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ABSTRACT

In this paper we investigate the extent to which the U.S. income tax system of 2004 collects tax on capital income, and the implications of extending tax-preferred savings accounts. We do so by applying a methodology that estimates how much tax is collected on capital income by calculating how much tax revenue would change if the tax system were modified to exempt income from capital in present value—specifically by adopting what the Meade Committee (1978) called an "R-base tax"—while leaving the tax rate structure and tax incentives otherwise unchanged. The difference between actual revenue and revenue under this alternative tax system is a measure of how much tax on capital income is collected under current law. We find that, as of 2004, the U.S. tax system has returned to the situation of the mid-1980s wherein our income tax system raises little revenue from taxing capital income. If extensive tax-free savings accounts were to be introduced, the system would raise almost no revenue from capital income and possibly subsidize, rather than tax, capital income. The main culprit in this state of affairs is the retention of interest deductibility. Although the revenue from taxing capital income is small, the gains that would result from a clean consumption tax have not been attained, as there remain distortions to both saving and investment decisions, and distortions across capital assets, portfolios, corporate financing, and choice of organizational form under the patchwork of provisions that have been adopted.