Tax Reforms to "Promote" Saving would Backfire

Mason Gaffney, “Insights” Column in *Groundswell*

June 2005

There is a strong movement afoot to tax just consumption rather than all income. The “good reason” for this is to promote saving and investment, and thus enhance domestic capital formation, said to be the main force for economic growth, poorly defined but assumed to be a good thing. A battery of well-financed pols, along with many economists and divers publicists, are pushing it.

Leading proposals take mainly two forms. One is to create a national sales tax, obliterating the present income tax. The second is to exempt all saving and investing from the present income tax. This is more sly, is easier to achieve politically, is already partly in place, and is the more likely to occur, so my examples will come from it.

There are several faults in the proposals. A chief one is to distract us from the major cause of overconsumption, viz. turning land value gains into cash. Some call it “living high on the old homestead,” which is imprecise but gives you the idea. “Equity withdrawal” is a more generic term. The land under and around homes is indeed a major element of land gains, but mineral, commercial, recreational, industrial, transportation, radio-wave, sylvan, and all kinds of lands and waters and other natural resources are involved, including those held by corporations, governments, and eleemosynaries.

An owner may “withdraw equity” by selling land for a gain; or borrowing (tax-free) on the swollen value; or neglecting maintenance and replacement of buildings, counting on the land gains to maintain his or her assets while milking the old capital as a “cash cow.” In all cases, the NIPA (National Income and Product Account) does not count the land gains as income. NIPA does not count them as anything, they are outside its purportedly “aggregate” social accounts, just as they are outside the consciousness of most modern economists (except when they invest privately). However, the gainers spend them on consumption - with no output corresponding to it. This shows up in NIPA as dissaving.

Some economists dig a little into causes of dissaving. They mostly omit equity withdrawal from land value gains as a major cause, distracting us instead with other explanations. Some favored ones are social security (with no mention that our FICA taxes ARE a form of saving, squandered not by us but by Congress for the benefit of richer taxpayers); improved insurance (pooling risks, a net social gain); easy credit for housing (but with no mention of equity withdrawal); student-loans (with no mention that they are invested in human capital); and consumer credit (not mentioning it is dwarfed by mortgage credit). One may sense some class bias in the choice of examples.

The same economists are puzzled why the following causes have not increased saving the way they are “supposed to”: the fall of income tax rates in top brackets; the rise of the percentage of our population in the high-saving ages, 45-65, after 1995; and the rise of average incomes.

Economist Robert Barro got promoted from Rochester to Harvard and became a Business Week guru for theorizing that Federal deficits would stimulate private individuals to save more. Milton Friedman cheered. This notion is, to put it charitably, not proving out. As for "business saving" (as of undistributed corporate profits) it gets lost in the shuffle.

Stiglitz & Walsh, whose current Macroeconomics text is a cut above most, do mention the "wealth effect" of high stock values, making people "feel richer" and thus spend more on consuming. The authors would seem to be getting warm, but then they dismiss the rise of home prices: it has just "meant that more individuals were saving in the form of home equity" (p.225). Thus, their only direct reference to the rise of land values, while vague, has it backwards. Scanning other current texts on macro, the quality is downhill from there.

A bright spot is the ongoing work of Oxford's John Muellbauer, who may even be having a hearing in HM Treasury in Whitehall. It is hard to assess the impact, even from close up, and that much harder from this distance. We do know, however, that Britain has gone over to a VAT, and has not fully repaired Maggie Thatcher's vandalism of its local rating system, so Britain has a long climb ahead simply to get out of the pit it has dug itself into.

The result in the U.S., at least, is counterproductive policy advice from economists: raise sales taxes, and lower any tax, of whatever kind, that hits real property. This class includes property taxes, of course, but also estate taxes, inheritance taxes, taxes on the income from property (both land and capital), capital gains taxes, and severance taxes. The resulting higher land values lead to more equity withdrawal and less saving - the opposite of the alleged "good reason" for taxing only consumption.

This neglect of equity withdrawal from real estate is not a simple oversight. It is the result of years of perverting economists' training and vocabularies and techniques - their "groupthink," if you will - to cloud their understanding of it and intimidate them from mentioning the obvious. Poterba and Krugman, highly visible writers, also brought it up in the early 1990s, but without following through, and their "words like silent raindrops fell, and echoed in a well of silence". Mentioning equity withdrawal in any but a favorable light may have become a modern solecism, for it would discredit the measures actually proposed.

These measures include removing land rent, values, and gains from the base of the income tax. This is to be done by letting land buyers write off the expenditure in the year they buy. If the buyer is in, say, a 20% tax bracket, the Treasury thus puts up 20% of the purchase price. After that it gets back at most 20% of the net cash land rent, which is just a return of its own investment. If it's residential or recreational land, with no cash flow, the Treasury gets back nothing. In addition, mentioning how equity withdrawal pays for consumption would discredit the fellow-traveling proposal to exempt all "capital gains" (read land gains) from the income tax. It would weaken ongoing proposals to obliterate property taxes and severance taxes and taxes on estates and inheritances.

A second major fault in the proposals to tax only consumption is confused ambivalence toward saving. There is a strong residue of Keynesian demand-side economics among economists, journalists and pols, so that spending of all kinds is more often praised than censured, even as the gurus scold us, "the public," for our prodigality and indiscipline with money. Most economics texts are uselessly indecisive on this point.

On one page they tell us that saving is desirable to create capital to abet growth, and on another that consumer spending is the key to growth and jobs, and saving is a menace. Pols and the Fed chief, Alan Greenspan, may thus pick whichever position suits their p.r. needs of the moment. As to the causes of saving, most toss it off as an automatically increasing function of income, and perhaps of interest yields.

A third major fault is misidentifying “consumption.” Economists are careless with definitions, as Henry George brought out in his day, and the modern profession has not reformed. For example, many champions of taxing consumption cite the authority of J.S. Mill, who did indeed write that the income tax should exempt saving. None of them has noted, though, that Mill defined house purchase as a consumer expenditure, not saving, and scathed grandiose mansions on display in conspicuous locations as wasteful. Modern NIPA, in contrast, calls all housing a capital outlay.

We know that Mill, like Smith and the Physiocrats, viewed land rent as being peculiarly eligible for special taxation, so we may reasonably infer that if he had been present at the creation of NIPA he would have suggested several improvements. NIPA for example ignores wasting slots of land-time by underuse, which should be included as part of consumption. Investing in human capital is called consumption, as though weddings, pregnancies, birthings, commuting, nurture, housekeeping, chauffeuring kids, and grades K-12 are all frivolity on a par with jockeying ATV’s over fragile lands, or bar-hopping. On the second matter, the childless Mill actually had no sympathy with the costs of parenting, a point on which his Malthusianism trumped his humanitarianism, but we needn’t follow him on everything—just make sure we define our terms, and make others do the same.

NIPA does NOT call depleting hydrocarbons consumption, or even a business cost. This custom originated during W.W. II when the idea was desperately to maximize gross output, and damn the social costs. The custom is outrageously obsolete now, but the power of inertia is so strong that macro-economists do not even resist efforts to redefine terms: they simply ignore them. These are such big topics in their own rights, and so damning of NIPA and modern macroeconomics, that we defer fuller treatment for a sequel.