-based tax, the United States would become a tax haven, not by allowing companies to avoid paying tax but by changing the way in which they do so.

Follow the Money

One of the benefits of consumption taxes seen by its proponents is the simplicity of imposing taxes on cash flows rather than on income, since cash flows are observable and
income, especially capital income, often requires complex calculations. But it is possible to use this advantage of cash flow taxation even when the underlying objective is to tax income.

This approach underlies the capital-gains tax scheme in Auerbach and Bradford (2004), which effectively imposes a positive tax rate on capital gains through a rising cash-flow tax rate profile. In that system, the taxpayer perceives a positive tax rate on capital gains even though the government never observes or measures capital gains. The same approach appears in the scheme for first-year capital recovery, proposed in Auerbach and Jorgenson (1980) as a simple way of providing inflation-invariant real depreciation deductions to firms. Under that approach, investors would receive an upfront deduction upon purchasing an asset, equal to the present value of depreciation allowances for that asset calculated using an appropriate real discount rate, and would never have to keep track of asset bases thereafter.

Conclusions

The taxation of capital income and wealth is very complex, growing more so as the economy evolves, even as the importance of effective taxation grows with inequality. Yet our analysis has provided us with the tools to do better, particularly if we depart from standard approaches and tax bases that are being left behind by reality.
References


