Equal Income Tax for All Businesses Rates

Foresters often seek a softening of tax burdens on forests in hopes of fostering more-intensive timber management. Typical of this view is the most recent Society of American Foresters (SAF) position statement, "Federal Income Tax Treatment of Timber Investment" (SAF 1998), a portion of which states,

The Society of American Foresters favors a federal tax system that encourages opportunities for investing in private forestry, enhances the application of sound forest management principles, and improves the health and long-term productivity of the nation’s privately owned commercial timberlands.

At first glance this seems reasonable enough... until we see that such a statement would apply to virtually any industry. The problem is that without reducing taxes for everyone, we can’t design an income tax that will “improve the health and long-term productivity” of all enterprises—agriculture, mining, electric utilities, transportation, forestry, manufacturing, services, and any other sector one might want to name. Taxes, by their very nature, are discouraging, and lawmakers are faced with convincing arguments for tax relief from many quarters. To avoid playing favorites, one approach to fairness is to design taxes that are no more discouraging to one enterprise than to another. That’s the essence of a “neutral” tax: one that doesn’t tend to change the market allocation of resources. Economists would call such a tax efficient. This paper reviews the concept of tax efficiency and explores the difficulties in justifying lower tax rates for timber production than for other ventures.

Efficiency

The efficiency argument says that if you think the market is allocating resources efficiently, don’t impose a tax that will change that allocation—that is, don’t impose a nonneutral tax. “Allocation” could be, for example, distribution of land, labor, or capital to different activities. For now, let’s look at capital allocation and assume an efficient market, where without any taxes capital would tend to move where rates of return were best. In such a market, the equilibrium before-tax rate of return on the last dollar invested (the “marginal” rate of return) in different activities would be about the same, say 7 percent, for a given level of risk.

For example, if recent investment in the gadget industry yielded a lower-than-average return, say 5 percent, investors would pull money out of gadgets and reinvest elsewhere at 7 percent, thus pocketing a net gain. Less investment and the resulting decline in gadget output would increase gadget prices and eventually increase that industry’s marginal rate of return to the competitive equilibrium. Conversely, if added investment in widgets yielded higher-than-average returns, say 10 percent, capital would be drawn there from lower-return ventures, again yielding a net gain. Eventually, the resulting increased widget output would decrease widget prices and lower that sector’s marginal rate of return to the equilibrium 7 percent. Once the marginal rate of return is the same in all industries, for a given risk level, there’s no chance for net gains from shifting capital between industries.

Ample evidence exists that the foregoing efficient allocation of capital tends to occur in competitive sectors of the US economy, including timber production. For example, historically, land uses have changed back and forth between timber and agriculture in direct response to changes in output prices and profitability. Between 1965 and 1980, investments in southern...
pine plywood manufacturing flourished where rates of return were attractive. Later, capital moved more into oriented strand board and wafer board production in response to profitability.

**Inefficient Taxes**

Now let's introduce taxes into the above efficient market. Suppose an industry with a low marginal before-tax rate of return gets a lower tax rate than other taxpayers so that its after-tax rate of return becomes acceptable. Such a nonneutral tax would impede the desirable movement of capital from low to high before-tax rates of return. Considering only monetary outputs, a low rate of return in one sector should be the market's signal to produce less (until prices rise, and returns become acceptable), not a signal to reduce taxes.

The SAF federal income tax position (SAF 1998) hints at support for inefficient taxes by stating, “Current federal policies decrease after-tax returns from forestry investments, thus discouraging such investments.” Then, in the same document, we read, “Investments in private forest management are unique in many respects. They...may yield rates of return that are low relative to other capital investment opportunities.” Combining this with the statement that the SAF advocates federal tax policies that encourage sustained forest management investments “… could lead some to believe that softening the tax burden on timber might be a good idea. It would be good for timber production, yes, but not necessarily for the nation as a whole. For each gain so achieved in timber output, there would be a greater social loss because the tax preference would inhibit a desirable movement of capital into ventures with higher rates of return.

It is exactly the foregoing line of reasoning that prompts some analysts to suggest eliminating capital gains tax preferences, which Congress did in 1986. For example, in defense of equal tax rates for all types of income, a US Treasury Department report states that “any... differential in tax rates among assets can reduce economic efficiency by causing capital to be reallocated to assets with lower before-tax returns” (OTA 1985). In other words, with an efficient starting point of equal before-tax marginal rates of return, reducing one sector's tax rate will cause capital to move there, increasing production and lowering its output prices until after-tax rates of return are equated. Equal after-tax rates of return imply lower before-tax returns for the favored sector. And it's the before-tax return that is of social relevance: the total return, private income plus taxes. In 1997, however, despite efficiency arguments to the contrary, Congress reinstated the capital gains tax preference for noncorporate taxpayers holding assets longer than one year. Rather than evenhandedly stimulating aggregate investment, this policy, in an inefficient fashion, favors certain investments over others.

But wouldn't an evenhanded or neutral tax policy cause us to run out of timber? The answer is no, because less investment in low-return timber ventures will decrease timber output and increase wood prices, leading to acceptable rates of return on the remaining timber investments and continued capital replacement in the industry. Moreover, in the United States, past timber price growth has been accompanied by dramatic increases in private reforestation and improved utilization of existing timber. Also, past and projected timber growth substantially exceeds harvest nationwide (Klempcrer 1996, p. 380; USDA-FS 1994).

Another point to consider is that moderate rates of return in many timber investments may reflect less-than-average risk. A number of analysts see less risk in most timber investments than in, say, many types of manufacturing where rates of return are greater to compensate for higher risk (see Mills and Hoover 1982; Fortson 1986: Webb et al. 1987; Redmond and Cubbage 1988; Zinkhan et al. 1992).

Where overall risks are below average, rates of return should be lower. Investors demand higher rates of return on riskier ventures to compensate for the undesired volatility in returns. Despite efficiency arguments against lower taxes for capital gains from timber, the idea that such policies might stimulate timber output appeals to some. But there is no guarantee that a forest owner whose tax rate is reduced will spend the tax benefit on increased forest management investment. In addition, economic theory suggests that a decrease in timber taxes leads to higher forestland values, in which case the rate of return on refor-
tion cost plus land value remains unchanged (on the tie between taxes and land values in forestry and agriculture, see Turner et al. 1991 and Pasour 1973; regarding rates of return on reforestation plus land value, see Klemperer 1996, p. 236–38). In fact, a 1981 study of the US Government Accounting Office reported, “None of the many sources we contacted…could provide firm evidence to support generally claimed values for conservation and reforestation from capital gains tax treatment” (US-GAO 1981). As logical as it may seem to predict more-intensive forest management when capital gains tax rates are lowered, such responses are hard to document statistically (Chang 1983). To stimulate reforestation, for example, we would need a subsidy more directly tied to the practice—for instance, the existing reforestation tax credit, or the sometimes-proposed expensing of reforestation costs. But such subsidies raise the same inefficiency questions discussed above.

Nonmonetary Outputs

Notice that the foregoing efficiency arguments relate only to financial outputs. What about arguments for preferential tax treatment of timber based on nonmonetary benefits that society values, like open space, scenic beauty, or watershed protection? The problem with this argument is that in many regions, nonintensive forestry will yield mixed species and brush as long as soils are not unstable. One could convincingly argue that such vegetation protects soil and water resources just as well and is just as beautiful to nonforesters as the capital-intensive commercial timber production that a tax preference is designed to foster. Ribe (1989) notes that in near-views of forests, most people prefer more open stands that permit visual penetration. But there is little research suggesting that, all else equal, artificially regenerated stands (stimulated by tax preferences?) would necessarily be more beautiful than those regenerated naturally.

In general, tax policy is a rather blunt tool to gain specific nonmonetary outputs like open space or scenic beauty. For example, special tax concessions to foster partial cutting along selected streams and roads or to encourage forested open space near cities might be temporarily successful. But such policies cannot prevent eventual clearing and land sale when alternative uses promise large enough profits.

Some analysts point to benefits of better trade balance through increased wood exports or greater rural economic vitality if timber outputs are stimulated by tax concessions. The problem with such arguments is that unless the nation’s total investment is increased, boosting one sector comes at the expense of less investment elsewhere and the attendant contractions.

Unequal Pains and Gains

Even though one can argue that gains from repealing a tax preference can exceed losses, the problem is that losses will often be concentrated painfully in certain sectors. But gains from diverting capital to higher-return ventures will be scattered throughout the economy and not so readily noticed. This is the problem of concentrated losses and diffuse but larger gains, a common result of many policies, which are therefore hard to implement. An example is the 1986 repeal of the former capital gains tax preference for timber income; this brought concentrated losses to timber growers but larger diffuse gains scattered across a greater number of short-term ventures receiving whatever investment was diverted from forestry. Boyd and Hyde (1989) estimated that the national efficiency gains realized after the capital gains tax preference was repealed in 1986 exceeded losses by at least $240 million annually. For years this beneficial repeal had been strongly resisted by timber interests because that was where the losses would be concentrated.

Conversely, some proposed nonneutral tax preferences or other policies could yield concentrated gains to a small group and even greater, but very diffuse, losses to large groups. Lobbying pressure for such undesirable policies can be intense on the part of gainers, while the individual losers may hardly feel the difference. An example is the effort by the timber industry to have Congress reinstate the capital gains tax preference for corporate timber income.

Basis Indexing

Increased inflation makes the capital gains tax more burdensome. A way to solve this unfair burden would be to index the tax-deductible basis for inflation—a practice not allowed under current law. For example, if the general price level, as measured by the consumer price index, doubled between purchase and sale dates of an asset, indexing would let you double the original purchase cost (or basis) when deducting it to calculate taxable capital gain. The current SAF tax position statement supports basis indexing. Such a measure would increase tax efficiency because, without indexing, the negative tax impacts of inflation aren’t uniform for all types of assets (Klemperer and O’Neil 1987). Although indexing would make the capital gains tax fairer, the benefits to long-term timber investors would be relatively small, since the tax-deductible basis is usually a small portion of the taxable income.

Conclusions

Too often foresters have the view that what’s good for timber output is good for the nation. But we need to step back and look at the whole economy, noting that a subsidy for timber— for example, through reduced taxes—can bring greater wood output at the expense of less investment and output in other sectors earning higher before-tax rates of return. Thus, in a smoothly functioning economy, the costs of such reduced nontimber outputs will exceed the gains in the forestry sector. However, one reform that could make the income tax more fair and neutral would be basis indexing.

It’s also important to recognize that failure to stimulate timber output with tax concessions will not cheat future generations. As long as aggregate investment of some type continues, we are providing for the future (Milliman 1962). Chains of short-term ventures can yield benefits for the distant future just as well as long-term forestry investments.
Literature Cited


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