The Daily Dish

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Over the weekend, the presumptive Republican nominee Donald Trump signaled several sudden changes to his stance on economic policy, stirring up more controversy surrounding his candidacy. Trump retracted a previous proposal of reducing taxes for all Americans, stating that he and other wealthy citizens are willing to pay more in taxes. More controversially, Trump called for raising the minimum wage, an issue with heavy opposition within the Republican Party.

Soon to be released data on China's economic performance may determine whether the Fed raises U.S. interest rates this June. Recent slow job growth and a drop in labor participation in the U.S. casts heavy doubt on the prospect of the Fed raising its benchmark interest rate. A decision is expected to be released in the coming weeks.

Eakinomics: Taxing Carried Interest — Concepts, Proposals, and Demagoguery

Carried interest is an integral feature of the financial arrangements of partnerships, a management structure broadly utilized in the United States and especially prominent in finance, insurance, and commercial real estate. In this structure, some partners take on a managerial role, while most of the partners simply contribute equity to the partnership. In return for their management role, these partners are granted an equity stake. Under current law, when these partners sell their stake, the income is treated as capital gains and taxed at the 20 percent capital gains rate.

How should carried interest be taxed? There are two possible benchmarks: an income tax and a consumed-income tax. Under a income tax approach, the instant the partner is granted an equity stake, this would constitute income and should be taxed — at ordinary income tax rates — on the value of this grant. Notice that current-law treatment is wrong because it does not impose that tax (which is like implicitly assuming it has zero value). Later, when the equity stake is sold, the partner realizes a capital gain — the difference between the sale price and the value when granted. This increase in value should be taxed as a capital gain.

Notice that the current tax treatment gets it wrong in two ways: no tax at the time of grant and treating the entire amount (not the difference between the sale value and the grant value) as a capital gain.

The second approach would tax only consumed income, exempting the return to saving and investment. Under this approach — think of a traditional Individual Retirement Account writ large — all income that is saved is deducted and not subject to tax. Under this approach, when the partner is granted the equity stake he or she implicitly has received income, but immediately invests it in the partnership. The latter generates a deduction equal to the former. These offset and there is no tax. When the stake is sold, however, it is like withdrawing the principal (the equity) and interest (earnings accumulated over time); both should be subject to tax at ordinary income rates.

The current tax treatment gets it wrong under a consumed-income tax as well because it does not tax the equity stake and earnings at ordinary rates.

That's the dull economics. Somehow, however, carried interest has become a boogeyman of the progressive left. The New York Times pasted the hyperventilating title "Ending Tax Break for Ultrawealthy May Not Take Act of Congress" above an article advocating for changing the tax treatment by administrative action. First, carried interest is not a tax break "for" the "ultrawealthy" — the same rules apply to everyone — but the line between fact and advocacy was removed from the Times long ago. Second, more executive overreach by the Obama administration is the last thing the nation needs.

But most remarkably, the actual proposal under discussion would be to tax carried interest at ordinary income tax rates; i.e., according to the principles of a consumed-income tax. If (and this requires willing suspension of disbelief) one believes that the fight over carried interest is a fight about the principles of tax policy, then the New York Times and the remainder of the progressive left is advocating for a consumed-income tax that should permit every American (including the "ultrawealthy") to deduct every dime that they choose to not consume.

A principled discussion of tax policy would focus on (a) what to tax — income or consumed-income, (b) the rates at which it should be taxed, and (c) the degree to which these principles should be overruled by other social objectives (charitable giving, etc.). Sadly, the discussion on the left and right revolves only around populist pandering to take more from the "rich" — because they can.

From the Forum

U6-Fix by Douglas Holtz-Eakin, AAF President