August 26, 1983

HOW TO CURE AMERICA'S CAPITAL ANEMIA

INTRODUCTION

Capital is the life blood of economic growth. Without enough capital, investment lags, equipment ages, competition falters, and jobs disappear. Today, the United States is suffering from capital anemia. The U.S. savings rate remains the lowest among industrialized countries and America's gross fixed investment, as a share of domestic output, is a third less than Japan's. Despite help from the Reagan tax cuts, which merely restored individual tax rates approximately to their 1978 levels, the savings rate fell in the first quarter of 1983 to 4 percent of after-tax income--the lowest since 1950. Adjusted for investment to replace obsolete plant and equipment, the share of national income devoted to net nonresidential fixed investment fell more than half during the 1970s.

Alarmed by this low level of savings and capital investment, many policymakers are rushing forward with quick-fix solutions. Among the most hastily conceived and counterproductive are the "industrial policy" initiatives. Such proposals are seductive. Most industrial policy proponents talk of bolstering capital formation and stimulating economic growth, often sounding remarkably like born-again supply-siders.

Unlike supply-siders, however, the supporters of a national industrial policy believe that the free marketplace cannot efficiently raise and allocate the capital necessary to revamp U.S. factories and spawn new technologies--especially with the huge federal deficits now looming over the capital markets. These economists and policymakers, therefore, recommend a broad range of new government powers, tariffs, and subsidies intended to channel funds to high growth "sunrise" industries while modernizing declining "sunset" industries.

Another school of economists, however, believes that it is high taxes, especially on capital investment and savings, that are crippling the ability of the marketplace to provide new capital. It is these taxes, not deficiencies in the market economy or the lack of a cohesive industrial policy, that are causing the nation's capital anemia. To cure it requires a huge dose of reform to reduce tax rates on American savings and investment. Freed from the disincentives now imposed by the tax code, American business would regain its competitive vigor.

Investment in the U.S. is taxed repeatedly. Corporate profits are taxed at up to 46 percent and then taxed over again when distributed to shareholders as dividends and capital gains. Capital is also subject to state and local taxes, taxes on interest income, and estate and gift taxes. As a result of inflation, total taxes on capital exceeded 70 percent by the late 1970s. This meant that, although the real rate of return on corporate capital was 9.4 percent before taxes in 1975-1978, it fell to only 2.8 percent after taxes. The tax wedge, in other words, took more than two-thirds of corporate profits. This low after-tax return simply cannot prompt the capital investment necessary to replace aging plant and equipment and fuel vigorous growth.

High taxes substantially increase the cost of capital, creating enormous competitive disadvantages for U.S. industry compared with its foreign competitions--particularly the Japanese. Example: The cost of equity and debt to Japanese businesses to finance investments (called the cost of capital services) is about one-fourth that to U.S. industry.

The Japanese economic miracle, in fact, owes much more to its abundant and low-cost capital than to its much vaunted industrial policy. The lower cost of capital allows Japanese firms to invest and to fund research which American businesses could not afford. Japan's tax collectors treat capital favorably in a number of ways: (1) Japan does not tax capital gains; (2) it provides special tax treatment to dividends; and (3) it encourages citizens to save. The U.S. should take a page from the Japanese success story and enact tax reforms to encourage greater capital formation.

Government intervention in the marketplace through industrial policies fails to acknowledge America's dangerous capital shortfall. The Reagan tax reforms are but a first step. Now required are: (1) replacing the current income tax system with a consumption tax; (2) abolishing the corporate income tax; (3) abolishing capital gains and dividend taxes; (4) taxing stockholders for corporate profits. As a first step, the tax bias against saving and investment must be reduced by expanding Individual Retirement Accounts, exempting a share of net savings from personal income taxes, and granting businesses a more realistic depreciation deduction.

THE CAPITAL SHORTFALL

Many studies conclude that the U.S. rate of capital investment and saving is insufficient for adequate economic growth, job expansion, and a rising living standard.[1] Annual U.S. saving of gross domestic product (GDP) averaged 19.2 percent between 1960 and 1980. By comparison, Japan saved 34.5 percent of GDP, and West Germany about 25.4 percent. Compared to other nations, the U.S. personal saving rate is also at rock bottom, averaging only 6.1 percent of after-tax income between 1960 and 1980--compared to 19.4 percent for the Japanese and 15.6 percent for the West Germans. While the Reagan personal income tax cuts seem to have boosted this low rate somewhat, a surge in consumer spending in the first quarter of 1983 reduced the rate to 3.9 percent, the lowest quarterly level since 1950. Congress must now couple the personal tax reductions--which, in fact, only restored tax rates to their 1978 levels--with further tax relief for savings and investment.

TABLE 1

International Comparisons of Saving Rates

(1960-1980)

	Personal Saving Rate (as a percent of after-tax income)	Total Gross Saving Rate (as a percent of GDP)
United States	6.1	19.2
Japan	19.4	34.5
Germany	15.6	25.4
France	14.3	24.4
United Kingdom	9.6	19.8
Italy	16.6	23.3
Canada	7.1	21.6

Calculated by Evans Economics, Inc., Washington, D.C.

These figures actually overstate the capital available for new investment, since a significant portion of savings is needed

---

[1] See Norman B. Ture and B. Kenneth Sanden, The Effects of Tax Policy on Capital Formation, prepared for the Financial Executives Research Foundation, 1977.

just to replace obsolete plants and equipment. The net saving rate, which measures savings for expansion, averaged 7.5 percent from 1966 to 1970, but declined to an average of 5.8 percent between 1976 and 1980. In 1982 it fell dramatically to a pathetic 1.9 percent of GDP.

Countries with low saving rates predictably are plagued with low rates of capital investment and low productivity, as Table II demonstrates.

TABLE II

	Gross Fixed Investment (as a percentage of GDP)	Productivity* (Manufacturing)	
	1960-1980	1960-1973	1973-1980
United States	18.2	2.8	0.5
Japan	32.5	9.0	4.7
Germany	34.9	4.7	2.9
France	22.7	5.7	3.2
United Kingdom	18.3	3.6	1.7
Italy	20.8	5.7	2.1
Canada	22.3	4.2	-0.2

Source: Organization for Economic Cooperation and Development, July 1982 and December 1982.
*Real value added per person employed.

Among Western nations, the U.S. has been stymied at the bottom of the investment and productivity ladder for two decades. Japan, meanwhile, devoted the greatest share of its GDP to gross investment among industrial nations and enjoyed a productivity rate nine times that of the U.S. from 1973 to 1980. Other industrial nations generally follow this pattern.

U.S. investment has fallen dramatically since the 1960s (see Table III). The share of gross national product (GNP) devoted to net nonresidential fixed investment fell by more than half between the last half of the 1960s and the late 1970s. Net fixed investment averaged 4 percent from 1965 to 1969, but dropped sharply to 1.8 percent of GNP in the 1975 to 1978 period. The rate of growth in nonresidential fixed capital also dropped. After expanding about 5.5 percent in the late 1960s, the rate of growth of fixed investment dropped in half to 2.4 percent in 1975 to 1978.

TABLE III

Investment and the Real Net Return to Capital

	Investment as a percentage of GNP	Growth in capital stock	Pre-tax return	Effective tax rate	Post-tax return
1955-1959	2.5	3.5	11.1	69.7	3.4
1960-1964	2.3	3.3	11.6	62.2	4.5
1965-1969	4.0	5.5	13.3	59.5	5.5
1970-1975	3.0	3.9	9.8	72.2	2.8
1975-1978	1.8	2.4	9.4	70.2	2.8
1955-1978	2.8	3.8	11.1	66.6	3.8

Source: Martin Feldstein, Inflation Tax Rules and Investment: Some Evidence, National Bureau of Economic Research, July 1982.

WHY SAVINGS AND INVESTMENT ARE LOW

The principal reason for the collapse of investment has been the effect of higher taxes on capital. The combined capital taxes paid to federal, state, and local governments, from all sources, increased from an average of 55 percent in 1965, immediately after the Kennedy tax cuts, to 90 percent in 1974 and remained at over 70 percent during the late 1970s.

Capital taxes surged mainly because of inflation. It increased corporate capital taxes in three principal ways: (1) depreciation allowances for capital equipment are based on historical cost, rather than on replacement cost. This overstates business profits for tax purposes in times of inflation; this kind of historical depreciation raised corporate tax liability by $25 billion in 1979 alone; (2) calculating inventory according to historical cost generates illusory business profits. This added another $30 billion to corporate tax liabilities in 1979; (3) inflation increases the taxable capital gain on sales of assets--giving the Treasury a further windfall of $10 billion in 1979.[2]

As Table III shows, these inflation induced tax increases reduced the real rate of return on corporate capital from an

---

2 Lawrence H. Summers, "Tax Policy and Corporate Investment," National Bureau of Economic Research, Working Paper No. 605, December 1980, p. 9.

average of 9.4 percent before taxes in 1975 to 1978 to just 2.8 percent after federal, state, and local taxes. This broad tax wedge significantly reduces the incentive for risk taking.

Some economists measure the cost to the economy due to tax code distortions. They call this "excess burden." Capital taxes impose the greatest excess burden. Economists Martin Feldstein, Michael Boskin, and Lawrence H. Summers, in separate studies, estimate that capital taxes reduce output by more than $100 billion a year. Charles Ballard, John Shoven, and John Whalley, in another study, calculated that every additional dollar from capital taxes costs 49 cents in lost economic output. The entire tax system's distortions waste an estimated 13 cents to 22 cents per dollar of tax revenue raised.[3] The tax system, in other words, imposes very heavy costs on the economy, in addition to removing resources directly.

THE COST OF CAPITAL IN AMERICA AND JAPAN

Capital taxes hamstring American business. George Hatsopoulos, chairman of a Massachusetts high-tech company and a director of the Federal Reserve Bank of Boston, told the Joint Economic Committee of Congress recently that U.S. firms face a real cost of capital of approximately 20 percent per year[4]. In Japan this cost is about 75 percent below that level. This advantage decisively boosts Japan's international competitiveness--especially in high-tech industries. The Hatsopoulos study reveals, moreover, that the real cost of capital services in the U.S. increased in the 1970s from 15 percent between 1963 and 1973 to over 20 percent after 1973, where it remains today. While U.S. capital costs soared, Japan's declined from 7 percent to 5 percent in 1981.[5]

Tax-Free Saving

Japan's attractive tax environment is the major stimulus for its high rate of capital formation and low real cost of capital.[6] The Japanese taxpayer can earn tax-exempt interest income on certain deposits totaling 14.5 million yen ($61,000). The tax code,

---

3 Charles L. Ballard, John B. Shoven, and John Whalley, "The Welfare Cost of Distortions in the United States Tax System: A General Equilibrium Approach," National Bureau of Economic Research, Working Paper No. 1043, December 1982, p. 23 and Abstract.

4 Dr. George N. Hatsopoulos, "High Cost of Capital: Handicap of American Industry," American Business Conference, Inc. and Thermo Electron Corporation, April 26, 1983.

5 Ibid., pp. 1-2.

6 Arthur Anderson & Co., "Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolion Stock Investments and Dividend and Interest Income in Eleven Countries," prepared for the Securities Industries Association, June 1983.

for example, allows investors to earn tax-exempt interest on government bond investments up to 3 million yen ($13,000). Savers can invest 3 million yen in savings deposits at banks or at the post office and the interest income is tax free. And workers can use payroll deduction plans to earn tax-free interest on up to 5 million yen ($21,000). Aside from these tax-exempt accounts, the Japanese worker's interest income from bonds and time deposits is taxed at only 35 percent. Washington, by comparison, taxes all interest income, at rates up to 50 percent.

Zero Capital Gains Tax

Japan treats corporate profits, capital gains, and dividends more favorably than the U.S. The U.S. taxes long-term capital gains at a maximum rate of 20 percent and short-term capital gains (held less than 1 year) at up to 50 percent. Japan, however, exempts long- and short-term capital gains from taxes. Even with the Reagan tax cuts, only the stagnant United Kingdom (30 percent) and economically troubled Sweden (22 percent) tax long-term capital gains at a higher rate than the U.S. Japan's refusal to tax capital gains encourages stock purchases, boosts small business entrepreneurship, and stimulates capital investment.

Low Taxes on Dividends

Along with most U.S. trading competitors, Japan taxes dividends at a lower rate than the U.S. Compared to the maximum rate of 50 percent in the U.S., Japan typically taxes dividends at 35 percent. Distributed earnings of Japanese corporations capitalized at over 100 million yen ($422,300) are taxed at 32 percent; retained profits are taxed at 42 percent. This ameliorates the double taxation of dividends, enhances the attractiveness of stock investment, and lowers the cost of corporate capital.

The Japanese worker can receive a lump sum retirement payment from his firm free of tax. In 1981, according to economist David Henderson, a retired worker paid no tax on the first $45,000 of such retirement income.[7] These corporate retirement funds are now a major source of investment capital in Japan. The U.S. only permits tax-deferred retirement savings through IRAs and Keoghs.

Impact on High Tech

Thanks in large part to this tax treatment of capital, the Japanese paid just 5 percent for their capital services in 1981, while U.S. industry had to pay 19 percent. This means that a product costing $10,000 in labor and capital in the U.S. would cost the Japanese as little as $4,900. Lower labor costs are one reason for this, but lower capital costs account for about 45 percent of the difference.[8]

---

7 David R. Henderson, "The Myth of MITI," Fortune magazine, August 8, 1983, p. 113.

8 Hatsopoulos, op. cit, p. 33.

High capital costs in the U.S. are especially destructive to the risky, long-term investments typical of high-tech projects. It has been estimated that a U.S. investor would be willing to risk only 40 percent of what a Japanese investor would on the research and development (R&D) costs for a project requiring five years of development, given similar conditions. This is due to the disparities in the relative costs of capital.[9]

This is why Hatsopoulos and others concerned about high-tech industrial development are so alarmed at the high cost of capital in the U.S. American high-tech firms, beset with heavy capital costs, often cannot compete with the Japanese. As the evidence shows, it is Japan's low cost of capital, not targeted industrial policy, that makes funds available to expanding firms and is sustaining the Japanese economic miracle.

THE 1981 AND 1982 TAX LAWS

Many economists maintain that the changes made in the 1981 Economic Recovery and Tax Act (ERTA), followed in 1982 by the Tax Equity and Fiscal Responsibility Act (TEFRA), have reduced sufficiently the taxes on capital. They claim that any further cuts in capital taxes are unnecessary, and even would be counterproductive, since they would widen the deficit and push up interest rates. Some argue that substantial increases in business taxes and personal tax rates are needed to reduce deficits and stimulate investment by reducing interest rates.

The 1981 tax act, in truth, stopped well short of the reforms needed to eliminate the tax bias against saving. The Accelerated Cost Recovery System (ACRS), which was the keystone of Reagan's 1981 capital enhancing initiative, only reduced the cost of capital by about 1.2 percent and mostly benefited those industries having large fixed assets. The high-tech companies employing fewer fixed assets got much less benefit from ACRS.[10] While the 1982 Act reversed some of these reforms, the 1981 Act has had a very positive impact.

(a) Accelerated Depreciation (Accelerated Cost Recovery System--ACRS)

ERTA improved depreciation for tax purposes, and so helped shield businesses from the high effective taxes on corporate capital caused by inflation. ACRS also reduced some of the tax distortions under previous law. But because TEFRA eliminated about 70 percent of ERTA's capital incentives, major additional tax initiatives are now needed to bolster capital investment.

---

9 Hatsopoulos, op. cit, p. 36.
10 Hatsopoulos, op. cit, p. 27.

(b) Incentives for Personal Saving

The 25 percent personal tax-rate reductions reduced the high marginal taxes on savings significantly. Lowering the top marginal tax rate on investment income from 70 percent to 50 percent has encouraged capital formation. This has given a significant boost to new equity offerings and to the bond and stock markets. Previously, high capital gains taxes had sharply diminished these important sources of business capital and had undermined seriously small business startups. Now the financial markets are flush with new funds, due, in part, to the capital tax cuts.

(c) Indexing Tax Brackets for Inflation

Indexing tax brackets for inflation will be a powerful stimulus to capital formation. Though indexing only affects the personal income tax brackets, dividends, interest, and capital gains are taxed through the personal income tax when they accrue to individuals. More important, three-quarters of all businesses are sole proprietorships, Subchapter S corporations, or partnerships which pay taxes through the personal tax code. These businesses tend to be the smaller, faster growing firms that contribute disproportionately to job creation and innovation.

THE REMAINING TAX AGENDA

Major Reforms

The 1981 tax changes may be lifting the U.S. from last place among Western nations in productivity and capital formation, yet the reforms did not go nearly far enough. U.S. tax code changes are needed to eliminate the tax bias against saving and investment.[11] The most direct means of achieving this would be to switch to a consumption tax. Under this system, income would be taxed only when consumed, not when saved. A consumption tax is neutral between present and future consumption, taxing each at the same real rate. Currently, future consumption is taxed at a much higher rate than present consumption because extra taxes are applied to the earnings from savings already taxed. By increasing the after-tax return to saving, a consumption tax would encourage saving and investment.

A number of reforms would construct a comprehensive consumption tax:

---

[11] Ture and Sanden, op. cit. The following closely follows the approach in this book.

(1) Tax either net savings or the net return to savings--not both.

To figure taxable income under the latter method, the taxpayer simply computes income and deducts net savings. Interest income is taxed when consumed. This would eliminate the double taxation of savings, a major barrier to capital formation.

(2) Eliminate the corporate profits tax.

A consumption tax would not tax corporate earnings until they are consumed. Retained earnings and other forms of net corporate savings would be excluded from taxes. Shareholders would pay taxes on distributed business profits when they are spent. This treatment eliminates the double taxation of dividends, reduces the tax burden on capital, and equalizes the tax treatment of different kinds of investment.

(3) Abolish business depreciation allowances and replace them with "immediate expensing" of all asset purchases.

The purchase of assets is a form of saving and should, therefore, be deductible from income. All proceeds from the sale of assets including stocks and bonds would then be included in the taxable income in the year of the sale. Capital gains and losses would be entirely eliminated from the tax code. This tax treatment eliminates the inflation induced distortions of historical depreciation, creates tax neutrality among all classes of assets, and enhances incentives for capital investment.

(4) Eliminate estate and gift taxes.

Inheritances should be taxed only when spent. Inheritance taxes directly bear on capital investment and, therefore, shrink the pool of savings and dampen capital investment income.

(5) Reduce Marginal Income Tax Rates.

Because high marginal tax rates magnify the bias against work, saving, and investment, the federal personal income tax should be lowered to a flat rate of 19 percent.

Limited Tax Revisions

The chances of Congress enacting such changes in the tax structure are slim in the near term. But incremental changes could nudge the tax code in the direction of mitigating significantly its anti-saving bias and thereby encourage capital formation. Examples:

(1) Corporate Income Tax-Rate Reductions

The tax on corporate profits, most experts agree, distorts the relationship between the corporate and noncorporate sectors, discriminates unfairly against certain assets, and discourages corporate investment. To correct this, the corporate income tax should be abolished and corporate earnings taxed only when consumed. As a step toward this, Congress could reduce the tax rates on corporate income. Complete elimination of the corporate income tax would have reduced the cost of capital by 3.5 percentage points in 1981.

(2) Corporate Deduction for Dividends or Shareholder Tax Credits

The corporate profits tax discriminates against equity financing while encouraging heavy indebtedness because interest expense is deductible from taxable income, but dividend payments to shareholders are not. The result: Dividends are subject to double taxation, once at the corporate level, and again at the personal level.

One means of eliminating this distortion would be to allow corporations to deduct dividends from taxable income in the same manner as they deduct interest outlays. This would eliminate double taxation and give equal tax treatment to both equity and debt finance. The Hatsopoulos study calculates that this would reduce the cost of capital to profitable firms by 9 percentage points, cutting it from 19 percent to 10 percent. An equivalent method would be to give a credit to shareholders for the tax that corporations have already paid on distributed earnings.

(3) Capital Gains Tax Reform

Thanks to inflation, capital gains taxes often become taxes on capital itself. The current tax system makes no distinction between inflation induced gains and gains caused by real improvements in value. The assessed value of capital investments, therefore, should be adjusted for inflation, so that taxes are paid only on real gains. The tax also should be reduced and, ultimately, eliminated to enhance the environment for capital formation.

The Treasury ironically may find itself collecting more revenues from a lower rate than it does now. In 1978, for example, the tax was reduced from 40 percent to 28 percent. This spurred enough additional investment to generate a net increase in revenues.[12]

---

[12] Mel Colchamiro, "Revenue Estimmtes of an Elimination of the Capital Gains Holding Period," Office of Economic Research, New York Stock Exchange, July 1983. See also "An Analysis of the Capital Gains Holding Period," Office of Economic Research, July 1982, pp. 9-10.

The holding period for capital gains should be eliminated, bringing the U.S. tax treatment of capital gains more into line with the other industrialized countries. The extra tax that Washington imposes on gains on investments held less than one year encourages investors to hold assets for longer than they otherwise would, thus restricting the mobility of capital and discouraging investment in equities. Studies find that eliminating the capital gains holding period could generate more net revenues for the government by causing stockholders to sell off stocks more often and by stimulating equity investment.[13]

(4) Expanding the IRA Deduction

Individual Retirement Accounts (IRAs) have attracted an estimated $30-$50 billion in funds in 1982. These accounts encourage individuals to put aside funds for their retirement. While many savers may be shifting funds from existing accounts into IRAs, as existing savings accounts are drawn down, new saving will flood to IRAs in order to take advantage of the tax break. Congress could accelerate this by eliminating the penalty for early withdrawal and increasing the ceiling for deductions.

Congress also could allow savers to deduct a share of their savings, say 50 percent, from taxable income, thereby cutting marginal tax rates on savings. The 1981 ERTA took a small step in this direction. One provision allows an exclusion of 15 percent of net interest income up to $3,000 ($6,000 on a joint account) starting in 1985.

(5) Reductions in Marginal Income Tax Rates

The bulk of the Reagan personal tax cuts have been eaten up by bracket creep and Social Security tax increases. Most Americans, in fact, will be no better off in 1988, from the point of view of tax burden, than they were in 1978. While only 3 percent of taxpayers in 1960 faced marginal tax rates of 30 percent or above, 34 percent were in that tax bracket or higher in 1981. The Reagan tax cuts will only restrain increases in those tax rates. Marginal tax rates should be cut further.

CONCLUSION

Supporters of industrial policy have proposed "a government-industry partnership" to pick winners and bolster losers. What they overlook is that the U.S. already has a system to pick winners and losers: the marketplace. In the marketplace, a complicated network of financial institutions, individual entrepreneurs,

---

13 Ibid.

and investors decides which projects deserve funding. History proves that this is extraordinarily more successful than having Washington bureaucrats or politicians allocate resources. An industrial policy would insert the government into the heart of economic decision making.

Advocates of an industrial policy gaze longingly--and enviously--at Japan as a model. This is wise. But they seldom recognize what they are looking at. Japanese success stems not from an industrial policy,[14] but from Tokyo's favorable tax treatment of capital. The result: Japanese businessmen can count on a high volume of capital at a far lower cost than their American counterparts.

The U.S. should emulate Japan, not by imitating an irrelevant industrial policy, but by copying its tax treatment of capital and investment. Like Japan, the U.S. should reduce taxes on capital gains, corporate income, dividends, and savings. Like Japan, the U.S. should free up the market so that it can raise and allocate capital efficiently. The ultimate goal should be replacement of the current U.S. tax system with a consumption tax. Such reforms would increase the capital available to the American economy, thus triggering vigorous and sustained economic growth and millions of new jobs.

Thomas M. Humbert
Walker Fellow in Economics

---

[14] See also Katsuro Sakoh, Ph.D., "Industrial Policy: The Super Myth of Japan's Super Success," Asian Studies Backgrounder No. 3, The Heritage Foundation, July 13, 1983.