Taxing People Like Shares: How Pro-Labour Tax Simplification Can Help Reduce Income Inequality and Promote Long-Term Economic Growth

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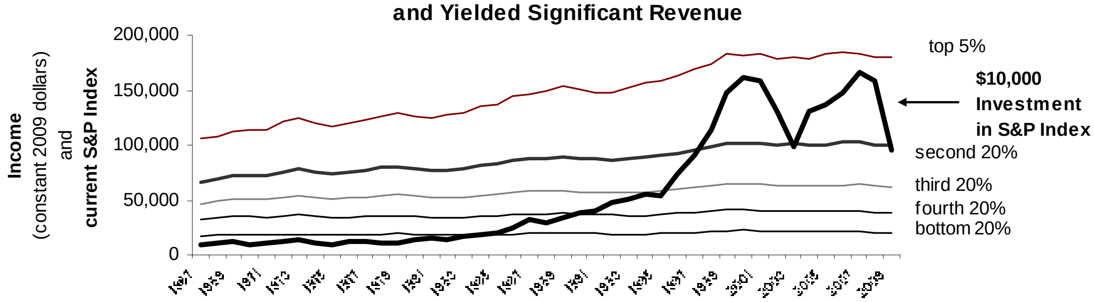
Abstract: Stagnant wages in the US have contributed largely to income inequality. No wonder given friendlier capital tax rates, compared with labour. Could the much-debated change to the US tax code hold the key to a fairer society? In this brief, I will discuss the economics and ethics of changes to worker taxes. Specifically, I will look at equal taxation of income taxes and capital taxes. I will discuss how other such taxes in places like South Korea have helped achieve social (read macro-ethical) goals. I will also provide estimates of how such taxes would reduce income equality in the US, and their effect on the budget deficit. Its an article about ethics because of the balancing of "good" across political-economic groups.

Can a change in public ethics help solve one of the most difficult policy questions of our day? Not since the Roaring Twenties has income been so unevenly distributed. Figure 1 shows the data you have probably already seen. The top US households have seen rapid gains in their income since the capital-friendly policies of the Reagan administration. Such gains have coincided with a booming stock market. With a tax rate of 15%-ish on capital and 33%-ish or more on labour, working has never been so unprofitable. Most treat these trends as exogenous outcomes of the economy and politics. Yet, behind the numbers lie ethical choices. We tax capital less than labour because of the implicit assumptions about the "goodness" of capital. Our decisions allowing gains from capital to benefit more than wages reflect ethical choices. So does our silent consent. Could giving wages the same moral value as dividends, capital gains and windfalls from Silicon Valley entrepreneurship help solve several of our most pressing problems?

Figure 1: Progressive Capital Taxes Would Have Allowed Post-Tax Wages to Expand and Yielded Significant Revenue



The figure shows US household income by income segments in constant 2009 dollars. We have rescaled the S&P Index to 1967=10,000 in order to allow for comparison. We have not deflated the S&P Index in order to keep the graph and our procedures relatively simple.

Sources: Table 694 of the US Census Bureau's *2012 Statistical Abstract.* S&P come from *Yahoo Finance* series S&P 500 (^GSPC) and have been scaled to 1967=10,000.

From Ethics to Income Taxes

Policy has failed to reflect large changes in economic theory which viewed capital as inherently good relative to labour. In the first serious models of the 20th century (like the AK Model and Solow Growth Model), economists of the 1960s-1970s argued that economic growth comes from "optimising" the country's capital stock. For policymakers looking to maximise growth, the social "good" demanded gathering capital and reducing worker (population) sizes. Reagan-era advisors had put pro-capital ethics into practice – with reductions in dividend and capital gains taxes. The Tax Reform Act of 1986 embodied the ethical choices lying behind these models. By the 1990s, economists knew that knowledge and human capital make the gains from capital possible. Yet, policymakers have not adjusted to the implicit ethics of endogenous growth theory. In our post-industrial endogenous growth world, workers carry the capital they use in their heads. Wages simply represent a dividend on human capital – why shouldn't they be taxed as such?

Why is human capital taxed like labour instead of capital?

Our tax system penalises capital in people rather than of machines. Consider your own life. When you write a report, a computer programme or a city plan, you must pay 33% or more of that money in tax. You must contribute to social security, insurance and social obligations like unemployment. Yet, when you invest in software that does these things for you, you only pay 15% on the benefits. You may reduce taxes through depreciation on the machine over <u>its</u> useable, and when you reinvest in its upkeep. Yet, our policymakers have decided that when you invest in a graduate course, you receive incommensurate tax breaks for the investment. You may not depreciate its value as <u>your</u> useable life.

People "depreciate" just like machines, but we don't get a tax break for it.

Economics and politics both involve decisions about the allocation of scarce resources. Title 26 of the US Code (known as the Internal Revenue Code) embodies moral decisions -- explicitly stating which tax rates are "good" (allowed) and "bad" (prohibited). Title 26 of the Code of Federal Regulations represents the way our government puts our ethics into practice. These choices represent ethical decisions based on outdated views about capital.

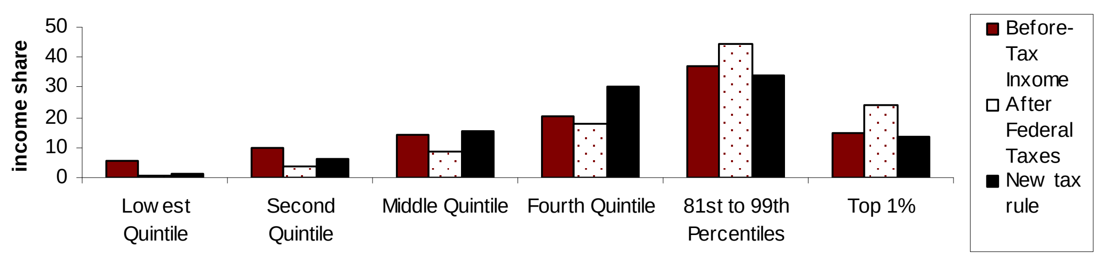
What would happen if we taxed labour just like capital?

What would happen if we taxed wages more like capital gains? We know that high taxes on wages relative to capital have correlated with increasing income equality in the US. We also know that countries with higher levels of inequality tend to have lower growth rates. Such a finding makes sense. Knowledge workers – particularly those in the middle class – have less money to fly to conferences, invest in continuing education, buy new computers, pay membership fees in professional associations, and do the other things we do. Taxing human capital more like financial capital increases middle-class workers disposable income in two ways. First, they keep more money on April 15th – using the extra money to grab new ideas by engaging in all the activities all us professionals do. Second, as we spend, we learn new things and have ideas – some of which result in marketable products.

What does it mean to tax people like machines? Simply setting a flat tax at 22% (for example) does not result in the same level of taxation. Non-distortionary taxation would require the IRS not to tax money used for health insurance, retirement payments and welfare (unemployment contributions) in the same way it taxes vacations in Hawaii or wild nights out with the boys. Investments in education and conferencing around would need to attract the same tax treatment as investments in 3D printers and assembly lines. The idle wealthy would necessarily pay more tax. In such a world, you would to report a capital gain when the boss gives you a bonus. A raise would be reported as an increased dividend payment on human capital. Conversely, an illness or unemployment could result in a (human) capital loss – both decreasing the intellectual tools one uses at the home/office in the future.

Several countries have already started down such a path. Economists have already started to calculate the best tax for human capital in places like Canada. Korea provides a recent example of pro-labour taxation – offering tax reductions for firms that pay out profits as wages. Economists have calculated that tax rates need to fall for middle-income families by up to 33% to take into account human capital. Such a tax clearly brings wage taxes more in line with capital taxes. As we show in Figure 2, if we implemented such a productivity-adjusted tax, real wages would rise and income inequality would fall. In this model, just equating marginal taxes toward marginal productivities does the trick.

Figure 2: Taxing People Like Capital Would Get the Distribution of Income Back toward the Ethics of the Times



The figure shows income shares for various income levels in the US in 2011. We show before tax income shares and after-tax shares from the CBO. Interestingly, the richer end up richer after taxes. Taxing labour like capital has the effect of redistributing wealth to the middle classes.
Source: Figure 1 from the CBO's The Distribution of Household Income and Federal Taxes, 2011 with "new tax rule" calculated using modelling from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2128213. Our estimates will likely change as we refine the model.

Doesn't such a tax boil down to a regressive flat tax – ultimately hurting the poor? Many countries have implemented flat taxes, also on the ethical/moral grounds revolving around the equality of tax treatment between labour and capital. Yet, people need not pay the same nominal tax rate as machines. The real effective tax workers would pay (or companies would pay on their behalf) would depend on incentives given to pay wages, the speed by which workers replace their human capital, costs of living and so forth. **The real, effective tax rate -- which leaves firms indifferent at the margin between using people and machines having the same long-term social, marginal productivity – can be anything.** The model we use to calculate such a tax rate will –itself- reflect ethical choices. Yet, I doubt Treasury will involve any of us in modelling choices and decisions.

Wouldn't treating labour more like capital increase budget deficits? By all indications, the budgetary effects of such tax treatment would be to lower revenues now, and increase them later. We do not need to drop tax rates to the lowest common denominator. The OMB can tell us which rate would balance the budget while still maximising growth. Yet, we do know that our current tax system costs us $134 billion, due to its complexity. Adopting a simpler, more equitable taxation method would help balance budgets as well as reflect modern ethics.

The Complexity of Simplicity

Behind "taxing people like machines" lies taxation law based on principles rather than onerous procedure. We have all heard the criticisms of the current Code, and its 74,000 page corpus of commentary on the tax code which grows at about 1% per year. The ever ever-expanding sets of exclusions, exceptions and specifications shows how far we have moved from the taxation based on treating all factors of production equally. We offer education credits to individuals and R&D credits to companies because they are easy to understand. Yet, taken together, they create an incomprehensible whole.

Simple rules treating labour more like capital could help to de-complicate our tax laws. In the 1990s, social scientists buzzed with excitement over the new theory of complexity. The theory held that the fantastic complex systems we see around us stem from simple "generating" rules. "Stay a fixed distance from your neighbour" helps explain complex flocking of geese to the spirals in flowers. Economists loved the new Science of Complexity because we could rival Mother Nature's world, by creating simple rules followed by each person individually. In the tax area, a simple rule would help us keep a simple, non-discriminatory and non-distortionary tax system, the gold standard of tax systems. Could simple rules like "treat labour like capital" help develop an effective tax system without the undue complexity? At the very least, such simple rules would help guide what is already a complex debate.

We used to tax people just like capital in the late 1980s, when both income and income equality shot up. In that time, you paid more tax when you got richer – whether you got rich from digging ditches or speculating in stocks. Let's return to the ethics of that time.

Dr. Bryane Michael is currently at the University of Oxford and Hong Kong University. He used to teach public finance at Columbia University and served as advisor to tax authorities in Russia, Turkey, Bulgaria, Macedonia, and Kosovo. He specialises in the use of economic analysis of social and private costs/benefits in legal drafting.