

Taxes & jobs ^(MS) 8-18, Chi.

Wicks NTA program, ideas.

1. Cpl. not enough, but "the way employed" — A. Smith
Give Smith's e.g.
2. Cobb-Dougl. fu. omits this. Implicit assum. —
the sneakiest kind. Probably unconscious too.
But "error worse than crime — error begets crime." G.K.
Cheriton. anticipate b, & whole theme. What determines (over)
3. Cobb-Dougl. also omits vert. intrn. i.e. is pre-Keynesian.
We must ask, who produces K. Integrate Vert.
4. Donaldson Brown, profit is margin $\times$ turnover.
But note corollary: if T hi, margin low, so
labor's share is hi; & small K employs more
workers.
5. Wicksell noted same, e.g. of Wine ec. p. 139 TMJaw
Replmt. demand; reinv. source. Cash flow from recovery. Inver from assets.
6. Now all we need is incentive to equilibrate
Show that low wage speeds turnover; low i slows it.
Elaborate, in these ways. Need incentive to employ, not just (over)
7. Role of taxes. Payroll tax same effect as hi wage.
Drives wedge. Cite Laffer; Wilson. Kennedy.
Prop. tax, same as high i .
ITC, same as low i .

how K is employed? Relative price, plus instl. bias
Price after tax.

incentive to invest. They are not ~~same~~.

Great fallacy is that incentives ^{to invest} ~~for~~ K are what employs labor. Incentives ^{to employ} ~~for~~ labor are what is needed. Each one results in investing, but different kinds of investing.

8. Cap. gain exemption, much worse than ITC
Helps slower K more
" land most of all.
9. Inflation, phantom profits, may hit K inc. harder
But doesn't hit land at all
Hits fast K harder, bcs. tax on phantom not deferred
Kempner, Gaffney.
10. Techn. determinism, shared by Marxists &
conservative tax reformers, rules out price-elast. of substitu.
11. Draw on energy outline for e.g.:
In use of energy
In produ. of .., vertically integrated.
Parallel response, among certain groups, who
assume enrgy. has to be resource-int. & K-int.

13/11/11

"The no. of useful & productive laborers is everywhere in prop. to the quant. of K stocks which is employed in setting them to work, and to the particular way in which it is so employed." - A. Smith,

W. of N.

Ture says double taxn. of K.

But parents are taxed on the income they use to raise children: then children pay taxes.

Ture is really saying, in roundabout way, tax only wages:
Turn inc. tax into a wage tax.

But this destroys arguments which rationalized inc. tax to begin:

1. Progressivity. Exempt the top
2. Uniformity. Causes suborn. K for labor, land for labor
3. Incentives. Maxs. disincentive to work.
Maxs. incentive to lobby for unearned I.

M. Rubin

- 0 -

TF41 H. Han

4:30 Pick

"Taxes & Jobs"

Dictate, type up, submit to Jubs. - e.g. J Evolutionary Ecs.

We hear a lot these days about need for more K, to make jobs.

Is ^{suspect of being} ~~most by~~ special pleading, bcs. punch line is ~~always~~ preferential tax treatment for prop'ty. inc.

Yet, discounting for that, is still a case to be argued on objective grounds, take seriously.

It had better be a very good case, bcs. it goes far toward destroying the case on which Am. public originally bought the inc. tax concept.

- Makes it regressive. Cuts off the top - esp'y. when we focus on exempting K gains.

- Exempts unearned Δ to L.V. Esp'y. again, when focus on pref. treatment for cap. gains. Leaves inc. tax as a payroll tax mainly.

- Uniformity, neutrality. This encourages substituting K & land for labor

- Incentives.

Mins.

~~less~~ incentive to work

Maxs.

.. .. lobby for unearned Δ .

This paper ~~also~~ outlines ~~that~~ another thing...

I don't think it is a good case.

1. K is not enough, but "the way employed" - A. Smith

"The no. of ... laborers is ... in prop. to the quant. of K stock which is employed in setting them to work, and to the particular way in which it is so employed."

"The quant. of labor which equal K's are capable of putting in motion, varies extremely according to their employment."

E.g.

"A K employed in the home trade will sometimes make 12 operations, or be sent out & returned 12 times, before a K empl. in the for. Trade ... has made one."

J.S. Mill had same idea. "K... in unsold goods does not set in motion any indy. (Thus) K may be so employed as not to support laborers, being fixed in machinery, bldgs. ~~locked up~~ locked up in a form useless for the support of labor."

.... suppose half (^{one's} ~~year's~~ K) effects a permanent improvement... He will employ next... year only half the no. of laborers."

(& add, deliver only half the final goods to consumers.)

A K shortage thus has 2 causes & $\therefore$ 2 solutions. The one we hear most about, ^{"Theory A"} ~~is a shortage~~ ~~in Quantity~~ is a shortage in Quantity. Solution: get more. Method: exempt income of K from tax. -- shift to wages & salaries.

~~(& why)~~

This method is wasteful; & too self-serving; & may not work. — It exempts land inc., esp. cap. gains approach (ITC better.)

— It exempts K overseas, which shd. be called home, to be consistent w. job creat'g effort

— It perpetuates & adds to structural distortions that misallocate K, & ties it up in labor substitutes.

~~tax shelters~~ E.g. muni. bonds; tax shelters; undistrib. profits not subject to test of market; timber regenerating naturally.

— It shifts taxes to wages & salaries, causing subtn. vs. them.

Theory B

Second cause, ^{Theory B} neglected, is misuse, misalloc. of K. Call it Δ demand v. same effect as reduced supply.

Call it fat K, ^{for K} locked up in uses not comply. to labor, encouraged by tax shelters.

Solution: tax K uniformly, in non-distorting ways at a rate no lower than wages are taxed.

(Both cd. be lower than land, but land tax neutral.)

The ~~non-distort~~ least distorting way to tax K is prop. tax, bcs. is just like raising i.r. No "locked-in effect", or any of its cousins.

Is easy to show mathly. re a tax on realized K gains, effective rate of tax declines as asset is held longer.

Going back to A. Smith, the Q of labor which the favored slow K ~~sets~~ sets in motion is much less than the same K turning fast -- but taxed higher.

Solution: make inc. tax as uniform as possible. No time for tech. details, but do not imply pref. treatment of cap. gains, but the revenue. Nor does it imply, ^{always} rev. sharing.

2. Advocates of Theory A believe K is, ^{always} comply to labor. Use 2 approaches: horiz. intd.; & vert. int. Horiz. intd. is repd math. by Cobb-Douglas fn.

~~STANDARD~~
$$P = C L^{\alpha} K^{\beta}$$

$$MP \text{ of } L = \frac{\partial P}{\partial L} = C K^{\beta} \frac{d L^{\alpha}}{d L} = C K^{\beta} \alpha L^{(\alpha-1)}$$

More K increases not just $\frac{P}{L}$, but $\frac{\partial P}{\partial L}$.

Implicit assumptions are sneaky. Those who make them are often as unaware as anyone. Calling it a Cobb-D. fu. makes it easier to detect mathematically; but ~~not~~ the use of math. in general discussions following, (I suspect the same as tho they were getting a computer print-out) makes it harder to detect in fact. Bes. people really aren't that fast in math - I don't like to show it.

Once you assume comply. then you rest yr. case on the Law of Dim. Retn. Or, take eng's "Requirements" approach \$Xk per job. Or, Harrod-Domar approach, fixed ratio $K:1$.

But this doesn't satisfy many but the converted. Bes. ~~there~~ much K obviously subs. for labor

- sheep, cattle, timber. There is a 3d factor, land. These have high valence for land, low for labor.

- farm machinery
- pesticides, herbicides, sprayed broadcast by air.
- indl. machines. Automation, cybernation
- power generation & distribn.
- mineral extraction & refining.
- polluting
- K-int. plants that localities compete to attract

(But what is good for local treas. is bad for nat. empl., a real conflict.)

To meet these obvious objections

Theory A, 2d approach, vntly. intd.

Labor produces K .

Keynesian
Variation:

Cap. needs ~~inv. out~~ are inv. outlets; which are needed to keep money circulating.

Ironically, this is based on Marx -- i.e., the ec. universe is always tending to run down, like an old clock, has to be wound up, by fabricating inv. outlets to soak up over-saving.

This is Keynes' macro.

Many Troubles w. this ^{now at crisis level.} Is based on declining ^{V or} T of money, & deflationary pressure, (& trauma of 1933 banking collapse, - ΔM , a long time ago.) Today, reverse: $\Delta V, \Delta M$.

Is based on idea Supply fails to create own Demand. Today problem is, Demand not resulting from contributions to Supply, thus pushing prices up.

reasoning leads to
Keynesian ~~is based on~~ waste or lock up, as solutions. Store up ^{K for the future} is no better than waste, is just done to satisfy irrational Puritan Ethic, (the Presbyterian Fallacy). Promise of "pie in the Sky in the Sweet Bye & Bye" is needed to convince Presbyterians to spend money. (K . was evidently bitten by a Presbyterian at an impressionable age.)

i.e. Thy. A, vert. intd. approach, is based on "Keynesian Ethic" that ~~E~~ sources of K are excessive, and the solution is to Waste K.

✓ This Keynesian Ethic hardly fits a theory of K shortage. ~~It~~ Is an Enormous Contradiction.

~~(Also, tax breaks for land don't encourage formation, just misallocation.)~~

So, Thy. A advocates limp along w. deficient theory. ~~(over)~~

3. Advocates of Thy. B believe ~~K~~ K is ~~either~~ comply. or subst. w. labor, depending on relative prices. Prices before tax

1st approach, horiz. int. Combo. of ITC + Payroll Tax (coupled w. hi min. wage & hi unempl. comp.) makes entres. sub. K for labor. Cap. gains, & other land loopholes, make sub. land for labor.

- Machines to replace people
- Equipment on standby
- Fewer men/acre on farms
- Build in more durability at front end; reduce mtrce, repair later.
- More virgin materials; less recycling.

They either stick w. horiz. version
or

Imply that untaxing K will ΔS , even tho proof of
this is lacking, & many think they have disproved it.

or
Ignore theory altogether, & assume that investing by
itself can create K .

None of these really hold water.

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Critics of Thy. B wd. now say Alas! all this locked-up K reps
inv. opps.

Thy. B,

1st approach, vert. int.

Here, K content of v.a. depends on how long
cap. tied up before recovery.

E.g. a house, fixed. 30 yrs, pay twice as
much in int. as principal. Is K-intensive.

Prodn. is accordingly very sensitive to cost of K.
Insensitive to w.r. So, if i low, w.r. hi,
pushes investors into housing &c. long-lived K.

This approach allows for fact that labor produces
K; & inv. creates jobs. But the K in housing creates
jobs once every 20 yrs or so, on ave. (assuming it is
half recovered & reinv. by then.) K ~~is~~ used to
grow canots, meantime, is recovered & reinvested at
least once a year. (& maybe more often, bcs. it won't
sit idle during off season.)

Canots are like A. Smith's K in the "home trade,"
making 12 operations while same K in fn. Trade
makes only one.

The reinvestment hires labor; the canots feed them.
(The house also shelters them, but value of service
flow is only i ; canots is $[1+i]$.)

It is common for Thy. A advocates to justify tax shelter

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for housing, or mun. bonds, or oil expln., by pointing to the jobs created. But all this K is pulled away from other uses, like carrots. The true comparison is over the whole life cycle of the slower K.

But are the carrots an efficient use of K?
The margin of profit is much less.

But "little and often makes much."
GM built on this. When Donaldson Brown came in from Du Pont to straighten up Durant's mess ca. 1920, introduced rational allocation of K. Rate of return is $\text{Margin} \times \text{Turnover} \div K$.

Considering ~~T as well as M~~ rather than just M, pushes yr. K into faster forms. There have smaller margins; but there are more of them. So use of K is just as effic.

What is the difference? K employs much more labor; and produces much larger output for consumers. I.e., has a much higher valence for labor.

I don't recommend all our inv. shd. go into working K (like carrots), none into fixed (like plant & equipment.) There is a self-equilibrating market mechanism that finds an opt. balance. If K is scarce, & labor surplus, higher i & lower $w.r.$ ~~just exists~~ draw K into working K, away from fixed K, until valence of K for labor rises, soaking up the surplus.

Problem is, this mkt. mech. is jammed by instl. bias.

Min. wage, unions, & welfare keep labor from becoming cheaper. So do payroll tax, inc. tax, pensions, fringes of all kinds based on payroll.

Instead Macro policy makes K & land cheaper, in the illusion that this makes jobs. Thy. A.

ITC (on sliding scale basis)

Cap gains ~~tax~~ preferences

Prop. tax relief, based by payrolls

Loan insurance, e.g. housing

Govt. investments, at low govt. rates. Hiways, pub. works

State & local bonds

Acc. deprec.

Multiple deprec.

Expensing

Energy underpricing (in lieu of taxn.)

Complements K

Subs. for labor

Is K-int. to produce.

Vicious circle. ~~These measures~~ To make jobs for labor, we adopt policies that make work for K & land, reduce demand for labor.

Summarize, relation of K , turnover & empl.
was well worked out by Knut Wicksell
A. Smith & J.S. Mill are quotable, but Wicksell
had the math. mind to get the whole art together.
(What he evidently lacked was the discrim. to
lean harder on this & sacrifice his other hobbies to it.)

~~Smith & Mill~~

Wicksell showed that the wages-fund —
today we wd. call it income-creating spending —
depends on how K is used. Specifically,
how fast it turns over.

It is only the part of K "set free" — i.e.
recovered — ea. yr. that can hire labor.

One firm (or govt. agency) can invest in
excess of deprecia — by tapping others. A whole
economy cannot, (except by new saving.) It is
a closed system.

So, to Δ the K set free ea. yr., must Δ
turnover. Delivers goods to hold down prices; &
gives business free capl. to reinvest.

Policies needed: lower labor taxes; raise land taxes;
seek uniformity & neutrality in tax. of K , at a rate
no lower than labor pays.

Infln. works a special tax on K (except leveraged debtors.) This partly evens things out betw. K & labor horizontally.

But vertically, not so. It is harder on faster K. Bes. the slower the K, the more deferred is the tax. of phantom profit.

So infln. is harder on working K than fixed K; $\therefore$ induces invts. ~~less~~ of least valence to labor

Notes

3. Richard Musgrave, The Theory of Public Finance,
(NY: Mc Graw-Hill Book Co., 1959)
p. 165, and works there cited.
Richard Musgrave, B. E. Bittker, C. O. Galvin, and
J. A. Pechman, A Comprehensive Tax Base?

(Branford, Conn: Federal Tax Press, Inc., 1968), and
works there cited.

5. [As is, and add] Nicolaus Tideman and ~~David~~ Donald
Tuckman, "The Tax Treatment of Business Profits
under Inflationary Conditions," in Henry Aaron
(ed.) Inflation and the Income Tax

(Washington: The Brookings Instn., 1976) pp. 38-41.

David Klempner makes the same point in
a new MS which I have seen but cannot
yet locate.

than the rate on wages (the rate on both wages and capital income could be lower than the rate on land income, for the last is neutral and taps economic rent).

Professor Henry Simons and others have long noted that an increase in one's wealth is income and that a neutral tax on capital gains would tax gains at the time they accrue. Simons and the others then despaired of taxing unrealized capital gains in practice. Note, however, that the property tax does take a bite of unrealized capital gains each year, and it is easy to show mathematically that a property tax in a perfect market is exactly a tax on unrealized capital gains. The property tax also takes a bite of that other kind of Haig-Simons income which the income tax misses, that is, imputed income of owner-occupied residential and recreational property.

A nondistorting way to tax capital income therefore under the income tax is to make it resemble as much as possible the property tax. Over at the other extreme it is easy to show mathematically the necessary corollary that a tax on realized capital gains has an effective rate which declines as the asset is held longer.

Going back to Adam Smith, the quantity of labor which the favored slow-turning capital sets in motion is much less than the same capital puts to work when it is turning fast.

The solution implied by Theory B therefore is to make the income tax as uniform as possible in its treatment of different kinds of capital. This is not the place for technical details of a comprehensive tax base with intertemporal neutrality. There is a substantial literature by William Vickrey, Joseph Pechman, Paul Samuelson, Richard Musgrave, Henry Simons, Robert Murray

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Haig, Emil Sunley and others³ to which I subscribe and to which I have added a few foot-notes.⁴ Suffice it here that this line of reasoning does not imply preferential treatment of capital gains but if anything the reverse. Neither does it support revenue sharing which simply replaces the more neutral property tax with the less neutral income tax.

Inflation has the effect of creating phantom taxable profits for capital. We could perhaps in the name of neutrality justify lower nominal rates on property income than labor income in order to compensate for the taxation of phantom inflationary profits on property income. Unfortunately in practice this argument is made most strenuously where it is least appropriate, that is on long term capital gains. The phantom profit realized on working capital is taxed continuously from year to year as the phantom profits are realized. The phantom profit on long terms gains on the other hand is not taxed until the capital asset is sold. Thus the profit on year one is not taxed as it accrues but the taxation is deferred, as with all capital gains. The effect of inflation therefore is to increase the tax system's intertemporal bias in favor of slower yielding capital.⁵

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⁴ Mason Gaffney, "Tax-induced Slow Turnover of Capital," WESTERN ECONOMIC JOURNAL, 5(4):308-23 September, 1967.)
-----, "Tax-induced Slow Turnover of Capital," (unabridged), AMERICAN JOURNAL OF ECONOMICS AND SOCIOLOGY, January, 1970 through January, 1971.

⁵ Mason Gaffney, "Toward Full Employment with Limited Land and Capital," in Arthur Lynn, Jr. (ed.) PROPERTY TAXATION, LAND USE AND PUBLIC POLICY (Madison: University of Wisconsin Press, 1976,) App. 4

If we do grant a lower nominal tax rate to capital income we should not do the same for land income because there is no phantom income in rents. Neither is the cause of full employment served by encouraging the substitution of land for capital or labor.

And if we adjust taxes to compensate for phantom profits, we should also do something for phantom salaries caused by withholding. Income taxes are based on a mythical gross salary before withholding of income taxes, FICA, FUTA, involuntary pension exactions, and perhaps other items. this puts a large added tax burden on payrolls compared to sheltered property income.⁶

THEORY A: CAPITAL SHORTAGE AS A SIMPLE QUANTITATIVE PROBLEM

Part of Theory A must be the implication that capital is always complementary to labor, whatever its use. Advocates generally do take this position. There are two approaches, one which looks at the economy as horizontally integrated, and the other which looks at it as vertically integrated. The first

⁶ In the present mood of tax reduction it is timely to consider this reform. Let us base income taxes on disposable income, D, rather than, as now, on gross income, G. If T=Tax, and t=tax rate, then under this method $T=t(G-T)$ from which follows

$$T = \frac{t}{1+t} G. \text{ Thus, for example, a tax rate of 100\% on D is just}$$

50% on G. This change would allay the existing bias against payrolls caused by withholding against them while at the same time deferring the taxation of wealth accruals until they are realized in cash. This would devalue many basic tax loopholes for property income. At the same time, it would increase after-tax work incentives by reducing the basic progressivity of the rate structure. One easy way to implement would be simply to let people deduct Federal tax payments from Federal tax base each year as they made out their returns. The effects of this one simple change would be quite profound and almost entirely for the better.

✓ wound up by fabricating investment outlets to soak up oversaving. Keynesian macroeconomics, in spite of its variation^s, elaborations, and intricacies, is ultimately based on this old clock concept.

There are many troubles with this paradigm, such that it is now reaching a crisis. It is based for one thing on the implicit assumption of declining velocity or turnover of money, and pervasive deflationary pressures. It is based for much of its impact on the trauma of the 1933 banking collapse which is getting to be ancient history. Now we have had several decades of increasing velocity and increasing money supplies.

The old paradigm is based on the idea that supply fails to create its own demand. Today demand is not creating its own supply, thus creating inflation of product prices. Incomes which are created today by paying people to produce capital which will not be ready for consumption for 30 years are clearly inflationary in the short run. In the long run they are inflationary because they reduce the number of real transactions which any given money supply must finance.

In Keynes, one solution to oversaving is simply waste. However, to satisfy the puritan prejudice we store up capital for the remote future as a more culturally acceptable alternative to waste. Any sort of spending would be equally good, but the promise of "pie in the sky in the sweet bye and bye" is offered as a sop to convince crusty Presbyterians to spend money. (Keynes was evidently bitten by a Presbyterian at an impressionable age.)

Whatever we may think of Keynesian economics today, Theory A in its vertically integrated approach is based on the Keynesian ethic that the sources of capital are excessive and the solution is to hide away capital in forms that

✓ will contribute as little as possible to the overproduction problem of the near future. The checkmate for the followers of Theory A today is that this Keynesian ethic flatly contradicts ~~fit~~ a theory of capital shortage. It poses an insoluble problem for those who would hold Theory A.

THEORY B: CAPITAL STRUCTURE AND JOBS

Theory B has it that capital may either complement labor or substitute for it, and which kind of capital investors create depends on relative prices. Thus the capital structure may adjust so that the existing supplies of capital and labor will match each other. In addition to relative prices, however, the capital structure is affected by institutional bias, including tax bias; and such bias may interfere with the market's homing in on full employment.

We may approach Theory B first of all from the horizontally integrated viewpoint. An investor who is contemplating substituting machinery for labor observes that the machinery gets him an investment tax credit while the employment of labor costs him a payroll tax. The high minimum wage and generous unemployment compensation keep wage rates from falling, and the combination makes entrepreneurs substitute capital for labor. Similarly the deductability of interest and property taxes, and the capital gains preferences, induce him to substitute land for labor.

Replacement of persons by machines is the most dramatic example of substitution, but probably not the most important. Some other kinds of substitution are the substitution of capital- and resource-intensive materials for labor-intensive materials. Processes as well as products are malleable. We can substitute capital by building in more durability at the front end to reduce

if interest rates are low this pushes investors in to housing and other investments of long life. High wage rates push them out of short investments like textiles or vegetable farming, but have small relative effect on housing.

Using this approach, we allow for the fact that labor produces capital, and investment creates jobs. But the capital in housing only creates jobs once every twenty years or so on the average (assuming it is half recovered and reinvested after twenty years). Let's compare this with a farmer's investment in growing carrots. The farmer recovers and reinvests his capital at least once a year (and maybe more often because he won't let it sit idle during the off season). Carrots are to be compared to Adam Smith's capital in the "home trade" making twelve operations while the same capital in foreign trade makes only one. Foreign trade here is comparable to housing. In a word a given sum of capital keeps more people busy over the years if it turns over faster. Each reinvestment creates a new payroll.

But at the same time each year's output of carrots feeds the brutes. The house to be sure also shelters them but the value of its service flow is only interest on the value plus a small recovery of principal. The value of the carrots is interest on the capital plus the whole principal.

✓ It is common for users of Theory A ~~advocates~~ to justify tax shelters for housing (or municipal bonds or oil exploration or other capital-intensive investing) by pointing to the jobs created. But all this capital is switched away from other investing, like growing carrots. The true comparison is not between something and nothing but between capital intensive and labor intensive investing. The comparison has to be made over the whole life cycle of the

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✓ slower capital, where in the fast capital, as Adam Smith said, may make 12 operations while the slow capital makes but one.⁹

But are the carrots an efficient use of capital? The margin of profit is much less. Here we hark back to another paragon of the Age of Reason, Benjamin Franklin, who told us that "little and often makes much." It is not just the margin of profit that makes capital efficient, it is margin times turnover. This has been one of the leading principles of rational business management at least since Alfred Sloan reorganized General Motors in the 1920's with some advice from Donaldson Brown who came in from Dupont to help straighten out the cash flow crisis created by the over-expansive Mr. ^{Will} Durant. Sloan and Brown took great pains to require each division to earn a minimum return on capital. The return was defined as margin times turnover divided by capital.¹⁰

Elementary as this may sound, (and oversimplified besides), it played a leading role in the rational management of that enormously successful mass of capital at General Motors. And it is not so elementary that we can assume it to

9 It follows that in any one year, in a balanced economy where retirements are matched by new investments, a given capital in (things like) carrots generates a regular flow of gross investment 12 times greater than an equal capital invested in (things like) trees of 12-year life, (including any other capital whose average recovery period is 12 years.) The reasoning by which this follows is analogous to that by which one "stacks" the echo effects of the Keynesian horizontal multiplier into the vertical or simultaneous multiplier. ~~into the vertical or simultaneous multiplier.~~ Such stacking gives another true comparison of the employment effects of switching investment from fast capital to slow.

10 Thomas J. McNichols, EXECUTIVE POLICY AND STRATEGIC PLANNING, (New York: McGraw-Hill Book Company, 1977) p. 44.

The great illusion of macroeconomic policy is that the way to make work for labor is to make work for capital by making capital cheap. This is Theory A. Some of its manifestations are the following: the investment tax credit, with sliding scale to avoid giving preference to fast turnaround investments; the 20% additional first-year depreciation for capital with life over 6 years; preferential treatment of long-term capital gains; property tax relief in the guise of revenue sharing financed by increasing state and federal "income" taxes which hit payrolls harder than property income; guaranteeing loans to pump cheap capital into housing and many other capital-intensive products; direct investment by government force-feeding capital into highways, public works and so on; non-taxation of state and local bonds, making cheap capital available to state and local governments; accelerated depreciation granted to ~~fixed~~^{durable} capital;¹¹ multiple depreciation of buildings; expensing of certain durable investments; and underpricing energy in lieu of taxation (the last point fits the bias because energy complements capital, substitutes for labor and is capital-intensive to produce).

Where the objective is really to make jobs, Theory A policies are self-defeating. An unrecognized self-defeating policy is most dangerous, because its failure is taken as a sign that more is needed.

SUMMARY

The relationships of capital, turnover and employment were particularly well worked out by Knut Wicksell, the "Swedish Austrian". Adam Smith and John

¹¹ The combination of I.T.C., accelerated depreciation, and the 20% additional first year depreciation let one write off slow-turning Capital nearly as fast as quick capital, and sometimes faster.

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Stuart Mill are quotable but often self-contradictory, while Wicksell had the mathematical mind and tools to get the whole act together. (What he evidently lacked was the discrimination to lean harder on this discovery than less important interests, a problem that may be endemic to mathematicians.)

Wicksell showed that the "wages fund"--today we would call it "income creating spending"--depends on how capital is used and specifically on how fast it turns over. It is only the part of capital as he said "set free"--i.e. recovered --each year that can hire labor.¹²

One firm can invest in excess of depreciation by tapping others. The whole economy cannot, except by new saving. It is a closed system. For a whole economy to increase the capital "set free" each year it must increase turnover. Turnover delivers goods to hold down prices at the same time that it gives business free capital to invest in payrolls. Full employment and price stability are the joint products of an optimal rate of turnover.

To this end the needed policies are lower taxes on labor, higher taxes on land, and intertemporal uniformity in the taxation of capital. The shortfall is not so much of the stock of capital, but of the flow of income-creating, job-creating investment and reinvestment of capital. To remedy this, simply make it cheaper to use labor, and dearer to hold torpid capital and inert land.

¹² Knut Wicksell, LECTURES ON POLITICAL ECONOMY, Trans. E. Classen (New York: The Macmillan Company, 1938), pp. 194-96.
----- VALUE, CAPITAL AND RENT, Trans. S. H. Frowein (London: G. Allen and Irwin, 1954), pp. 127, 160.

References and other footnotes; numbered consecutively.

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- 1 2 Adam Smith, WEALTH OF NATIONS, (~~Republished by~~ New York: Random House, republished, 1937) pp. 338, 341, 349.)
- 2 2 John Stuart Mill, PRINCIPLES OF POLITICAL ECONOMY (Boston: Lee S. Shephard, 1872), pp. 41-63, passim. See also J.S. Mill, ESSAYS ON SOME UNSETTLED ISSUES OF POLITICAL ECONOMY (London: Longmans, Green, Reader and Dyer, 1874), pp. 55-59.
- 3 5 See separate sheet
- 4 5 Mason Gaffney, "Tax-induced Slow Turnover of Capital," WESTERN ECONOMIC JOURNAL, 5(4):308-23 (September, 1967.)
-----, "Tax-induced Slow Turnover of Capital," (unabridged), AMERICAN JOURNAL OF ECONOMICS AND SOCIOLOGY, January, 1970 through January, 1971.
- 5 6 Mason Gaffney, "Toward Full Employment with Limited Land and Capital," in Arthur Lynn, Jr. (ed.) PROPERTY TAXATION, LAND USE AND PUBLIC POLICY (Madison: University of Wisconsin Press, 1976.) Appendix 4, pp. 161-62. This is a mathematical demonstration.

The same theme is developed by David Klemperer,

- 6 6A In the present mood of tax reduction it is timely to consider this reform. Let us base income taxes on disposable income, D, rather than, as now, on gross income, G. If T=Tax, and t=tax rate, then under this method $T=t(G-T)$ from which follows

$$T = \frac{t}{1+t} G . \text{ Thus, for example, a tax rate of 100\% on D is just}$$

50% on G. This change would allay the existing bias against payrolls caused by withholding against them while at the same time deferring the taxation of wealth accruals until they are realized in cash. This would devalue many basic tax loopholes for property income. At the same time, it would increase after-tax work incentives by reducing the basic progressivity of the rate structure. One easy way to implement would be simply to let people deduct Federal tax payments from Federal tax/each year as they made out their returns.

base

The effects of this one simple change would be quite profound and almost entirely for the better.

No. Page

- 7 6 See note on p. 6 itself.
- 8 7 See the use of Cobb-Douglas by Norman Ture, TAX POLICY, CAPITAL FORMATION, AND PRODUCTIVITY (New York: National Association of Manufacturers, 1973) p. 14. Presumably this assumption has become embedded deep in the current Ture Tax Impact Project (TIP) for N.A.M.
- 9 12 It follows that in any one year, in a balanced economy where retirements are matched by new investments, a given capital in (things like) carrots generates a regular flow of gross investment 12 times greater than an equal capital invested in (things like) trees of 12-year life, (including any other capital whose average recovery period is 12 years.) The reasoning by which this follows is analogous to that by which one "stacks" the echo effects of the Keynesian horizontal multiplier into the vertical or simultaneous multiplier. Such stacking gives another true comparison of the employment effects of switching investment from fast capital to slow.
- 10 12 Thomas J. McNichols, EXECUTIVE POLICY AND STRATEGIC PLANNING, (New York: McGraw-Hill Book Company, 1977) p.44.
- 11 14 See note on p. 14 itself
- 12 14 Knut Wicksell, LECTURES ON POLITICAL ECONOMY, Trans. E. Classen (New York: The Macmillan Company, 1938), pp. 194-96.
----- VALUE, CAPITAL AND RENT, Trans. S.H. Frowein (London: G. Allen and Irwin, 1954), pp. 127, 160.

"TAXES, CAPITAL AND JOBS"

by

Mason Gaffney

A paper delivered to ~~the~~ the National Tax Association, ^{Chicago,} August, 1978

We hear a lot these days about the need for more capital to make jobs. Some of what we hear and read ~~is obviously orchestrated as part of a continuing but~~ ^{~~simply as we may discount as self-serving~~} ~~growing~~ ^{lobbying} campaign for more preferential tax treatment of ~~property~~ ^{profits} income. Yet ~~discounting for that,~~ there is ~~still~~ a case ~~to be~~ argued by sincere and public-minded people on objective grounds which we must take seriously.

ivity It had better be a ~~very~~ ^{the one} good case, because it goes far to ^{ward} ~~destroying the~~ ^{program} ~~other case,~~ the one on which the American public has bought the income tax concept. Preferential income tax treatment of property income cuts off the top brackets of income receivers from tax liability, especially when we ~~focus on~~ exempting capital gains. Preferential treatment exempts or favors the unearned increment to land values, especially again when we ~~focus on favoring~~ capital gains. The thrust of proposals being seriously advanced today is to convert the income tax into simply another payroll tax, socializing a large share of personal effort while eliminating the public equity in the ~~basic~~ ^{land and capital} resources of the nation.

also Preferential tax treatment for property ^{also} destroys the neutrality or uniformity argument for income taxation. It encourages substituting capital and land for labor. It forces higher rates on personal effort, ^{weakening} thus ~~minimizing~~ the incentive to work while maximizing the incentive to lobby in legislatures and the Congress for public works and other federal outlays which create unearned increments to land values.

2

Are these hardships necessary in order to ~~attract, hold and maintain~~ *induce investors to make jobs?* capital? This paper outlines an alternative thesis that the use of capital rather than the simple quantity of capital is the key to full employment; and that tax preferences for property income bias ~~the use of capital in the wrong~~ *against* ways ~~to make jobs. investments with investors~~ *investors against using capital to make jobs.*

THE USE OF CAPITAL VERSUS THE QUANTITY OF CAPITAL

Adam Smith saw our idea very clearly, as follows: "the number of... laborers is...in proportion to the quantity of capital stock which is employed in setting them to work, and to the particular way in which it is so employed." *(emphasis mine)*

"The quantity of labor which equal capitals are capable of putting in motion, varies extremely according to their employment." ... "A capital employed in the home trade will sometimes make 12 operations, or be sent out and returned 12 times, before a capital employed in the foreign trade...has made one." ①

Adam Smith is here evidently referring to capital as stock in trade, for generating employment, fixed capital frozen in buildings or turnpikes was so sterile as hardly to be worth mentioning. John ~~Stewart~~ ^{Stewart} Mill makes this even more graphic by distinguishing between fixed and circulating capital. "Capital ...in unsold goods does not set in motion any industry. (Thus) Capital may be so employed as not to support laborers, being fixed in machinery, buildings,... locked up in the form useless for the support of labor.

...Suppose half (one's capital) ^e affects a permanent improvement. ...He will employ next...year only half the number of laborers." ②

That ^s he doesn't get his money back from the permanent improvement next year and therefore has nothing to spend on another payroll. A modern economist might object that the money could be printed by a friendly central bank, but

John ^uSt^uewart Mill might very correctly answer that this printed money would not deliver any final goods to consumers and therefore only drive up prices. ~~some-~~
~~thing~~ he had not learned to ^{ac}except ^{inflation} with the same facility as we have today, or to regard ^{it} as anything but a fraud.

Assuming if you will that Smith and Mill make sense, a capital shortage has two causes and therefore two solutions. The cause we hear most about--lets call it Theory A--is a simple short ^{fall} in quantity. The solution obviously is to get more. The proposed method is to exempt the income of capital from taxation, and ⁱncidentally shift taxes to wages and salaries and other rewards of personal effort.

This method wastefully gives away much more than is needed to accomplish its goals. It exempts land income as I have already remarked, especially when preferential treatment of capital gains is emphasized. (The investment tax credit and accelerated depreciation for new construction are free of this ~~but~~ criticism, ^{however.})

This method in practice exempts capital overseas which really should be called home if the purpose is to make jobs in our own country.

This method perpetuates and adds to structural distortions that misallocate capital and tie it up in the form of labor substitutes in highly capital-inten-sive industries and activities. Some examples of this are premature streets and water supply systems financed by tax-free municipal bonds. Tax-sheltered exploration for oil and gas is another example. It ties up capital for decades before recovery and it finally produces energy which is compl^eimentary to capital in down stream uses. Yet another example is timber allowed to regenerate naturally, i.e. without the effort of planting--which ties up land for 80 to 150 years under each crop with minimal application of labor.

Finally this method shifts the tax burden to ^{payrolls, (profit and receiving employment)} ~~personal effort~~, thus causing employers to substitute capital for labor and causing many workers to prefer welfare, crime or the pursuit of charity and unearned income to productive labor.

The second cause of a capital shortage--~~lets call it~~ theory B--is relatively neglected, ~~and its implications are not so soft on property owners,~~ ^{or hard on workers.} Theory B follows the lead of Adam Smith and John ~~Stewart~~ ^{Stewart} Mill and looks at the misuse and misallocation of the capital we already have. Misuse and misallocation have the same effect as increased demand and/or reduced supply. There is ~~a lot of fat in the capital structure,~~ where capital is locked up in less productive uses to which it is attracted by tax shelters. "Fat" also suggests that the capital is ~~porpet~~ ^{torpid} and combines less with labor, thereby ~~contributing little~~ ^{making few jobs,} ~~or nothing to job creation.~~

The solution under theory B is to tax capital uniformly in neutral and nondistorting ways. Not only should different investments be taxed ^d at the same effective rate, but the rate on property income in general should be no lower than the rate on wages (the rate on both wages and capital income could be lower than the rate on land income, for the last is neutral and taps economic rent).

Professor Henry Simons and other have long noted that an increase in one's wealth is income and that a neutral tax on capital gains would tax ~~them~~ ^{gains} at the time they accrue. Simons and the others then ^e ~~dispaired~~ of taxing unrealized capital gains in practice. ~~It is interesting and significant to note,~~ however, that the property tax does take ~~the~~ a bite of unrealized capital gains each year, and it is easily to show mathematically that a property tax in a perfect market is exactly a tax on unrealized capital gains. The property tax also

takes a bite of ~~that other kind of property income~~ that other kind of ^{Haig-} ~~Hank~~ Simons income which the income tax misses, that is, imputed income of owner-occupied residential and recreational property.

A nondistorting way to tax capital income therefore under the income tax is to make it resemble as much as possible the property tax. Over at the other extreme it is easy to show mathematically, ^{the necessary corollary} that a tax on realized capital gains has an effective rate which declines as the asset is held longer.

Going back to Adam Smith, the quantity of labor which the favored slow-turning capital sets in motion is much less than the same capital puts to work when it is turning fast.

The solution ^{im} ~~ap~~plied by Theory B therefore is to make the income tax as uniform as possible in its treatment of different kinds of capital. This is not the place for technical details of a comprehensive tax base with ^{ter} ~~an~~temporal neutrality. There is a substantial literature by William Vickery, Joseph ^{hm} ~~Peck~~ ³ ~~an~~, Paul Samuelson, Richard Musgrave, Henry Simons, Robert Murray ^{Emil Sunley} ~~Hage~~, and others ⁴ ~~to which I subscribe to which I subscribe~~ and to which I have added a few ^{foot-} notes. ⁴ Suffice it here that this line of reasoning does not imply preferential treatment of capital gains but if anything the reverse. Neither does it support revenue sharing which simply replaces the more neutral property tax with the less neutral income tax.

Inflation has the effect of creating phantom ^{taxable} profits for capital. We could perhaps in the name of neutrality justify lower nominal rates on property income ^a ~~than~~ labor income in order to compensate for the taxation of phantom inflationary profits on property income. Unfortunately in practice this argument is made most strenuously where it is least appropriate, that is on long term capital

profits, we should also do something for phantom salaries ~~wages~~ caused by withholding. Income taxes are based on a mythical gross ~~wage~~ ^{salary} before withholding of income taxes, FICA, FUTA, ~~compulsory~~ ^{involuntary} pension exactions, and perhaps other items. This ~~works~~ ^{puts} a large

added tax burden on payrolls compared to sheltered property income. ~~***~~ ⑥

⑥ In the present atmosphere of tax reduction, it is timely to consider this reform. ^{Let us base} ~~from~~ ~~base~~ income taxes on disposable income, D , ^(over) ~~where~~ $D = Y - T$. A tax rate, t , based on D is equivalent to ~~the present rate~~ $Yt / (1 - t)$. Thus, a 100% ~~tax~~ ^{is} on D is 50% on Y , for example. This change would remove the present bias caused by withholding ^{from wages while} ~~and~~ ^{deferring} ~~far toward~~ ~~devaluing~~ ~~most~~ ~~loopholes~~ ~~and~~ ~~the~~ ~~deferral~~ ~~of~~ ~~tax~~ ~~on~~ ~~unrealized~~ ~~property~~ ~~income~~. It would ~~simultaneously~~ ^{compensate by closing} ~~reduce~~ ^{in effect} ~~close~~ many loopholes and shelters for the super-rich. It's worth a look.

rather than on gross income, G . If $T = \text{tax}$, and $t = \text{tax rate}$, then under this proposal $T = t(G - T)$, from which follows $T = \frac{t}{1+t} G$.

gains. The phantom profit realized on working capital is taxed continuously from year to year as the phantom profits are realized. The phantom profit on long terms gains on the other hand is not taxed until the capital asset is sold, thus the profit on year one is not taxed as it accrues but the taxation is deferred, as with all capital gains. The effect of inflation therefore is to increase the tax systems ^{intertemporal} bias in favor of slower yielding capital. (5)

If we do grant a lower nominal tax rate to capital income we should not do the same for land income because there is no phantom income in rents. Neither is the cause of full employment served by encouraging the substitution of land for capital or labor.

and if we adjust taxes to compensate for phantom ~~income~~ (to 6A)

THEORY A: CAPITAL SHORTAGE AS A SIMPLE QUANTITATIVE PROBLEM

Part of Theory A must be the implication that capital is always complementary to labor, whatever its use. Advocates generally do take this position.

There are two approaches, ~~the~~ one which looks at the economy as horizontally integrated, and the other which looks at it as vertically integrated. The first or horizontal approach is represented mathematically by the Cobb-Douglas Function. In this ^{much-abused} function ~~as is well known~~, output equals a constant times the product of labor and capital, each raised to a power (usually less than one.)

Differentiating output with respect to labor we get the marginal product of labor, which ~~is now equal to~~ a constant times the quantity of capital ^{raised to a power,} and divided ~~by the quantity of labor,~~ ^{less than one.} (and divided by labor to a power less than one.) #7

In the Cobb-Douglas approach therefore, more capital necessarily increases not just the average but the marginal product of labor as well.

(7) #

$$P = C H^{\alpha} K^{\beta}$$

~~$$\alpha < 1, \beta < 1$$~~

~~$$(1)$$~~

$$\frac{\partial P}{\partial H} = C \alpha \frac{K^{\beta}}{H^{1-\alpha}}$$

$$(2)$$

where P = Product; C, α and β are constants; H = Human effort; and K = Capital

Implicit assumptions like this one are sneaky. Those who make them indeed are often as unaware as anyone of what they are doing. Calling it a mathematical function makes the implicit assumption easier to detect mathematically, but the use of mathematics in general discussions, where ^{half} ~~95%~~ of the listeners or readers are not really following, ^{of e} ~~anyway~~, makes it harder to detect in fact.

Once the implicit assumption ^{of e} ~~complementarity~~ is put across, then you may rest your case on the law of diminishing returns. ^(p) Alternatively you can take engineering "requirements" as your approach and say that one job requires X thousand dollars of capital. A third method is to buy the models of Professors Harrod and Domar, with fixed ratios of capital to output.

But this approach leaves unsatisfy^d many of the unconverted. Because common observation tells us that much capital substitutes for labor and dis-employ^es workers. Sheep, cattle and timber are obvious examples. There is a third factor of production--land. Sheep, cattle and timber have high "valence" (to borrow a chemical term) for land, ^{de} ~~But~~ a low valence for labor. They have long historical records as ^{the} ~~the~~ populators of the countryside, ^{are} ~~and~~ equally obvious example is farm machinery, and farm machinery is ~~obviously~~ one species of a large genus of machines that substitute for labor. In industrial plants we may add automation and ^{cy} ~~cy~~ ^{are} ~~is~~ ^{are} very capital-intensive; mineral extraction and refining, which may be even more so, and so on. Every local public finance officer knows that some plants are much more capital-intensive than others, ^{became} ~~and~~ unfortunately for national employment, localities ^{now} have stronger incentives to attract ^{than} ~~the~~ ^{more} ~~more~~ capital-intensive plants ^{than} ~~and exclude the~~ labor-intensive ones, ^{and it is} his job to know the difference.

To meet these obvious objections to theory A in its horizontally integrated form, the advocates turn to a second approach which is vertically integrated. Farm machines may displace farm workers, but it is labor that produces the farm machines. Turning this around we have the ^{Keynesian} ~~Kanening~~ variation which stresses not the labor producing capital, but the capitalist hiring workers by investing in capital. Here, capital-intensive projects are a boon because they are outlets for investment which are needed to dispose of surplus savings and thus keep money circulating. Ironically this approach is quite Marxian. In Marx the economic universe is always tending to run down like an old clock and has to be wound up by fabricating investment outlets to soak up over saving. ^{Keynesian} ~~Kanening~~ macroeconomics, in spite of ~~all~~ its ^{various} many elaborations, and ~~subtle~~ intricacies, is ^{ultimately} ~~essentially~~ based on this old clock concept.

There are many troubles with this paradigm, such that it is now reaching a crisis. It is based for one thing on the ^{implicit} ~~assumption~~ of declining velocity or turnover of money, and pervasive deflationary pressures. It is based for much of its impact on the trauma of the 1933 banking collapse which is getting to be ancient history. Now we have had several decades of increasing velocity and increasing money supplies.

The old paradigm ^{is} ~~is~~ based on the idea that supply fails to create its own demand. Today ~~the problem evidently is that~~ demand is not creating its own supply, thus creating ~~product~~ ^{of product prices.} inflation. Incomes which are created today by paying people to produce capital which will not be ready for consumption for 30 years are clearly inflationary in the short run. In the long run they ~~should be~~ ^{are} inflationary ~~too~~ because they reduce the number of real transactions which any given money supply must finance.

Keynes

In ~~Ka~~nes one solution to over saving is simply waste, however, to satisfy the irrational demands of the puritan ^{prejudice} ethic we store up capital for the remote future as a more culturally acceptable alternative to ~~pure~~ waste. Any sort of spending would be equally good, but the promise of "pie in the sky in the sweet by and by" is offered as a ^{ey} stop to convince crusty Presbyterians to spend money (~~Ka~~nes was evidently bitten by a Presbyterian at an impressionable age) ~~and often baited~~ ~~and baited them~~ never ceased to mock them and their supposed ideas).

Whatever we may think of ^{ey} Keynesian economics today, Theory A in its vertically integrated approach is ~~evidently~~ based on the ^{ey} Keynesian ethic that the sources of capital are excessive and the solution is to ~~hide~~ away capital in forms that will contribute as little as possible to the overproduction problem of the near future. The ^{checkmate} contradiction for the followers of Theory A today is that this ^{Keynesian} ~~Keynesian~~ ethic ^{flatly contradicts} does not fit a theory of capital shortage. It poses ~~an enormous contradiction and a large set of insoluble problems~~ for those who ^{hold Theory A.} would resolve ~~it~~. I do not see therefore how Theory A can be made to hold ~~water~~.

AND

THEORY B: CAPITAL STRUCTURE ~~IN~~ JOBS

Theory B has it that capital may either ^ecomplement labor or substitute for it, and which kind of capital investors create depends on relative prices, ^{ie} thus the capital structure may adjust so that the existing ^{ie} supplies of capital and labor will match each other. In addition to relative prices, however, the capital structure is affected by institutional bias, including tax bias, and such bias may interfere with the markets homing in on full employment.

We may approach Theory B first of all from the horizontally integrated viewpoint. An investor who is contemplating substituting machinery for labor

observes that the machinery gets him an investment tax credit while the employment of labor costs him a payroll tax. The high minimum wage and generous unemployment compensation keeps wage rates from falling, and the combination makes entrepreneurs substitute capital for labor. Similarly the deductibility of interest and property taxes, and the capital gains preferences, induce him to substitute land for labor.

Replacement of persons by machines is the most dramatic example of substitution, but probably not the most important. Some other kinds of substitution are the substitution of labor-intensive materials ~~for~~ ^{for labor-intensive materials.} ~~of~~ ^{for} capital and resource-intensive materials. Processes as well as products are infinitely malleable. We can substitute ~~in~~ capital by building in more durability at the front end to reduce maintenance and repair later. We can adapt to variability of demand by having excess capacity on standby in preference to utilizing more labor. We can shift the stage of production at which value is added, as for example letting timber add more value on the stump so that less ^{labor} is required in the mills. We can substitute land for labor by using fewer men per acre on farms and shifting to less laborious kinds of crops. The possibilities are limited only by the imagination and the observation of actual practice.

Critics of Theory B might now say, ah-ha! Capital "locked-up" in power plants and hydro-electric dams and premature highways and excess capacity represents investment opportunities, exactly what Dr. ~~K~~^{ey}nes ordered. Investment is what draws money out of ^a ~~h~~ords, keeps it circulating, and keeps the big clock from running down.

In answering this Theory B gets really interesting and I think terribly useful, giving important insight into where modern macroeconomics has gone

wrong. Austrian economics has long anticipated this objection, whether advertently or not, by looking at factor proportions in a vertically integrated scheme. When we look at the relations of capital and labor in sequence instead of ⁱⁿ parallel, the capital content of value-added depends on how long capital is tied up before its recovery.

For example if we finance a house over thirty years we pay twice as much in interest as in principal. The service flow over life is highly capital-intensive because 2/3 of the payments go as interest to pay for the use of capital.

Production of houses accordingly is very sensitive to the cost of capital, as we know. It is ^{much less} ~~quite~~ insensitive to wage rates, so observation has it that if interest rates are low and ~~wage rates are high~~ this pushes investors ^{to} in housing and other investments of long life. *High wage rates push them out of short investments like textiles or vegetable farming, but have small relative effect on housing.*

Using this approach, we have allowed for the fact that labor produces capital, and investment creates jobs. But the capital in housing only creates jobs ~~only~~ once every twenty years or so on the average (assuming it is half recovered and reinvested after twenty years). Let's compare this with a farmer's investment in growing carrots. The farmer recovers and reinvests his capital at least once a year (and maybe more often because he won't let ^{it} sit idle during the off season). Carrots are to be compared to Adam Smith's capital in the "home trade" making twelve operations while the same capital in foreign trade makes only one. Foreign trade here is comparable to housing. In a word, a given sum of capital keeps more people busy over the years if it turns over faster. Each reinvestment creates a new payroll. But at the same time each year's output of carrots feeds the brutes. The house to be sure also shelters them but the value of its service flow is only interest on the value plus a small recovery of

principle. ^{al.} The value of the carrots is interest on the capital plus the whole principle. ^{al.}

It is common for ^{users of} Theory A ~~advocates~~ to justify tax shelters for housing (or municipal bonds or oil explorations ^{investing} or other capital-intensive operations) by pointing to the jobs created. But all this capital is ^{switched} pulled away from other ^{investing} uses, like growing carrots. The true comparison is not between something and nothing but between capital-intensive and labor-intensive ^{investing} ~~uses of capital~~. The comparison has to be made over the whole life cycle of the slower capital, where ⁱⁿ the fast capital, as Adam Smith said ^{may} makes 12 operations while the slow capital makes but one. (9)

But are the carrots an efficient use of capital? The margin of profit is much less. Here we ~~may~~ hark back to another paragon ^{of} ~~from~~ the age of reason, Benjamin Franklin, who told us that "little and often makes much." It is not just the margin of profit that makes capital efficient, it is margin times turnover. This has been one of the leading principles of rational business management at least since Alfred Sloan reorganized General Motors in the 1920's with some advice from Donaldson Brown who came in from Dupont to help straighten out the cash flow crisis created by the over-expansive Mr. Durant. Sloan and Brown took great pains to ~~allocate capital equa~~ ^{marginally} among the divisions, requiring ^e ~~each~~ ^{division} ~~one~~ to earn a minimum return on capital. The return was defined ^e as margin times turnover, divided by capital. (10) Elementary as this may sound, ~~it~~ ^{(and over-} ~~simplified besides)~~, it played a leading role in the rational management of that enormous and enormously

successful mass of capital at General Motors, and it is not so elementary that we can assume ~~that~~ ^{to be} ~~is~~ incorporated in the management of the nation's capital as influenced by its tax system.

The tax system, based on the working principle "shoot anything that moves," militates against turnover, because each turnover creates one or more taxable events.

When a manager considers turnover in addition to profit margin this pushes his capital into faster turning forms. These have smaller profits but there are more of them. So the use of capital is just as efficient.

~~And~~ ^{then} what is the difference? A given capital ^{rolling over faster} employs ~~much~~ more labor and produces ^{more} ~~a much larger~~ output for consumers. It sets in motion, as Adam Smith would have said, more workers; and ~~it~~ sets them in motion productively so their employment does not simply generate inflation.

I would not recommend that all our investments ~~should~~ go into working capital like carrots and none into fixed capital like ^{roadbeds, harbors, telephone poles,} plant and equipment. There is an equilibrating market mechanism that finds an optimal balance. If capital is scarce and labor surplus, this should lead to higher interest rates and lower wage rates which draw investment into working capital, and away from fixed capital, until the "valence" of capital for labor shall have risen, soaking up the surplus labor.

The problem is that this equilibrating mechanism is jammed by institutional biases. Minimum wage laws, union pressures and welfare as an alternative keep labor from becoming cheaper. Conservatives may ^dapplause that statement, but are they consistent enough then also to note that payroll taxes, including most of the income tax and pension fund contributions based on payroll, have ~~exactly~~ the same effect?

~~At any rate~~ the greater ^{by making capital cheap} illusion of macroeconomic policy is that the way to make work for labor is to make work for capital ~~(and incidentally to give preferential treatment to land income as a by-product)~~. This is Theory A. ^{some} of its manifestations are the following: the investment tax credit, ~~complete~~ with sliding scale to avoid giving ~~any greater~~ preference to the ~~more labor intensive~~

the 20% additional first-year depreciation for capital with life over 6 years;

fast turn around investments; preferential treatment of capital gains; ~~complete~~ ^{long-term} with similar sliding scale; property tax relief in the guise of revenue sharing financed by increasing state and federal "income" taxes which ~~are mainly~~ ^{hit} payroll, ~~taxes~~ ^{harder} than property income; guaranteeing loans to pump cheap capital into housing and many other capital-intensive products; direct investment by government ^{force-feeding capital into} in highways, public works and so on; non-taxation of state and local bonds, making ~~very~~ cheap capital available to state and local governments; accelerated depreciation granted to fixed capital; ^{#11} multiple depreciation ^{of buildings;} expensing of certain durable investments; and underpricing energy ^(in lieu of taxation); (The last point fits the bias because energy complements capital, substitutes for labor and is capital-intensive to produce.)

Where the objective is really to ~~big~~ ^{make} jobs, Theory A policies are self-defeating, and unrecognized self-defeating policy is ~~the~~ most dangerous, ~~concept~~ ^{imaginable} because its failure is taken as a sign that more is needed.

SUMMARY

The relationships of capital, turnover and employment were particularly well worked out by ~~Knut~~ ^{Kanute} Wicksell the "Swedish/Austrian." Adam Smith and John Stewart Mill are quotable but often self-contradictory, while Wicksell had the mathematical mind and tools to get the whole act together, ^{(what he evidently} ~~lacks~~ ^{ed} was the discrimination to lean harder on this discovery and sacrifice ~~other hobbies to it,~~ ^{interests} a problem that may be ^{endemic} ~~with~~ ^{to} Mathematicians.) ^{than less important}

Wicksell showed that the "wages fund"--today we would call it "income -- creating spending"--depends on how capital is used and specifically on how fast it turns over. It is only the part of capital ^{as} he said "set free"--i.e. recovered --each year that can hire labor. ⁽¹²⁾

- (11) The combination of I.T.C., accelerated depreciation, and the 20% additional first year depreciation let one write off ~~slowly~~ ^{slowly turning} capital nearly as fast as quick ~~turning~~ capital, and sometimes faster.

One firm can invest in excess of depreciation by tapping others. The whole economy cannot, except by new saving. It is a closed system. For a whole economy to increase the capital "set free" each year it must increase turn over. Turn over delivers goods to hold down prices at the same time that it gives business free capital to invest in payrolls. Full employment and prices ~~stability~~ are the joint products of an optimal rate of turn over.

To this end the needed policies are lower taxes on labor, higher taxes on land, and ^{intertemporal} uniformity in the taxation of capital, ~~at a rate no lower than that~~ which labor pays. ~~The shortfall is not so much of capital, but of the investment and reinvestment of capital to in the flow of~~ ^{the stock of} income-creating, job-creating ~~investment of capital~~ investment ~~and reinvestment of capital~~. To remedy this, simply make it cheaper to use labor, and dearer to hold torpid capital and inert land.

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- 5 6 Mason Gaffney, "Toward Full Employment with Limited Land and Capital," in Arthur Lynn, Jr. (ed.) PROPERTY TAXATION, LAND USE AND PUBLIC POLICY (Madison: University of Wisconsin Press, 1976.) Appendix 4, pp. 161-62. This is a mathematical demonstration.

The same theme is developed by David Klemperer, *unpublished MS; and by Nicolaus Tideman and Donald Tucker, "The Tax Treatment (over)*

- 6 6A In the present mood of tax reduction it is timely to consider this reform. Let us base income taxes on disposable income, D, rather than, as now, on gross income, G. If T=Tax, and t=tax rate, then under this method $T=t(G-T)$ from which follows

$$T = \frac{t}{1+t} G . \text{ Thus, for example, a tax rate of 100\% on D is just}$$

50% on G. This change would allay the existing bias against payrolls caused by withholding against them while at the same time deferring the taxation of wealth accruals until they are realized in cash. This would devalue many basic tax loopholes for property income. At the same time, it would increase after-tax work incentives by reducing the basic progressivity of the rate structure. One easy way to implement would be simply to let people deduct Federal tax payments from Federal tax/each year as they made out their returns.

base

The effects of this one simple change would be quite profound and almost entirely for the better.

of Business Profits under Inflationary Conditions",
in Henry Aaron (ed.) Inflation and the Income Tax
(Washington: The Brookings Instn., 1976) pp. 38-41.

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- 7 6 See note on p. 6 itself.
- 8 7 See the use of Cobb-Douglas by Norman Ture, TAX POLICY, CAPITAL FORMATION, AND PRODUCTIVITY (New York: National Association of Manufacturers, 1973) p. 14. Presumably this assumption has become embedded deep in the current Ture Tax Impact Project (TIP) for N.A.M.
- 9 12 It follows that in any one year, in a balanced economy where retirements are matched by new investments, a given capital in (things like) carrots generates a regular flow of gross investment 12 times greater than an equal capital invested in (things like) trees of 12-year life, (including any other capital whose average recovery period is 12 years.) The reasoning by which this follows is analogous to that by which one "stacks" the echo effects of the Keynesian horizontal multiplier into the vertical or simultaneous multiplier. Such stacking gives another true comparison of the employment effects of switching investment from fast capital to slow.
- 10 12 Thomas J. McNichols, EXECUTIVE POLICY AND STRATEGIC PLANNING, (New York: McGraw-Hill Book Company, 1977) p.44.
- 11 14 See note on p. 14 itself
- 12 14 Knut Wicksell, LECTURES ON POLITICAL ECONOMY, Trans. E. Classen (New York: The Macmillan Company, 1938), pp. 194-96.
----- VALUE, CAPITAL AND RENT, Trans. S.H. Frowein (Longond/: G. Allen and Irwin, 1954), pp. 127, 160.

References

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2

1. Adam Smith

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2. J. S. Mill

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3. Wm. Vickrey

Jos. Pechman

Paul Samuelson

Richard Musgrave

Henry Simon

R. M. Haig

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4.

M. Saffery

Tistoe

TFELLC

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6 5. M.G. TFEELC, App. 4, pp. 161-62

David Klumpner, "

6A 6. Note on p. 6A

6 7. Note on p. 6

7 8. This is done by N. Tunc,

12 9. It follows that ^{in a balanced economy,} in any one year, a given capital in carrots ~~is re-invested~~ 12 generates a flow of gross investment 12 times greater than an equal capital invested in trees of 12-year maturity (or any other capital whose average recovery period is 12 years.) This is analogous to the "stacking" process by which one converts the Keynesian horizontal multiplier into the simultaneous vertical multiplier. This, too, gives a true comparison of the employment effects of switching investment from fast capital to slow.

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McNichol,

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Wicksell

Small Business Report

Employers to get socked with workers' comp. premium hike

Your costs to insure your employees could take another big hike next year, depending on what you **do today!** Write and urge your legislators to **oppose SB 375 (Greene) unless important amendments are made.**

SB 375 in its present form could cost you as much as 13 percent more for workers' compensation insurance. For example, if you now pay \$200 per year per employee, SB 375 would increase that premium to \$226 per employee. For a small firm with 10 employees, that is an increase of \$260 a year. Premiums may be higher as determined by the type of business.

SB 375 would increase the injured worker's maximum disability benefit from \$154 to \$280 per week (this is a disincentive for anyone to go back to work) and the death benefit from \$55,000 to \$200,000. It would create a new layer of bureaucracy. The bill fails to deal with excessively liberal awards which make California's law the most liberal in the nation.

Employers recognize that temporary disability and death benefits have not changed since 1977 and the permanent disability benefit was last changed in 1972. Although some increase is justified to keep pace with costs, the California Legislature, since 1975, has increased benefits four times and has refused to do anything about costly abuses in the program.

Business is working for at least four important amendments:

1) Tighten the workers' compensation law (Labor Code Section 3202) which now is an open door for super-liberal interpretation by courts and the Workers' Compensation Appeals Board. (Costly awards for injuries not in the course of employment, rewarding employees for their own negligence, benefits for injuries and conditions which existed before the employee was hired are commonplace.)

2) Hold the line on benefits or reduce what is proposed. Any increase should be phased in over a two-year period to alleviate any increases to you the employer.

3) Decrease the proposed death benefit (the bill now calls for a 264 percent increase!), and limit the amount of a cash settlement.

4) Change the provision that creates an administrative bureau to make certain it results in reduced litigation. (As written, we believe the provision will not cut legal costs, is unconstitutional, and limits your right of due process.)

We are in favor of protecting the injured employee, but there must be equal protection for the employer.



Max Seabaugh

The Target

Introducing at the Carnival — Higher Workers' Compensation Costs!

Before this bill is acceptable it must tighten the rules that allow the injured worker to qualify for workers' compensation benefits. The legislature must recognize its responsibility to

you. While the legislature has the right to increase benefits, it also has the duty to protect **you**, the employer who pays for the benefits.

Continued on back page

To know us is to trust us

A recent readership study of the **Small Business Report** revealed one bit of shocking news. *Some Chamber members did not know where this report came from or who was writing it.* In a word, some small business readers didn't trust what they read, therefore they were afraid to write their legislators.

Because we've all been burned by hucksters, it is easy to become trapped by skepticism. It is "easier" to do nothing, than take a chance that what we do is harmful or wrong. Unfortunately, given the current legislative climate in California,

doing nothing is the most harmful thing small business as a community can do to itself.

Bad legislators thrive on — and good legislators are frustrated by — constituent silence and apathy.

This report is the result of work done by 10 California Chamber of Commerce legislative advocates. They look at proposed laws to see how those bills will affect your business — both in the short and long run. When we see one that will hurt your business (like

SB 375 without amendments) we try to stop it before it becomes law. If it will help you, we lobby to get it passed.

The **Small Business Report** is distributed by 196 chambers of commerce in California, so you probably got the one you're reading from your local chamber.

It's our job to find out what's happening to you legislatively and to tell you about it. *It's up to you to help yourself by writing to your legislator.*

We've won three victories for

small business in as many months.

With your support, our deeds will speak louder than our words. Know us and judge us by our deeds; we know trust will come in time.

Dick Rush
Director, Small Business

Small Business Report is a monthly supplement to the California Chamber of Commerce **Alert**. June 20, 1980.

Workers' comp

Continued from front page

★Action needed

What **you can and must** do to protect yourself: **Write** to one or more members of the Assembly Finance, Insurance and Commerce Committee. Urge them to oppose SB 375 unless these vital amendments are made. They are: Alister McAlister (chairman), Bruce Young (vice chairman and chairman of the Workers' Compensation Subcommittee), Art Agnos, Tom Bane, Paul Bannai, Douglas Bosco, Victor Calvo, Jim Ellis, Richard Hayden, Ross Johnson, William Lancaster, Bruce Nestande, Louis Papan, Richard Robinson, Mike Roos and Frank Vicencia

Also write to members of the Senate Industrial Relations Committee. They are: Bill Greene (chairman), John Schmitz (vice chairman), Ray Johnson, Joseph Montoya, Alan Robbins, Newton Russell, and Alan Sieroty. The address for both committees is: State Capitol, Sacramento, CA 95814.

Senators Roberti and Presley meet with Small Business Task Force; call for unity and support



Crime-fighting Senator Robert Presley, left, is welcomed by Clay McGowan, chairman of the California Chamber Small Business Task Force at the May 29 meeting. Presley called for small business support to pass three bills dealing with shoplifting, public safety bail, and sale of drug paraphernalia through the Assembly Criminal Justice Committee.



Senator Roberti advised, "If you wish to have a positive impact on your future as small entrepreneurs, you must stay active in the legislative process." Represented were: White House Conference Delegates, task force members, and Senate Select Committee on Small Business Advisory Board members. Roberti, chairman of the Senate Select Committee, has been named small business lawyer advocate of the year by the U.S. Small Business Administration.