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Taxing labour and capital in the age of AI

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How do you explain to young people entering the US workforce that government taxes will take some 20 per cent plus from their paltry pay cheques while some megabillionaires will pay next to nothing? Like most developed countries, the US has long given preferential tax treatment to people who make money from investments over people who earn a living from wages. The unproven rationale for this costly tax break is that it incentivises investment. But as wealth continues to flow disproportionately to investors and away from workers — a trend that AI will probably accelerate — this policy needs a rethink.

There are many ways the US tax code favours investment income. Most controversial are the lower rates that apply to capital gains. Wages face a top marginal rate of 40.8 per cent while capital gains (and dividend income) are taxed at a top rate of 23.8 per cent. Importantly, gains are taxed only when investors' assets are sold or "realised". The rate is zero if they hold them until they die. Then, their heirs receive a "step up basis" at the asset's current market value. If a stock originally purchased at $10 is worth $100 when the share's owner dies, that $90 gain will never be taxed.

Tax preferences for investment income have been debated for decades. But the arguments are weak, the breaks are expensive and an estimated 70 per cent of the benefits flow to the top 1 per cent of earners.

Despite what proponents argue on investment incentives, there is little correlation between low capital gains rates and economic growth. As the billionaire Warren Buffett once observed: "People invest to make money, and potential taxes have never scared them off."

Advocates of these breaks argue that they promote efficiency but in fact they distort economic activity, as money is drawn away from its most productive uses to other activities simply to qualify for capital gains treatment. Proponents also argue that shareholder gains are already taxed at the corporate level. But a sizeable percentage of capital gains come from assets other than stocks, and corporate tax levels vary widely. Many big US companies pay no taxes.

Finally they argue that raising capital gains tax rates will lower tax revenues because investors will pursue tax shelters and/or hold on to their assets instead of selling them. But even with preferential

rates, investors pursue shelters and tax authorities struggle to define the boundaries between earned income and capital gains. Similarly, investors already avoid selling assets, for instance by borrowing against them and living off the untaxed loan proceeds. To tax more investor gains, the most workable solution is to end the "step up" and make them taxable at death.

Rich investors also benefit from the exclusion of investment income from Social Security's flat 12.4 per cent assessment on income up to $184,500. This is the main reason why a teenager entering the workforce will pay a higher percentage of their income in federal taxes than some billionaires. This spectacularly regressive tax is anachronistic because it is based on the original design of Social Security as a wage-insurance programme. But Social Security has evolved into a social safety programme. With the Congressional Budget Office projecting that the main trust fund of Social Security will approach insolvency in 7 years, wealthy investors must start paying their share.

Populist outrage over increasing wealth inequality has prompted many Democrats to propose surcharges on the super-rich. But the issue is tax fairness between wage earners and investors, and it shouldn't be partisan. Indeed in 1986, Congress eliminated capital gains rate preferences under Republican President Ronald Reagan and my former boss, Senate majority leader Robert Dole.

Revenue raised from eliminating these preferences could be used to reduce budget shortfalls, reduce rates, or some combination. The Committee for a Responsible Federal Budget estimates that dropping preferential rates for investment income and taxing unrealised gains at death would raise $1tn over 10 years.

With an ageing population and AI shrinking the base of wage-earners, young workers — if they can find jobs — will carry a disproportionate tax load throughout their lives unless we shift more of the burden to investors. Tech billionaires are fond of saying that government benefits such as universal basic income are the answer to AI-driven job displacement. But are they willing to help pay for it?