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# Unearned, and Taxed Unequally

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Whatever happened to "unearned income"?

That used to be the normal term for income from investments — dividends, interest and capital gains.

For some, that term produced images of "coupon clippers," another term you don't hear much anymore. The coupons in question were not the kind that get you 25 cents off on Jell-O at the grocery store. They were the ones that came attached to bonds in a precomputer age. To get your interest payment every six months, you literally had to clip off the coupon and take it to your bank.

More than half a century ago, when President Dwight D. Eisenhower proposed taxing dividends at lower rates than wages, Representative John W. McCormack, a Massachusetts Democrat who later was to become speaker of the House, was outraged.

"The Republican tax bill is indefensible in that portion which gives great benefits to corporations and constitutes a bonanza to stockholders, the larger ones in particular," he said in 1954. "It is unjust and in my opinion morally wrong to make a person with earned income pay considerably more in taxes than persons with unearned income from dividends."

That tax fight ended with a benefit for small shareholders, who would escape tax on the first $50 a year

of dividends. But annual dividends above that amount remained fully taxable at ordinary income tax rates, which ranged up to 91 percent. Mr. Eisenhower's proposal to cut the rates on such payouts was rejected.

Not until 2003 were dividend tax rates reduced below ordinary income tax rates. Then they were cut to 15 percent, the same as the capital gains rate.

For most of the history of income taxes in America, long-term capital gains — defined at different times as investments held for minimum periods of as little as six months and as long as 10 years — have been taxed at substantially lower rates than top ordinary income tax rates.

There was, in fact, only one time that capital gains were taxed at the same rates that were paid by people who earned their money by working. That was during the years 1988 to 1990, as a result of the Tax Reform Act of 1986 — a law championed by President Ronald Reagan.

To be sure, he changed his mind about unearned income in 1988. After Vice President George H. W. Bush, then campaigning to succeed Mr. Reagan, endorsed lowering capital gains taxes, the president allowed that might be a good idea. Mr. Bush and the Congress did lower them after he was elected.

These days, the conventional way to look at taxes on investments is to think they should be low to stimulate investment and thus help the economy. It is a view that has much more support in economic theory than in economic history.

Correlation is not causation, of course, but the economy has tended to do the best when taxes on unearned income were high. Economic growth was great during the 1950s, when dividends were taxed at very high levels and capital gains rates were 25 percent, much higher than they are now. Since 2003, tax rates on unearned income have been at their lowest levels ever, and economic growth has been sluggish.

Tax rates are not the reason for that, at least not directly. But it could be argued that low tax receipts now are having a pernicious impact, particularly on state and local governments. Their layoffs have

been a drag on the recovery, and the declining quality of infrastructure in many areas has hurt many businesses. If the federal government taxed unearned income anywhere close to historical averages, there could have been a lot more tax money available to help out when the credit crisis hit.

There is no question that tax policy has had a major impact on investment, but its impact probably has been less in the overall level than in the allocation of investments.

Corporate profits, at least theoretically, are taxed twice, once when the company earns them and again when shareholders are taxed on their dividend payments. But interest payments to bondholders are deductible to the corporation, unlike the dividends it pays to shareholders. As a result, there has been an incentive to finance companies with as much debt, and as little equity, as possible. That maximizes return on equity in good times, and allows companies to plausibly claim they will raise profits much more rapidly than sales. But it also makes bankruptcies more likely when the economy falters. The Eisenhower tax policy that outraged Representative McCormack was intended to reduce that incentive a little, by reducing slightly the rates on dividend income. Had it passed, it probably would have had little impact.

The most interesting effort to end double taxation of dividends came from President George W. Bush in 2003. He proposed that dividend payments be tax-free — but only if the company could show that the dividends were being paid out of profits on which federal income taxes had in fact been paid.

That proposal caused something close to panic among some business lobbyists. Had it been carried out effectively — and it was evident that the Bush administration had not thought through all the details before announcing the proposal — the result would have been that companies that pay taxes would have been able to offer tax-advantaged payouts, while those that managed to lobby for loopholes would have had to tell shareholders that they could get no such tax break. Shares in taxpaying companies would have outperformed shares in others, at least until a new equilibrium was reached.

The Bush proposal quickly was changed to simply lower the rate on dividends to 15 percent, the same

as the new capital gains rate. Before that, the maximum tax on dividends had been nearly 40 percent, while the capital gains rate went as high as 21.2 percent. Share owners get a break whether or not the profits being paid out were actually taxed at the corporate level.

This history came to mind this week when Mitt Romney told a news conference that his effective tax rate was probably around 15 percent. That makes sense, since he gets a lot of his income from "carried interest" on private equity investments, which is taxed at capital gains rates even though the executives who get those payments typically made no actual investment, and are instead being compensated for their work in putting together and managing the investments. Mr. Romney, a founder of Bain Capital, continued to share in those payouts long after he left the company. Until he offers more information, there is no way to know how much of his income came from actual investments, as opposed to carried interest.

It does seem odd that those who work for their money generally pay higher tax rates than those who simply collect investment income. It also seems odd that those who work in that one industry — private equity — get to pay lower rates than those who work in other businesses.

Perhaps Mr. Romney's ability to pay little in taxes will evoke interest in the issue this year. Whoever wins the presidential election, the country's deficit problems could provide an opportunity for the most serious tax reform since Mr. Reagan's 1986 tax act. That law lowered rates while reducing exceptions and loopholes, so that lower rates could produce as much money as the previous higher ones had brought in. It also ended the preferred tax status of unearned income.

It was a good idea then. It may be a better one now.

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