Capital Markets: The Importance of Lower Taxes

By Steve Slivinski and Solveig Singleton

Perhaps the single most important thing that policymakers should do to facilitate advances in innovation is to lower tax rates both for corporations and individuals. The more money that remains in the hands of the private sector, the more will be available to investors to support innovation.

Taxes and Growth

There is a strong correlation between a strong economy and low taxes. Studies by the Cato Institute and numerous others prove that the economy grows fastest when taxes are low. In an economy that is increasingly dependent on the flow and size of the capital stock, a tax system that is hostile to economic growth must be changed.

From 1776 until 1996, GDP per capita grew at the historically unprecedented rate of 458 percent. It effectively doubled every 40 years. But since 1978, the per capita growth rate in the United States has slowed considerably. That is, per capita GDP is still growing, *but more slowly than ever before in U.S. history*.

These facts show that expansive government programs to support innovation cannot maintain a healthy rate of growth. The ever-growing tax burden does far more harm than government intervention does good. To restore growth, including a healthy pace of innovation, we need to start with tax cuts so the private sector can fund innovation itself.

Why the Private Sector Must Lead

Allowing the private sector to bear the burden of investment is the fairest solution. Innovation is high-risk; many experiments with new techniques will fail. Taxpayer-funded innovation forces every taxpayer to bear these risks and fund potential failures. But private-sector investors choose their own level of risk. Because their own money is on the line, they have strong incentives to try to choose wisely.

Also, as the economy diversifies and becomes more global, the sums of money required to support new technologies will be incomprehensibly huge. By comparison, any government expenditures would be a drop in the bucket. Take investment in broadband communications networks as an example. McKinsey & Co. estimate that linking every classroom to the Internet by 2005 will cost $47 billion just for one-time installation costs, and operating those networks will cost an ongoing $14 billion per year. Russ Daggat, Vice Chairman of Teledesic, describes Teledesic's $10 billion investment in new broadband communications networks as "quite modest," a "drop in the ocean of global bandwidth." Estimates of the amount that will be invested around the world begin at $2 trillion and go much higher.

Governments simply do not have this kind of money. The private sector does. In education, training, research, and build-out, private sector monies must be freed to go to work. Policies that leverage the power of dollars in the private sector are far more likely to produce significant effects than scarce public monies.

Globalization of capital markets will also force governments to reduce taxes, create a more hospitable environment for investors, and lure more capital to their country. It is imperative that the U.S. reform it's tax code to allow a freer flow of private capital.

Allowing dollars to remain in the private sector also harnesses the power of *local knowledge* to further innovation. The importance of local knowledge in the economy is a concept developed by Nobel Laureate F. A. Hayek. Essentially, the problem that human beings solve through economic action is who needs what goods, when, and where, and how much do they need those goods as compared to others. The solution is not to be found in general economic or social theory. The answers to the questions posed above exist in the minds of myriad individuals, each with his or her own constantly changing and subjective portfolio of wants and needs. Centrally directed industrial policies have no access to this information; such policies must impose goals from above. When individuals in the private sector are left free to invest their own money, they can use their local knowledge to shape their own goals. And they are free to experiment in an endless bottom-up learning process about the best means to their own chosen ends. The most successful experiments are imitated, and the market moves forward from there.

Taxes on Individuals

Because of the increasing importance of the individual investor, lowering the income tax on individuals is just as important as lowering taxes for corporations. This chart compares the scope and scale of income tax collections in 1914 with those in 1994.

	1914	**1994**
Income Tax paid (billions)	$6.7	$683.4
IRS employees	$4,000	$110,000
Pages of federal tax law	$14	$9,400
Top Income tax rate	7%	40%
Income tax on median family	0%	28%

Tax-Cutting Proposals

The best pro-innovation policy is to cut taxes. The following reforms would allow far more investment money to remain in the hands of the private sector:

- Repeal the capital gains tax or, at the very least, cut the rate and index gains for inflation.

  The international economy has become substantially capital-intensive, and the American stock market is in the driver's seat. Thus, it is extremely important to pay attention to how the tax code affects decisions in this marketplace. By most accounts, the capital gains tax has a substantial effect on the decision of those within the capital markets.

  A recent study by DRI/McGraw Hill estimated that around 25% of the growth in the value of the stock market in the two years was due to the lowering of the capital gains tax rate in 1997.

  The U.S. is now composed of a new investor class. Participation in 401(k) plans has doubled over the past ten years. The capital gains taxes should not be construed as a tax on the rich. Instead, it should be seen as a tax on the new investor class and the burgeoning momentum that promises to increase the material wealth of everyone. The Capital gains taxes should be cut immediately.

- Abolish the federal estate tax.

  Few taxes are more hostile to saving than the "death tax." It is important that families be allowed and encouraged to save or invest money for their long-term stability. Most assets that are hit by this tax are already taxed at least twice, once as income and again as a capital gain. Therefore, getting rid of the death tax would provide incentives for people to take a long-term view of their lifetime investment decisions. This kind of incentive would provide the capital markets with another source of wealth.

- Replace the income tax with a national sales tax, and close down the IRS.

  The current income tax system--indeed, any tax system that taxes income--punishes savers and investors. A consumption-based tax, or a national retail sales tax as it is commonly known, would no longer maintain the federal tax system's bias against saving and investing.

Institutional reforms that keep taxes low are also important. These would include

- Requiring a super-majority vote to raise taxes;
- End the withholding tax;
- Outlaw retroactive taxes.

How to pay for these tax cuts? Simply eliminate programs of direct grants to businesses, better known as corporate welfare. Grants aimed at specific companies and industries should be abolished. The government is not good at picking winners and losers in the innovation arena. Who would have guessed, for example, that clear polyester thread--invented by the textile industry--would turn into an important new type of communications fiber as the accidental result of the meeting of textile and communications engineers in a hotel bar?

The Link to Social Security

Finally, great gains to innovation would come from privatizing social security. Why is this? Martin Feldstein, a professor of economics at Harvard University and president of the National Bureau of Economic Research, notes that Social Security reform and the need to spur economic growth are closely linked. The current Social Security system reduces national savings and investment. Transforming the current system into a system of private savings accounts, invested in stocks and bonds, would result in an influx of *$10 trillion or $20 trillion* into capital markets.