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How Would You Invest $1 Billion Under the Current Tax System?

By David Cay Johnston

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In this column, Johnston poses a question about what to do with a windfall, asking readers to ponder how the tax system affects investment decisions and suggest ways to increase demand for goods and services.

Today let's try a thought experiment, with reader participation, about the role of taxes in wealth creation.

For our thought experiment, imagine that you already have more than enough income to meet your consumption needs and desires, whatever they are.

Now imagine that $1 billion, after tax, was just deposited in your account. What would you invest to make your $1 billion grow? And how might taxes affect your decisions?

The first thing you will notice is a severe shortage of opportunities to increase your new wealth.

If you do not notice, your advisers will explain that the stock market that started revving in 1981 has become a sputtering engine in need of an overhaul. In the decade from January 1, 2000, through the end of 2009, the S&P 500, which represents 85 percent of the stock market's value, produced a real return of *minus* 3.84 percent compounded annually. That figure includes dividends being reinvested, by the way. Every dollar you had in this broad market index on millennium day was worth just 71 cents a decade later. The market has drifted even lower, and that dollar you invested on millennium day is now down to 69 cents. How low will it go?

These abysmal returns do not mean that companies failed to make profits in the aughts. Corporate profits, adjusted for inventory values and counted in 2009 dollars, grew 41 percent to $1.33 trillion in 2009, the federal Bureau of Economic Analysis reports show. Domestic industries, however, did not fare as well, their profits rising just 28 percent, with declines in the profits of utilities (-6 percent), manufacturing companies (-16 percent), and petroleum and coal (-54 percent).

Retail trade might look attractive as a place to invest, with profits up 30 percent in real terms in 2009 over 2000. Then again, retail outlets have been contracting since the Great Recession began in late 2007. Just this summer Saks Fifth Avenue closed five stores, with more cuts coming; American Eagle Outfitters closed 28 stores; and Men's Wearhouse said it plans to close as many as 60 stores — and that is just a sampling of retail retreats. The Great (long ago) Atlantic & Pacific grocery chain shuttered 25 stores, while Winn-Dixie closed 30. Even mighty Walmart, which gets taxpayer subsidies to build many of its stores and nearly all of its distribution centers, recently warned investors about tough times and tight pocketbooks that may hurt its performance.

You could put your windfall into real estate. There are abandoned homes, apartment buildings, and commercial and industrial buildings almost everywhere.

Then again, many of these empty buildings were not protected from freezing winters or soggy summers and are severely damaged with burst water pipes, moldy walls, and other costly damage. Some of our large store of constructed capital is rotting.

From Charlotte, N.C., to Syracuse, N.Y., to Southern California, you can drive down once busy arterial roads and pass abandoned strip malls, boarded-up auto malls, and office buildings with no tenants. Another, admittedly anecdotal warning sign: In a dozen trips to Los Angeles since December 2007, I have repeatedly driven at the speed limit on freeways during rush hour, freeways that were always jammed in the 1980s and 1990s. Restaurants are closing left and right, the total number of them nationwide falling for the first time since World War II. One in every 50 restaurants in Southern California closed in the last 12 months, the *Los Angeles Times* reported recently.

Empty properties used to mean bargains in real estate. If you can pick up properties for a song, you could increase your $1 billion when the market bounces back. But prices are still falling in many markets, and the trend is toward more commercial space like malls and storefronts going vacant in the years ahead because of reduced incomes and increased Internet shopping. It will be decades, if ever, before prices, in real terms, return to pre-2007 levels, a variety of real estate and economic authorities told *The New York Times* this month. And with factory utilization at its lowest levels since the 1930s, buying up industrial sites is riskier than driving on icy roads in February with bald tires.

There are lots of net operating losses out there, and with the liberal rules sponsored by business backers in Congress, the time to make use of them has been expanded. One problem: You need profits to offset those NOLs before they go poof.

There are some bright spots. Electronics industry sales profits continue to grow, although profit margins are thin because much of that industry has actual competition. And there are always new services to be invented that will add value. New services are a notoriously risky area (just ask investors in dot-coms like Webvan). Then again,

maybe you can start a new firm with almost no revenues and sell it for more than $1 billion (YouTube).

There are always opportunities. Even in the Great Depression, some people made fortunes. Your real problem is that your billion-dollar windfall faces intense competition for opportunities to profit.

Today America is awash with capital, overwhelmed with cash with no place to be profitably invested. American companies are sitting on a fantastically huge pile of cash — $1.8 trillion. That is 1,800 times the windfall you just collected in our thought experiment and equal to almost $6,000 for each American.

All this capital is a big change from three decades ago, when a shortage of capital for investment was presented as not just a problem, but a crisis for America.

Three, four, five, and six decades ago you would have enjoyed many opportunities to put your capital to work. The incomes of Americans were growing, and demand for goods and services grew right along with them, making many entrepreneurs so willing to take on risk that Michael Milken made a fortune selling corporate debt at real interest rates of 10 percent, 12 percent, and sometimes more.

The opportunities to profit were good enough that even such steep interest charges did not stand in the way of the boldest capitalists, although some of them found ruin while others enjoyed success.

Back in 1980 the American Council for Capital Formation had yet to be born, but public debate focusing on a perceived shortage of capital became part of the lexicon. And the push for rules that favored capital was packaged as a way to create not just more jobs, but more better-paying jobs. More capital formation means "a higher standard of living for all," according to the council to this day.

The success of this movement was largely in tax policy and its twin, regulatory policy. Lowered rates on capital gains and dividends, more favorable rules on avoiding recognition of income, and handcuffing tax auditors while drastically reducing their numbers all played a big role in this shift. So did rewriting regulatory rules, including those that required legal monopolies to show a connection between costs and rates, an idea now gone for the telephone, cable, pipeline, and electric monopolies and, to a somewhat lesser extent, for big railroads.

The movement to use tax and regulatory policy to encourage more capital formation had such success that today there is far more capital available than opportunities to profitably put it to work.

Capital that cannot be profitably employed loses value, both for its owners and for the society whose rules encouraged the creation of vast surplus pools of it. With no place to invest, much of this capital is idle. Real interest rates on the money that companies and individuals are parking in banks and money market funds until happy days are here again are losing value because real interest rates on savings are negative. Some banks pay interest of a tenth of a percent per year. Banks advertise "high yield" certificates of deposit that may add less than 1.5 percent per year, which after taxes and inflation results in a loss of a percentage point or more of savings per annum.

There is a lot of fear-mongering going on that raising taxes on the richest among us will make things worse and will reduce the availability of capital to invest. Senate Minority Leader Mitch McConnell, R-Ky., is among those who assert that raising taxes on the highest-income Americans will do damage, but he only asserts that because he has no evidence. Reports by the Congressional Research Service and the Congressional Budget Office, among others, show that it is more demand that is needed, not continued tax savings for those at the top. (For the CBO's report on the long-term budget outlook, see *Doc 2010-17341* or *2010 TNT 149-34*. For a CRS report on tax issues facing Congress, see *Tax Notes*, Apr. 19, 2010, p. 325, *Doc 2010-6445*, or *2010 TNT 57-24*.)

What is needed is a tax policy that will put that capital to work. And the way to do that is by adopting tax policies that will increase demand, just as we created a boom in capital through tax policies.

So where would you invest your windfall? And if $1 billion seems too much to imagine, then how would you invest a windfall of just $1 million?

The one safe investment would be to pay off any debt, except that debt is now priced at historic lows, which should make long-term borrowing at fixed rates very attractive.

So how to make capital more valuable? Let us turn here to an observation made in the middle of the 19th century:

> Labor is prior to and independent of capital. Capital is only the fruit of labor, and could never have existed if labor had not first existed. Labor is the superior of capital, and deserves much the higher consideration.

Those words come not from Karl Marx, but from the first State of the Union address given by that most famous of Republican presidents, Abraham Lincoln.

What Lincoln grasped is that capital and labor exist in symbiosis like the algae and fungi that make lichen, like the arterial and venous blood that sustain human life. If the veins that carry away carbon dioxide and other waste are smaller than those that bring oxygen and food, the body does not remain healthy. Indeed, pools of blood form and begin to rot, which if left untreated will kill the body.

Your imaginary $1 billion windfall is most likely to become more valuable if people have more money to spend on products and services. Doing that requires higher incomes. But demand is weak because of 14.5 million people out of work, another 12 million or so more people who want more work than they can get, and wages stagnant or falling for a majority of Americans. What we need is to get money circulating, not stagnating, and into the hands of people who will spend it.

The way to build demand right now is to work on tax policies that bring balance to our economy. That means hiring more teachers, not firing 300,000 of them. That means increasing real wages, not using government tax and regulatory policies to suppress them. It means raising taxes on those who make the most to get money circulating.

Nothing will do more to help small business than increasing demand, because it is the need to produce

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products and provide services that creates jobs. And nothing will generate more taxes to winnow down and eliminate budget deficits than a hearty increase in the flow between capital and labor.

So think about what you would do with that windfall and how we can exercise tax policy to help make it more valuable. Then send me your thoughts on how we can put tax policy to work to bring supply and demand into a healthy state of economic symbiosis so that we can make both more valuable and build a wealthier, healthier future for America.

Your thoughts? E-mail me at *JohnstonsTake@tax.org.*

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