What Should Tax Policy Be For Economic Growth?

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(Dated: December 1, 2017)

For several decades, the idea that economic growth results from promoting investing that creates jobs has motivated changes in tax policies that give incentives for investment. A recent analysis shows that more rapid economic growth would actually occur if there is an increase in demand [1]. This means that those who are likely to spend their money on consumption should have more money to spend to increase economic activity—particularly low to middle income workers and the poor. Not only would this benefit these consumers, it would also benefit investors, because they would have more opportunities to invest and receive higher returns from selling products and services to consumers. The entire economy would grow more rapidly.

The promotion of investment has included tax incentives that reduce government income. The income could instead be used for promoting consumption through a similar approach of reduction in taxes, increase in benefits for lower income individuals, or government investment in direct job creation through infrastructure or other projects. Over the long term, however, rapid economic growth would achieve what has often been promised for the promotion of investment: increase in revenue for government through increased economic activity overall.

It is helpful to review how current government tax policy favors investment. It may be surprising to many that the federal government currently taxes income of workers more heavily than income of owners. It does so primarily in three ways.

First, wages from work incur tax when received. Gains from investments, in contrast, are not taxed when they are earned. They are taxed only when the owner sells the property. Until then, the untaxed gains earn more gains for the owner. Tax experts refer to this deferral of tax as the realization requirement.

Second, when the investor dies the untaxed gain escapes tax forever. The heirs treat the investments as if they had paid cash for them. Tax experts refer to this as a step-up in basis.

Third, if the owner sells an investment held for more than a year at a gain, she can qualify for a tax rate substantially lower than the ordinary rate for wages.

Tax reform could change this approach to favoring owners over workers. First, it could modify the realization requirement by taxing gain on investments when earned. It may be difficult to ascertain the gain on certain investments like real estate. But for stock and securities traded on public markets, the owner can readily determine the amount of gain (and loss) at the end of the year. Tax reform could tax that net gain. Second, death could trigger the final accounting for an investor who has deferred tax for a lifetime. All the accrued gain would be subject to tax in the investors last return. Third, the ordinary tax rates could apply to capital gain.

These changes would be a major shift in tax policy. The analysis of economic growth should be performed to see the extent of changes that are needed in order to rebalance the economy. Perhaps all of these changes are not needed. The specific changes that should be made would best be guided by the analysis. However, it is reasonable to suggest that moving toward a tax policy that considers income of workers and owners more equally is a step in the right direction. The right balance of taxation on workers and owners should be adapted as the economy grows and changes.

It is important to note that a strategy of debt neutral tax reform, so that increases in taxes for investors is coupled to decreases in taxes for low income individuals may be unnecessary if a well designed policy that promotes growth is developed. Economic growth from the right policy, in this case the promotion of consumption, will increase government receipts relative to what is now expected to take place, would enable a reduction in national debt or higher levels of spending. Direct analysis of the policies themselves are needed for the extent of growth to be quantified.

[1] Yaneer Bar-Yam, Jean Langlois-Meurinne, Mari Kawakatsu, Rodolfo Garcia, Preliminary steps toward a universal economic dynamics for monetary and fiscal policy, arXiv:1710.06285 (October 10, 2017).