Cutting Capital Gains Tax Rates:

The Right Policy for The 21st Century

August 1999

Joint Economic Committee Staff Report
Office of the Chairman, Connie Mack
http://jec.senate.gov

Table of Contents

Section	Page
Foreword: Senator Connie Mack	ii
Overview – Executive Summary	1
Introduction	3
Background and History	5
Capital Gains and Economic Growth	6
Capital Gains and The Stock Market	13
International Comparison	14
Inflation and the Taxation of Capital Gains	16
Taxpayers' Responsiveness to Capital Gains Tax Rates	25
Beneficiaries of Lower Capital Gains Tax Rates	34
Conclusion	41
References	42

Foreword

To the Reader:

Proper taxation of capital gains is a complex issue. Capital gains differ from ordinary income in several respects. Because capital gains occur over time, their size is influenced by inflation. And, unlike most ordinary income, the realization of capital gains is largely a matter of choice.

In addition, there is a concentration issue – most people realize sizeable capital gains on only a few occasions such as when they sell a business or farm. As a result of these factors, capital gains are more sensitive to the rate of taxation than ordinary income.

The tax treatment of capital gains is particularly important since they are derived from entrepreneurial ventures. In modern high-tech economies, these activities are the engine that propels economic growth. Without growth, our living standards will stagnate. Thus, this booklet deals with an issue that touches each of our lives. I hope that you will find it both interesting and informative.

Senator Connie Mack
Chairman
Joint Economic Committee

The present tax treatment of capital gains and losses is both inequitable and a barrier to economic growth…. The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential growth of the economy.

President John F. Kennedy

Special Message to the Congress on Tax Reduction and Reform January 24, 1963

Overview – Executive Summary

Capital Gains and Economic Growth

- Economic growth is the proper focus of the debate regarding capital gains tax rates.
- The tax code's bias towards consumption over investment and multiple taxation of investment returns limit investment and retard economic growth.
- Capital gains play a unique role in fostering economic activity, especially by entrepreneurs in high-technology areas.
- Several economic studies conclude that lowering capital gains tax rates promotes economic growth.
- The optimal tax rate is the rate that is best for the economy, and it is lower than the rate that provides the government with the most tax revenue.
- The current top statutory rate of 20 percent significantly exceeds the optimal tax rate.
- Many economists, including Federal Reserve Chairman Alan Greenspan, believe that the optimal tax rate on capital gains is 0 percent.

Capital Gains and The Stock Market

- Lowering capital gains tax rates increases the prices of stocks and other assets.
- The 1997 cut in the top capital gains tax rate from 28 percent to 20 percent increased stock prices by approximately 8 percent.

International Comparison

- The US imposes higher tax rates on capital gains than most other countries, some of which do not tax capital gains at all.

Inflation and the Taxation of Capital Gains

- The most counterproductive and unfair characteristic of the tax on capital gains is that it taxes inflation, raising effective capital gains tax rates.
- Effective tax rates substantially exceed statutory rates and often surpass 100 percent.
- High effective tax rates force investors to retain assets, increasing the "lock-in" effect.
- The tax on inflation most severely punishes the elderly, low-income, middle-income, and less successful investors.
- Indexing (adjusting) capital gains for inflation – as some other countries have done – would eliminate this problem.

Taxpayers' Responsiveness to Capital Gains Tax Rates

- Taxpayers have a choice over when to realize capital gains and pay taxes.
- High capital gains tax rates lead investors to hold assets, increasing the "lock-in" effect.
- Lowering capital gains tax rates unlocks long-held assets and increases capital gains realizations. Increasing capital gains tax rates has the opposite effect.
- Greater realizations caused by lower capital gains tax rates lead to increased capital gains tax revenue and more revenue from other taxes.
- When predicting the budgetary effects of capital gains tax rate changes, it is necessary to account for behavioral responses by using "dynamic," rather than "static," scoring.
- The 1997 tax cut dramatically increased capital gains realizations and tax revenue.
- Capital gains taxes comprise a minor part of federal tax revenue.
- Cutting capital gains tax rates further would have little effect on the federal budget.
- Official government forecasters have consistently overestimated the revenue "losses" from capital gains tax rate reductions and the revenue "gains" from capital gains tax rate increases, because they use "static" rather than "dynamic" scoring.

Beneficiaries of Lower Capital Gains Tax Rates

- Greater economic growth benefits the entire country.
- Capital gains taxes disproportionately hurt elderly, low and middle-income investors who have less discretion over the timing of their capital gains.
- Most people who report capital gains do not have high annual incomes.
- People with high incomes are most sensitive to capital gains tax rates, because they possess the most flexibility and means to avoid high tax rates.
- High-income people pay a greater percentage of capital gains taxes when capital gains tax rates are low than when capital gains tax rates are high.

Introduction

Economic Growth

The most important characteristic of capital gains taxes is their negative effect on efficiency and economic growth. It is a mistake to focus on tax revenue and seek the capital gains tax rate that will yield the most tax revenue to the federal government (the revenue-maximizing rate). By definition, this tax rate must be greater than what is best for the overall economy (the optimal rate).

Too often, people wrongly devote attention to the federal government's budget rather than to the American family's budget, the overall wealth of the country, and the health of the economy. The proper emphasis should be on promoting efficiency and economic growth by reducing and removing investment disincentives caused by capital gains taxes.

Capital gains are central to economic growth. They reward entrepreneurs and investors who take risks and drive an expanding economy. Capital gains provide important incentives – *i.e.*, financial returns – for potential creators of new business ventures and investors. These actors play leading roles in fostering economic progress, and capital gains are an essential component of the return on their investments.

By unfairly taxing returns from investments, the present US tax system contains a strong prejudice in favor of consumption over investment. It does not tax after-tax income that people spend on consumption, but it does impose multiple levels of taxation on returns to after-tax income that taxpayers invest. This bias distorts incentives, alters behavior, restrains investment, and limits economic growth.

Capital gains are distinct from ordinary income. Investors realize them over time, not at regular intervals. This fact makes inflation an important consideration for investors and a critical issue in the taxation of capital gains. Taxpayers also have the power to choose when – and, sometimes, if – to sell an asset and realize gains that will trigger a capital gains tax liability. These special qualities reveal why the tax treatment of capital gains is so crucial.

Government Revenue

The question of government revenue should not be the center of the policy debate concerning capital gains. The federal budget is only a small part of the issue. Unfortunately, most people mistakenly judge capital gains tax policy solely, or largely, based on the impact on the federal budget.

In terms of raising revenue for the federal government, capital gains taxes are an ineffective and poor way to achieve those ends, producing relatively little revenue.

Revenues directly generated from capital gains represent only a small fraction – roughly 5 percent – of the federal budget. Most people incorrectly analyze changes in capital gains tax rates, because they ignore the fact that people respond to lower tax rates by increasing economic activity. This result of greater economic growth spurred by lower tax rates leads to increases in federal revenue from capital gains taxes, increases in revenue from other federal taxes, and decreases in federal expenditures.

In the past, official government forecasters, whom policy makers rely upon for budgetary estimates of tax rate changes, have repeatedly committed mistakes by neglecting these outcomes. Consequently, they have severely misjudged the budgetary effects of modifications in capital gains tax rates. Future budgetary predictions should incorporate the behavioral responses to different capital gains tax rates.

Background and History

A capital gain is the difference between the price initially paid for an investment and the money derived from selling it – the amount received from the sale of an asset above the investment's cost basis. For example, if Mary Smith invests $20,000 in company XYZ and sells all of her shares one year later for $21,000 (a 5 percent nominal – not accounting for inflation – return), she will have generated a nominal capital gain of $1,000. At the current top capital gains tax rate of 20 percent, Mary would have a federal tax liability of $200. If there were any inflation at all, Mary would pay some of this tax on phantom gains from inflation, because the US tax system does not adjust capital gains for inflation. In this case even if the inflation rate were only 3 percent, Mary's effective tax rate would be a staggering 50 percent![1] Therefore, a more accurate term for this tax would be the "capital formation" tax, because it is a penalty imposed on savings, investment and capital accumulation. Indexing capital gains for inflation would eliminate this unfair and destructive tax on illusory inflation gains.

Like ordinary income tax rates, capital gains tax rates have varied over time. From 1952 until 1978, the tax code provided a 50 percent exclusion of capital gains from income taxation. (For example, when the top marginal income tax rate was 70 percent, the resulting maximum capital gains tax rate was 35 percent.) The Revenue Act of 1978, through the Steiger Amendment, increased that exclusion to 60 percent, causing the top capital gains tax rate to fall to 28 percent (70%*40%=28%). When the Economic Recovery Act of 1981 under President Reagan lowered the highest marginal income tax rate from 70 percent to 50 percent, the maximum tax rate on capital gains dropped to 20 percent (50%*40%=20%). However, the Tax Reform Act of 1986 eliminated the 60 percent exclusion and established a maximum statutory capital gains tax rate of 28 percent, increasing the rate from 20 percent.

Because this legislation set the top capital gains tax rate by statute, increases in ordinary income tax rates in 1990 and 1993 did not raise capital gains tax rates. The Taxpayer Relief Act of 1997 returned the maximum capital gains tax rate to 20 percent. However, it increased the holding period – the time the tax code requires investors to hold investments in order for the returns to qualify as long-term capital gains – needed for that treatment from twelve to eighteen months. Finally, the IRS Restructuring and Reform Act of 1998 restored the holding period to one year. There are ongoing proposals to decrease capital gains tax rates further and to address the problem of taxing illusory gains from inflation.

[1] At 3 percent inflation, after 1 year the inflated value of her initial investment would be $20,600 ($20,000*1.03= $20,600). Therefore, her real gain would be only $400. ($21,000-$20,600=$400) A tax liability of $200 on a real gain of $400 yields an effective tax rate of 50 percent ($200/$400=50%). Higher inflation rates would produce even greater effective tax rates.

Capital Gains and Economic Growth

The Importance of Capital Gains to Economic Growth

Government can impede economic growth by imposing high marginal tax rates, particularly on savings and investment. Higher capital gains taxes reduce the incentive of individuals to invest in new equipment and structures that fuel economic growth. The counterproductive consequences for the economy are the most important characteristic of capital gains taxes and overwhelm the impact on the federal budget. While other factors obviously play a role in determining economic growth, everything else equal, lower capital gains tax rates produce greater economic expansion. This relationship suggests that some of the recent unexpected strength in the US economy stems from the 1997 cut in capital gains tax rates, because the tax on capital gains is the most growth-related tax in our system. It directly taxes human ingenuity while inhibiting both creativity and entrepreneurship – central forces behind the technological boom in the US.

Lowering capital gains tax rates and indexing gains for inflation would spur economic growth by decreasing the cost of capital. Because taxes comprise an integral part of the cost of capital, reducing capital gains rates lessens the cost of capital for borrowers. Lowering borrowing costs fosters more new business creation – especially technology startup firms – and increased expansion by existing firms. Economic progress results from entrepreneurial risk-taking. Lower capital costs promote economic activity by encouraging entrepreneurship, savings, and investment. An abundance of capital spurs technological innovations that allow workers to produce more with less effort by providing more capital per work hour. This outcome results in greater economic growth, lower unemployment, and higher wages without inflation. Capital, therefore, is the driving force behind economic growth. According to a study by Dale Jorgenson of Harvard University, the increase in US capital formation was responsible for nearly half of the growth of the US economy between 1948 and 1980.[2]

Entrepreneurs, Investors and Economic Growth

Capital gains reward risk-takers who develop and invest in new businesses that are critical to creating jobs, increasing wages, and stimulating economic growth. This condition is especially relevant for small, high-tech companies that are fundamental to propelling a vibrant economy. Without the potential for adequate returns, these essential determinants of economic expansion will not develop new high-tech products for consumers, create new jobs, and pay higher wages. A recent, comprehensive ten-country study by researchers at London Business School and Babson College demonstrates the strong connection between the pace of new business formation and the speed of economic expansion. In comparing the economic development of various nations, the

[2] Dale Jorgenson, *Postwar US Economic Growth*, Vol. 1 of *Productivity* (Cambridge, Mass: MIT Press, 1995).

study concluded that the "variation in rates of entrepreneurship may account for as much as one-third of the variation in economic growth."[3]

Actions that increase the value of resources are the engines of economic growth. Successful entrepreneurs perform this exact function – they combine existing resources into new goods and services that people value more highly than the resources required for their production. This phenomenon is obvious in many high-technology areas. For example, the components needed to make computer software are substantially less valuable than the software, itself. An entrepreneur with a useful idea, sound business plan, and good marketing strategy develops a product that people value. As entrepreneurs expand the output of such products, the demand for labor increases, pushing wages upward.

Entrepreneurs frequently rely on venture capital to help finance new firms and the sale of their company or initial public offering (IPO) to provide their financial return. Higher capital gains taxes limit the availability of venture capital and diminish the prospects for profitable returns. Lowering capital gains taxes raises the after-tax return, prompting more entrepreneurs to risk starting new companies. Cutting capital gains tax rates unleashes more venture capital to fund those new firms. In a recent study of the impact of capital gains taxes on venture capital, Paul Gompers and Josh Lerner of the Harvard Business School made the following conclusion. "[C]apital gains tax rates have an important effect at both the industry, state, and firm-specific levels. Decreases in the capital gains tax rates are associated with greater venture capital commitments…. Increases in capital gains tax rates have a consistently negative effect on contributions to the venture industry."[4]

When decision-makers consider investment alternatives, they evaluate both the expected ongoing income a venture will generate and the anticipated capital gain. Frequently, the returns will be entirely, or largely, from capital gains. This circumstance is particularly common for investments in high-technology startup firms that continually reinvest profits. For example, most publicly traded technology companies pay little, or no, dividends. Investors rely on capital gains to provide their returns. By increasing the after-tax rewards to investment, lowering capital gains tax rates would stimulate more investment, especially in projects that are new and provide uncertain results. Currently, many such endeavors are not proceeding, because high capital gains tax rates prevent investment in them.

The Bias Against Investment and the Double Taxation of Investment Returns

People both consume and invest using **after-tax** income. Taxpayers can avoid additional taxes by spending on consumption instead of saving and investing. The

[3] "New Entrepreneurs Appear Vital to Healthy Economic Growth," *The Wall Street Journal*, June 24, 1999, Business Bulletin, P. A1.
[4] Paul A. Gompers and Josh Lerner, "What Drives Venture Capital Fundraising?" NBER Working Paper 6906, January 1999, P. 2.

federal government does not tax consumption purchases (buying clothing, eating at a restaurant, spending on a vacation, etc.) made with after-tax dollars. However, our system does tax the return on after-tax income invested in corporations not just once, but twice – through corporate taxes and again through taxes on capital gains and dividends. Given this discrimination against saving and investment that the multiple taxation of the returns to capital magnifies and exacerbates, the low level of savings in the US is not a surprise.

Some people mistakenly contend that our system gives special preference to capital gains over labor income because of the 10 percent and 20 percent tax rates applied to long-term capital gains compared to higher tax rates on ordinary income. This analysis is seriously flawed, because it ignores the fact that investors receive returns from corporate stock based on **after-tax** corporate profits. Double taxation of returns to capital invested in corporations causes effective (compound) tax rates to substantially exceed both statutory capital gains tax rates and ordinary income tax rates applied to labor income.

When people sell shares of stock for capital gains, they are selling the right to receive profits already reduced by the corporate income tax rate of 35 percent. For every $100 of corporate profit, at the corporate tax rate of 35 percent, the government takes $35 in taxes. Investors subject to the top capital gains tax rate of 20 percent who receive the remaining $65 in capital gains, pay an additional $13 in taxes (20% of the after-tax $65 = $13). The outcome leaves the investor with $52 and the government with $48 of the original $100 profit. Therefore, the compound tax rate is 48 percent!

Investors in the 10 percent capital gains tax bracket face nearly as high a tax burden. After the initial $35 paid in corporate taxes, these investors pay an additional tax of $6.50 on the remaining $65 (10% of $65 = $6.50). The result is that of the initial $100 profit, the government has $41.50 and the investor $58.50, revealing a true tax rate of 41.5 percent! Even a 25 percent cut in the long-term capital gains tax rates would only lower the tax rates minimally (to 44.8 percent and 39.9 percent, respectively), still substantially higher than the tax rates applied to labor income.

The tax code bias against returns from investment are even more punitive for investment returns received in the form of short-term capital gains (for investments held less than 12 months) and dividends. These are both also paid out of after-tax corporate profits, but the tax codes treats them as ordinary income, imposing tax rates of 15, 28, 31, 36, and 39.6 percent in addition to the 35 percent corporate tax rate already levied. After properly accounting for the taxation at the corporate level, the compound tax rates for short-term capital gains and dividends at these ordinary income tax rates are 44.8, 53.2, 55.2, 58.4, and 60.7 percent, respectively!

These punitive tax rates on short-term capital gains and dividends stifle investment and distort incentives. A more effective, unbiased, pro-investment, pro-growth tax system would lower the tax rates on short-term capital gains and dividends and equate them with the tax treatment of long-term capital gains.

The Nature and Uniqueness of Capital Gains

Because investors realize capital gains in a time period different from the time when they invested, inflation affects true capital gains. If any inflation occurs during the investment period, the purchasing power – the amount of goods and services money can buy – of the initially invested dollars differs from that of the realized dollars when the investor sells the investment. For example, if someone invests $100 in a company and sells those shares in the future for the same $100, with any inflation during this period, the $100 realized from the sale would purchase less than the initial $100.

This example reveals the difference between **nominal** (before inflation) and **real** (after inflation) capital gains. In the example the investor realized no **nominal** gains. However, if prices generally rose by 10 percent during the investment period, then, the $100 realized would buy roughly 10 percent **less than** at the time of the investment. Therefore, there would be **real capital losses** of approximately 10 percent.

In addition to the multiple taxation of capital gains already described above, the US tax system further penalizes capital gains by taxing nominal gains that include general price increases solely reflecting inflation. This approach leads to people paying taxes on inflation – a situation that not only compounds the bias against investment, thereby impeding economic activity, but also clearly promotes unfairness. Taxpayers should not have to pay greater taxes to the government because of inflation that the government, itself, may have caused.

Because taxpayers usually have other financial resources, they have substantial discretion regarding the timing of realizing capital gains and, consequently, paying taxes on capital gains. Unlike the situation with most ordinary income, regarding the realization of capital gains, the taxpayer largely determines when they will occur and, consequently, when the government will tax them. Therefore, taxpayers are extremely sensitive to changes in capital gains tax rates. This characteristic reveals why it is even more important to measure capital gains correctly, treat them properly, and not tax them punitively.

Economic Studies

Several studies have shown that reducing tax rates causes greater economic activity. A 1995 study by Allen Sinai, then Chief Economist at Lehman Brothers, concluded that a proposed tax cut would increase real economic growth by roughly .7 percent annually.[5] In a later study of a smaller proposed capital gains tax rate cut prior to the 1997 legislation, Sinai forecast a resulting increase in GDP growth of .1 percent annually. He noted the following: "Capital gains tax reduction increases savings, capital

[5] Allen Sinai, Testimony before the House Ways and Means Committee, January 24, 1995.

spending and capital formation, economic growth, jobs, productivity and potential output."[6] Another study by DRI/McGraw Hill before the 1997 tax cut found similar, albeit smaller, benefits from lower capital gains tax rates and concluded the following. "The evidence suggests to almost all economists that a capital gains cut is good for the economy and roughly neutral for tax collections."[7]

Evidence since the 1997 legislation supports these conclusions. A June 1999 study by David Wyss, Chief Economist of Standard & Poor's DRI, an independent economic consulting firm, found that the 1997 cut in capital gains tax rates increased investment, thus improving economic activity. "The rise in investment spending creates the rise in productivity and real GDP. The lower cost of capital encourages business investment…. After 10 years, however, the capital stock is up 1.2% and productivity is 0.4% higher than in the baseline."[8]

Wyss found that the improvement in the economy over time is significant. "Our model suggests that after 12 years, GDP would be 0.4% higher than in the baseline, adding $116 billion to incomes."[9] Moreover, Wyss based these conclusions on conservative assumptions by not including the increased growth in new firms started by entrepreneurs that lower capital gains taxes stimulate. "The model analysis does not specifically account for that effect [the increase in entrepreneurship]. **The model probably understates the impact of capital gains…. If more creativity is unleashed, the results could be better than the model suggests**."[10] [Emphasis added] Therefore, in terms of the increase in economic growth, the benefits from the 1997 decrease in capital gains tax rates are likely greater than the Wyss study concludes.

Optimal Capital Gains Tax Rate

Despite the 1997 rate reduction, the top capital gains tax rate is still higher than the optimal rate – *i.e.*, the rate that would stimulate the most economic growth. It is important to recognize the distinction between this rate and the rate that would raise the most government revenue – *i.e.*, the revenue-maximizing rate.[11] In terms of triggering economic growth, attaining the optimal rate is the correct goal. James Gwartney and Randall Holcombe concluded the following: "The optimal tax rate weighs the economic cost of the higher rate against the benefits of more revenue. At the optimal rate, the marginal benefits derived from the revenue generated by a little higher rate are just equal

---

[6] Allen Sinai, Testimony before the Senate Finance Committee, March 13, 1997.
[7] DRI/McGraw Hill, "The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks," April 1997.
[8] David Wyss, "Capital Gains Taxes and the Economy: A Retrospective Look," Standard & Poor's DRI, June 1999, P. 3.
[9] Wyss, P. 5.
[10] Wyss, P. 7.
[11] For an in-depth discussion of the optimal rate, the revenue-maximizing rate, and the difference between them, see James D. Gwartney and Randall G. Holcombe's "Optimal Capital Gains Policy: Lessons from the 1970s, 1980s and 1990s," Joint Economic Committee Study, June 1997, especially Pp. 7-8.

to the marginal cost in the form of loss of productive economic activity squeezed out by the rate increase. Thus, the optimal rate is the rate that is best for the economy."[12]

At levels above the optimal rate, the capital gains tax inhibits economic growth. Therefore, the distinction between the optimal rate and the revenue-maximizing rate is critical, because the revenue-maximizing rate is too high from the perspective of economic efficiency. Gwartney and Holcombe made the following distinction between the two rates. **"Clearly the optimal tax rate is always less than the revenue-maximizing rate, because at the revenue-maximizing tax rate, a small increase in the tax rate eliminates productive activities without raising any additional revenue. In contrast with the optimal rate, the revenue-maximum rate is highly inefficient. Thus, the optimal tax rate will be well below that rate."[13]** [Original emphasis]

Since the optimal rate must be less than the revenue-maximizing rate, establishing the latter can help determine an upper bound for the former. A study by Lawrence Lindsey, then of Harvard University and later a member of the Federal Reserve Board, found the revenue-maximizing rate to be roughly 15 percent.[14] Additionally, evidence from the 1997 cut to 20 percent suggests that that policy increased tax revenue. This finding implies that the revenue-maximizing rate is no higher – and most likely lower – than the present 20 percent. Clearly, the optimal rate must be well below this figure. If the revenue-maximizing rate is 15 percent, as Lindsey suggested, then the optimal rate is lower still – obviously, considerably below the current 20 percent. Therefore, substantially cutting the top capital gains tax rate would move us closer to the optimal rate, improve economic efficiency, create more jobs, increase wages, and cause greater economic expansion.

Many respected economists maintain that having no capital gains tax at all would be optimal for economic growth. They argue that completely eliminating the tax – a capital gains tax rate of 0 percent – would be fair and most efficient for the economy, because the capital gains tax imposes multiple (at least double) taxation on savings and investment. By punishing such productive activity, the capital gains tax stifles capital formation, an essential force behind economic expansion. For example, Kenneth Judd of Stanford University has maintained that the optimal tax rate on capital gains is no greater than zero.[15]

Federal Reserve Board Chairman Alan Greenspan also has consistently supported abolishing the capital gains tax. In his 1997 testimony before the Senate Banking Committee, Chairman Greenspan elaborated on his previous testimony before the Senate Budget Committee.

---

[12] Gwartney and Holcombe, P. 7.
[13] Gwartney and Holcombe, P. 8.
[14] Lawrence Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," *National Tax Journal*, September 1987.
[15] Kenneth Judd, "The Optimal Tax Rate for Capital Income is Negative," NBER Working Paper 6004, April 1997.

> The point I made at the Budget Committee…was that if the capital gains tax were eliminated, that we would presumably, over time, see increased economic growth which would raise revenues for the personal and corporate taxes as well as the other taxes we have…. **The crucial issue about the capital gains tax is not its revenue-raising capacity. I think it's a very poor tax for that purpose. Indeed, its major impact…is to impede entrepreneurial activity and capital formation**…. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. **I argued that the appropriate capital gains tax rate was zero**.[16] [Emphasis added]

Other economists have supported Chairman Greenspan's view. In a 1994 study former Treasury Department economists Gary and Aldona Robbins concluded that among a variety of potential policies, by far the greatest contribution to long-term economic growth in the US would arise from eliminating the capital gains tax.[17] By removing a destructive bias against savings and investment, totally abolishing the capital gains tax would unleash the economy's powerful, natural forces.

[16] Alan Greenspan, Testimony before the Senate Banking Committee, February 25, 1997. (For Chairman Greenspan's recent comments on the subject, see his testimony before the Senate Banking Committee, February 23, 1999.)

[17] Gary and Aldona Robbins, "Putting Capital Back to Work for America," Institute for Policy Innovation Working Paper, no. 134, May 1994.

Capital Gains and The Stock Market

The effect of capital gains taxes on equity markets provides ample evidence of their detrimental impact on the economy. Decreasing capital gains tax rates increases stock prices. A recent study by Mark H. Lang and Douglas A. Shackelford of the National Bureau of Economic Research finds that the 1997 capital gains tax cut benefited stock prices.

This relationship was even more pronounced for companies that reward investors not through dividends but through capital appreciation – "growth stocks." A substantial number of these firms are young, developing, technology companies fueling much of the current economic growth in the US. However, the legislation helped stocks of all types. "Thus, the evidence suggests that investors viewed the budget agreement as favorable regardless of dividend status."[18]

The authors cite two explanations for the results. First, because potential investors anticipate that future stock returns will be taxed as capital gains, lowering the expected capital gains tax rate improves the appeal of stocks to investors. Furthermore, since the capital gains tax applies to gains for current shareholders, decreasing the expected capital gains tax rate improves stock market values. Capital gains tax policy influences financial markets, with lower tax rates yielding higher equity prices. "[T]he results suggest that anticipated shareholder taxes affect firm values."[19]

The DRI study by David Wyss bolsters these conclusions. "Since the new law passed in 1997, stock prices have soared 30%. About 8 percentage points (or 25 percent) of that rise can be explained by the change in capital gains treatment."[20]

The stock market does not exist in a vacuum, separate and distinct from the economy and public policy. These forces are woven together and continually influence each other. Therefore, lowering capital gains tax rates and indexing gains for inflation would enhance stock prices and benefit the entire economy.

---

[18] Mark H. Lang and Douglas A. Shackelford, "Capitalization of Capital Gains Taxes: Evidence From Stock Price Reactions to the 1997 Rate Reduction," Working Paper No. W6885, National Bureau of Economic Research, January 1999. P. 20.
[19] Lang and Shackelford, Pp. 4-5.
[20] Wyss, P. 2.

International Comparison

With the proliferation of global financial markets and the free flow of capital, worldwide competition for capital is greater than ever. Table 1 presents the findings of a recent study by Arthur Anderson for the American Council for Capital Formation (ACCF) Center for Policy Research. The results reveal that the US imposes higher tax rates on capital gains than most other nations. These higher capital gains tax rates put the US at a competitive disadvantage.

Additionally, of the few countries with higher capital gains tax rates, most provide an exclusion from taxation for some amount of gains, or, as in the case of Australia, index gains for inflation. Several other countries – Argentina, Belgium, Hong Kong, The Netherlands, and Singapore, for example – do not tax personal capital gains at all. The recent US rate cut improved the US situation vis-à-vis the rest of the world, but high relative capital gains tax rates still hurt the US internationally.

Even after the 1997 tax cut US capital gains tax rates still exceed the average among the countries surveyed. Additionally, unlike the United States most other nations do not require taxpayers to hold investments for a minimum time – a "holding period" – in order for investors to receive capital gains tax treatment. The US treats investments held less than one year as "short-term" capital gains and imposes higher ordinary income tax rates on those returns. Further reducing capital gains tax rates and indexing gains for inflation would improve US competitiveness, attract more capital and investment, and lead to higher US productivity.

TABLE 1

INTERNATIONAL COMPRARISON OF CAPITAL GAINS TAX RATES

Country	Gross Domestic Saving as a Percent of GDP	Maximum Individual Tax Rate	Individual Capital Gains: Max. Tax Rate on Equities		Individual Holding Period
			Short-term	Long-term	
Argentina	18.0	33.0	Exempt	Exempt	No
Australia	21.0	48.5	48.5	48.5; asset cost is indexed	No
Belgium	23.0	56.7	Exempt	Exempt	No
Brazil	18.0	27.5	15.0	15.0	No
Canada	21.0	31.3	23.5	23.5	No
Chile	26.0	45.0	45.0; annual exclusion of $6,600	45.0; annual exclusion of $6,600	No
China	44.0	45.0	20.0; shares traded on major exchange exempt	20.0; shares traded on major exchange exempt	No
Denmark[a]	21.0	61.7	40.0	40.0; shares valued at less than $16,000 exempt if held 3+ years	Yes, 3 years
France	21.0	58.1	26.0; annual exclusion of $8,315	26.0; annual exclusion of $8,315	No
Germany	21.0	55.9	55.9	Exempt	Yes, 6 months
Hong Kong[b]	23.0	20.0	Exempt	Exempt	No
India	31.0	30.0	30.0	20.0	Yes, 1 year
Indonesia	24.0	30.0	0.1	0.1	No
Italy	33.0	46.0	12.5	12.5	No
Japan	22.0	50.0	1.25% of sales price or 20% of net	1.25% of sales price or 20% of net gain	No
Korea	30.0	40.0	20.0; shares traded on major exchange exempt	20.0; shares traded on major exchange exempt	No
Mexico	34.0	35.0	Exempt	Exempt	No
Netherlands	23.0	60.0	Exempt	Exempt	No
Poland	26.0	40.0	Exempt	Exempt	No
Singapore	18.0	28.0	Exempt	Exempt	No
Sweden	50.0	57.0	30.0	30.0	No
Taiwan	22.0	40.0	Exempt (local company shares)	Exempt (local company shares)	No
United Kingdom[c]	N/A	40.0	40.0; shares valued at less than $11,225 exempt	40.0; shares valued at less than $11,225 exempt	Yes, 1 to 10 years
United States[d]	**16.0**	**39.6**	**39.6**	**20.0**	**Yes, 1 year**
Average	**25.2**	**42.4**	**19.4**	**15.9**	**79.2% have no holding period**

*Notes

Maximum Individual Tax Rate

[a] Maximum marginal tax rate is 20 percent for the assesment year 1997/1998 and 17 percent for 1998/1999

Individual Capital Gains

[b] Gains on shares held three or more years are tax exempt if taxpayer owns less than US $16,000 of the company's shares

[c] Sliding scale of rates applies to 1 to 10 years of ownership through an exclusion that rises gradually to 75 percent for assets held 10 or more years. Thus, assets held 10 or more years face a top marginal rate of 10 percent.

[d] Shares held 12 months or more are taxed at a rate lower than that on ordinary income under the IRS Restructuring and Reform Act of 1998.

Source: Study by Arthur Anderson LLP for American Council for Capital Formation Center for Policy Research.

Inflation and the Taxation of Capital Gains

Several aspects of the tax code discriminate against investments that experience capital appreciation. As already discussed, investors in stock of corporations, including equity mutual funds, face at least two levels of taxation. First, there is a 35 percent corporate tax. Then, investors must pay the capital gains tax on the remaining after-tax appreciation. At the current top statutory capital gains tax rate of 20 percent, investors pay a combined tax rate of 48 percent.[21] (Investors living in any one of the many states that also impose both corporate and capital gains taxes in addition to the federal ones, face even higher combined tax rates – clearly well above 50 percent.) Additionally, the tax code imposes a "loss limit" of $3,000 so that investors cannot deduct losses beyond this amount. While investors must pay taxes on all capital gains, they cannot fully deduct all capital losses.

The most deleterious and inequitable characteristic of the way the US tax system treats capital gains, though, is that it forces people to pay taxes on inflation. An investment's stated nominal gain has two components – real asset appreciation and price increases that merely reflect inflation. In the earlier example Mary Smith invested $20,000 in company XYZ and over one year earned a nominal gain of 5 percent ($1,000). At 3 percent inflation $600 of that amount just represented general price increases. The remaining $400 was the real asset appreciation. Because of the eroding effects of inflation, this amount represents slightly less than a 2 percent real gain.[22]

Investors pay capital gains taxes based on nominal gains that include inflation, rather than on real (after inflation) gains. Taxing inflation not only is unfair; it also depresses investment and increases inefficiency by heightening the "lock-in" effect – when investors continue to hold assets rather than incur large capital gains tax liabilities. Moreover, this tax on phantom inflationary gains disproportionately affects low and middle-income investors, the elderly, and those who receive low nominal rates of return on their investments. This phenomenon occurs, because, the lower the nominal rate of return, the greater the inflation component of that return. Therefore, investors with low rates of return experience a greater percentage erosion through taxes of their real returns than do investors with high rates of return. Indexing gains for inflation would eliminate this unfair practice and improve economic efficiency.

---

[21] For every $100 of corporate profit at the corporate tax rate of 35 percent, the government takes $35 in taxes. Investors who receive the remaining $65 in capital gains, at the top capital gains tax rate of 20 percent, pay $13 in additional taxes. ($65*20%=$13) The outcome leaves the investor with $52 and the government with $48 of the original $100 profit.

[22] The nominal return equals the product of the real return and inflation. In this example there is a 5 percent nominal rate of return, a 3 percent inflation rate and solved for real return. The formula is as follows, where r is the real return to be calculated: [1.05 = 1.03* (1+r)] The nominal return of investment equals $21,000. The inflation-adjusted return of investment is $20,600. Dividing the former by the latter ($21,000/$20,600) and subtracting 1 (for the original investment) to solve for r yields the real rate of return of 1.94 percent. This value is slightly less than the 2 percent number derived by subtracting the inflation component from the nominal return. However, subtracting the inflation rate from the nominal rate of return yields a close approximation of the real rate of return.

Future inflation rates are unpredictable, and this uncertainty represents added risk for potential investors. Taxing illusory inflation gains only compounds the costs to investors of prospective inflation and, therefore, discourages investment. Although inflation rates currently are low, there is no guarantee that this condition will continue in the future. Furthermore, because of the tax on inflation, investors who have owned assets, particularly through periods of high inflation and low – perhaps even negative – real rates of return, are likely to retain those investments. As long as they do not sell the investments, these investors will avoid paying exorbitantly high effective tax rates resulting from the tax on the phantom gains accompanying inflation. This situation increases the lock-in effect. Indexing gains for inflation would foster greater prospective investment and reduce the magnitude of the lock-in phenomenon.

History and Analysis

The historical evidence shows that because of the tax on inflation, investors frequently have had to pay astonishingly high effective capital gains tax rates, sometimes **of more than 100 percent**. Even worse, often investors have had to pay taxes on real capital **losses**, implying an infinite tax rate! Economists across the ideological spectrum have acknowledged these conditions. In 1980 Alan Blinder, whom President Clinton later appointed to the Federal Reserve Board, made the following conclusion. "Most capital gains were not gains of real purchasing power at all, but simply represented the maintenance of principal in an inflationary world."[23] Most investors experienced largely, or solely, phantom inflationary gains and not real gains; therefore, they paid capital gains taxes almost completely on inflation.

Several studies at various times have concluded that nominal gains – the subject of capital gains taxes – have far exceeded real gains. Inflation has always comprised a significant share of nominal gains. A study of taxable sales of corporate stock in 1973, prior to the highest inflation rates of the 1970s, found that of the $1,138 million in taxes paid in nominal gains, only $661 million (58.1 percent) represented taxes paid on real gains. Consequently, $477 million (41.9 percent) of the taxes paid were on phantom inflationary gains.[24] A 1990 study by the Congressional Budget Office (CBO) arrived at a similar conclusion. "Overall, inflation averaged 52 percent of nominal gains for stocks purchased between 1949 and 1988 and held until 1989."[25]

Taxing inflation dramatically increases real (effective) capital gains tax rates. A more recent analysis by the CBO of 1993 data found that, without the current tax law restricting losses to $3,000 annually – the "loss limit" – in aggregate there were **no real**

[23] Alan S. Blinder, "The Level and Distribution of Economic Well-Being," in *The American Economy in Transition*, edited by Martin Feldstein (Chicago: University of Chicago Press, 1980), P. 48.
[24] Martin Feldstein and Joel Slemrod, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," *National Tax Journal*, 31, June 1978, Pp. 107-118.
[25] CBO Paper, "Indexing Capital Gains," August 1990, P. 12.

capital gains, only net real capital losses. Even with imposing the $3,000 loss limit, inflationary gains accounted for slightly more than half of the nominal gains. The CBO concluded the following. "Taking account of that loss limit, capital assets other than bonds generated net capital gains of $81.4 billion, on average, before adjustment for inflation but only $39.5 billion once that adjustment was made. Thus, since inflation-adjusted capital gains amounted to about one-half of nominal gains in 1993, the effective tax rate on inflation-adjusted gains was about twice the rate currently applied to nominal gains."[26] Since the top capital gains tax rate in 1993 was 28 percent, most investors on average paid an effective capital gains tax rate of double that – 56 percent!

While the proportion of taxes due to inflation varies with inflation rates, rates of return, and the holding period of investments, inflation has represented a large portion of the taxes paid. Figure 1 depicts the total tax paid on an average stock investment made in June of various years and sold in June 1994 (using an average stock that commanded a real price of $100 in June 1994). The top section of each bar shows the portion of the tax paid on inflation, and the bottom part reflects the amount paid on real gains. Indexing gains for inflation would eliminate this considerable and unfair tax on inflation.

People Hurt by the Tax on Inflation

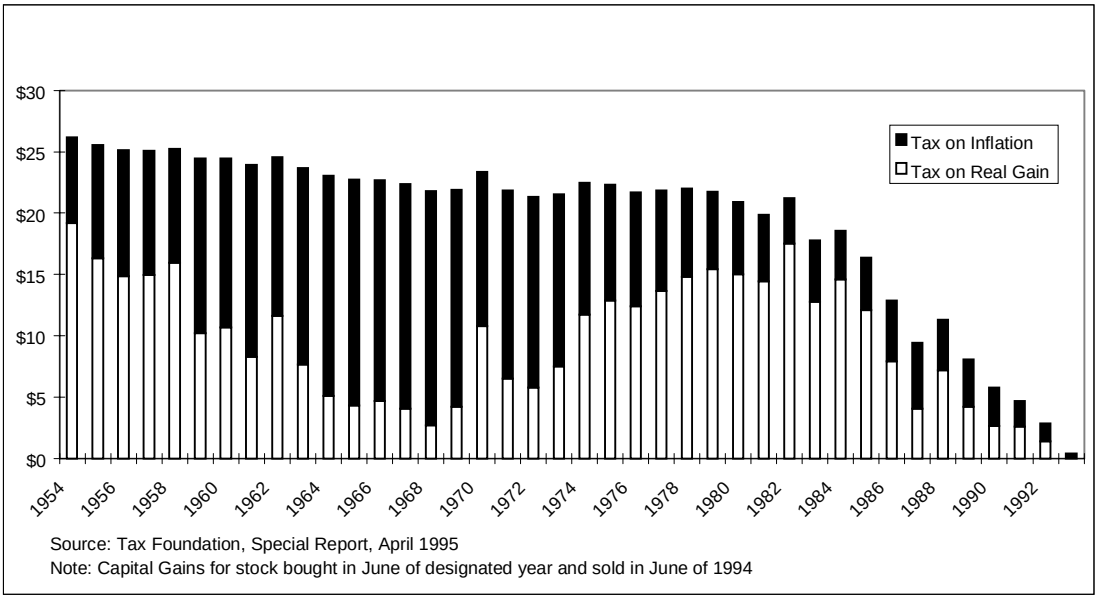
Taxing false inflation gains unfairly punishes low and middle-income investors, the elderly, and other taxpayers who have minimal financial flexibility and receive lower rates of return on their investments. According to the CBO, in 1981, on average, those taxpayers with adjusted gross incomes (AGI) of less than $100,000 who reported nominal capital gains had no real gains. These people paid taxes completely on inflation. For investors with incomes above $100,000, on average, inflation comprised just under half of their nominal gains. "Thus, among those reporting gains on stock in 1981, indexation would have provided the least tax reduction per dollar of reported gain to the highest-AGI taxpayers and the most to those middle- and lower-income taxpayers with gains. The average taxpayer receiving gains and with AGI below $100,000 would have owed no tax because no real gain had been earned."[27] A later CBO study of 1993 data arrived at the same conclusion for investors with incomes under $200,000, if there were no loss limit.[28]

---

[26] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," May 1997, P. 28.
[27] CBO Paper, "Indexing Capital Gains," Pp. 23-24.
[28] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 29.

FIGURE 1

TAXES PAID ON REAL vs. INFLATIONARY CAPITAL GAINS FOR INVESTMENTS MADE IN JUNE OF DIFFERENT YEARS AND SOLD IN JUNE 1994 FOR $100



By taxing phantom inflation gains, the current system imposes higher capital gains tax rates on investors who receive lower rates of return. Table 2 illustrates that, as the nominal rate of return approaches the inflation rate from above, the effective tax rate increases sharply. At nominal rates of return slightly above the inflation rate, the real tax rate surpasses 100 percent. For nominal rates of return less than the inflation rate, there are no real gains, and, therefore, the effective tax rate is infinity! This situation describes a condition where investors experience no real gains, but pay taxes only on inflation.

While these relationships are strongest when inflation is high, they still exist even at low rates of inflation. Figure 2 shows that even with minimal inflation, the present system imposes higher real tax rates on investors with low rates of return. At higher inflation rates the problem is even more severe. Taxing capital gains at such high rates is inefficient, and imposing higher effective tax rates on those who receive lower rates of return is unfair. There is no economic reason to tax risk-averse investors more severely than aggressive ones.

TABLE 2

EFFECTIVE CAPITAL GAINS TAX RATES FOR VARIOUS NOMINAL RATES OF RETURN, GIVEN 2.5 PERCENT ANNUAL INFLATION

Annual Nominal Rate of Return	Nominal Value of Asset Held Five Years	Nominal Capital Gain	Tax Liability at 20% Rate	Real Capital Gain*	Tax Rate on Real Capital Gain**
(1)	(2)	(3)	(4)	(5)	(6)
3%	11,593	1,593	319	279	114.3%
4%	12,167	2,167	433	852	50.8%
5%	12,763	2,763	553	1,449	38.1%
8%	14,693	4,693	939	3,379	27.8%
15%	20,114	10,114	2,023	8,799	23.0%
25%	30,518	20,518	4,104	19,203	21.4%

All calculations are based on a $10,000 initial investment held for five years with an average annual inflation rate of 2.5%.

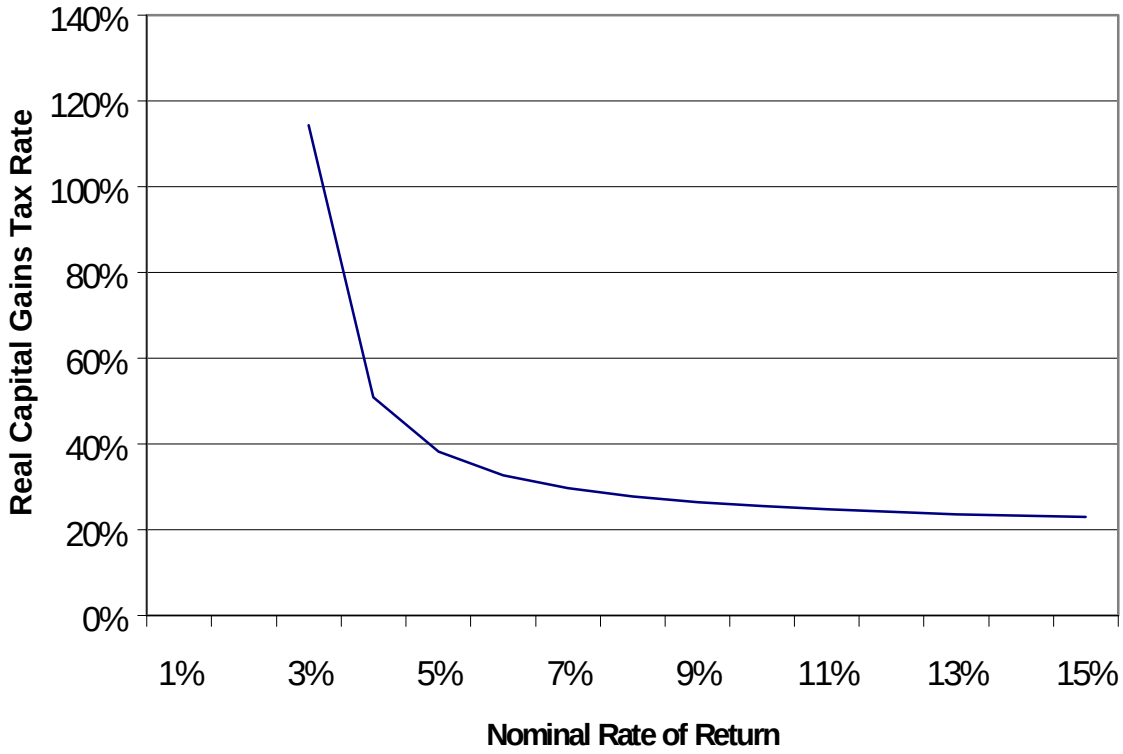
* This is equal to the nominal sales price of the $10,000 asset after five years (column 2) minus $10,000*(1.025)^5. The latter expression indicates the amount of current dollars that would have the same purchasing power as the original $10,000 investment had five years ago.

** This is equal to the tax liability (column 4) divided by the real capital gain (column 5). Both are measured in the purchasing power of the dollar at the end of the five-year period.

The unfair taxation of inflation causes the elderly, low, and middle-income investors to pay higher effective tax rates. High-income investors have greater flexibility regarding the timing of their capital gains realizations. Additionally, divergent real tax rates levied on investors with different rates of return explains a significant part of the reason why taxing inflation most seriously hurts low and middle-income investors and the elderly.

FIGURE 2

EFFECTIVE CAPITAL GAINS TAX RATES FOR VARIOUS NOMINAL RATES OF RETURN, GIVEN 2.5 PERCENT ANNUAL INFLATION



Source: JEC calculations (Assumes five-year holding period and 2.5% annual inflation rate. For nominal rates of return less than the inflation rate, the effective tax rate is infinity.)

The CBO observed the following: "Taxpayers in the highest income groups tend to earn higher real returns."[29] Those with lower real returns pay higher effective tax rates. Indexing capital gains for inflation would substantially reduce those high real tax rates, and would directly benefit the elderly, low, and middle-income investors. The policy would end the discriminatory practice of imposing higher real tax rates on investors with lower rates of return than on more successful investors.

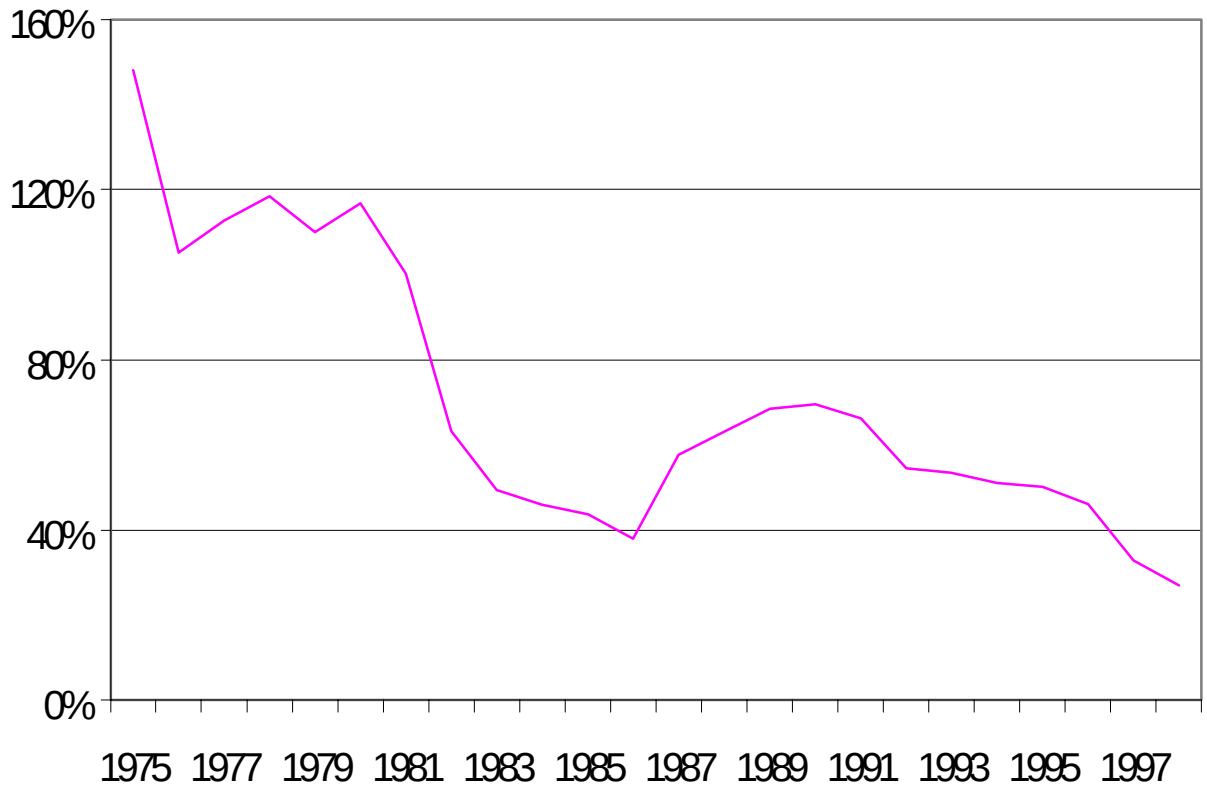
[29] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 28.

Effective Tax Rates and Indexation

As Figure 3 illustrates, the combination of lower statutory capital gains tax rates and less inflation has dramatically reduced effective capital gains tax rates (including phantom inflation gains) during the last two decades. This pattern has increased the rewards and reduced the risks of investments.

FIGURE 3

DECLINING INFLATION AND LOWER STATUTORY CAPITAL GAINS TAX RATES HAVE REDUCED EFFECTIVE CAPITAL GAINS TAX RATES

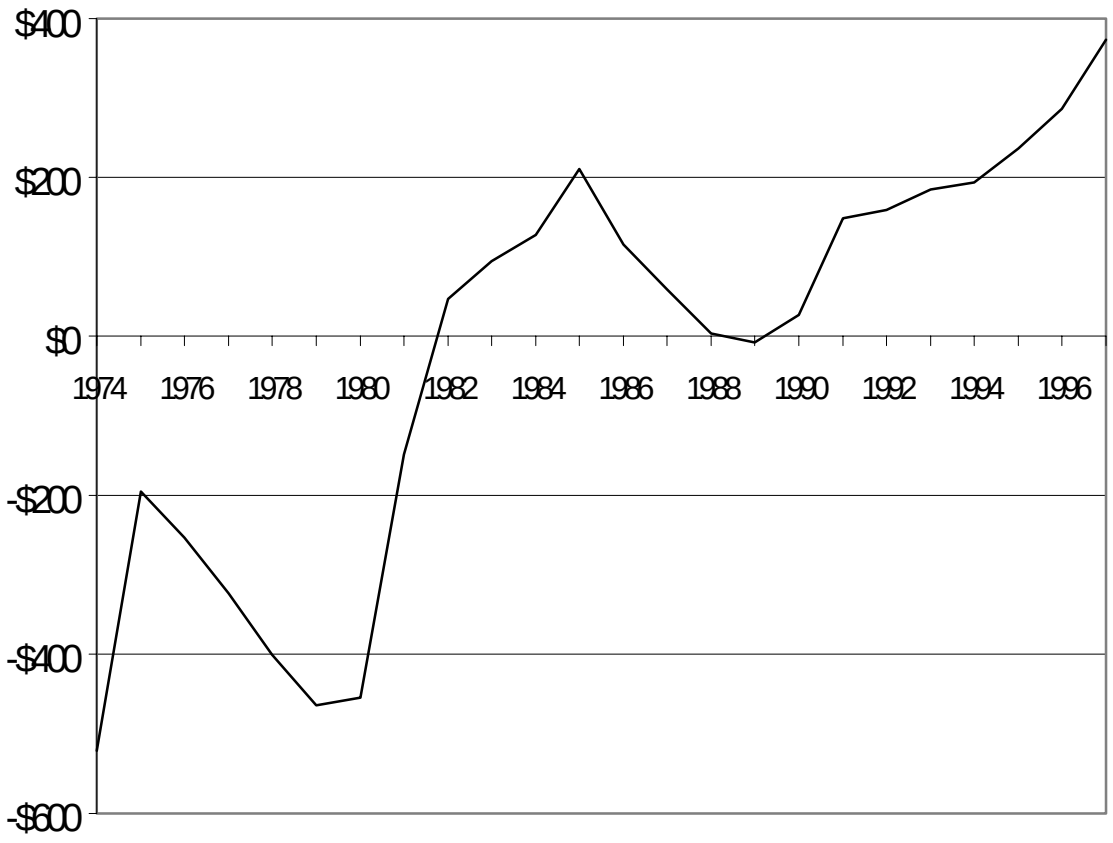


Source: Commerce Department, Internal Revenue Service and JEC Calculations (Assumes a one-year holding period and a 3% real rate of return.)

Figure 4 highlights the impact of inflation on the capital gains tax burden. For example, because of high effective capital gains tax rates, a one-year investment of $10,000 made in 1974 with a nominal return of 6 percent, resulted in a real after-tax capital **loss** of $522. The same $10,000 investment made in 1997 with the same 6 percent nominal return resulted in a real after-tax capital **gain** of $374.

FIGURE 4

DECLINING INFLATION AND LOWER STATUTORY CAPITAL GAINS TAX RATES HAVE COMBINED TO INCREASE REAL AFTER-TAX GAINS ON A $10,000 INVESTMENT



Source: Commerce Department, Internal Revenue Service and JEC calculations (Assumes a one-year holding period and a 6% nominal rate of return.).

That change represents a real, net after-tax difference of $896 on a $10,000 investment for the same 6 percent nominal rate of return. Nonetheless, this example shows that even such a one-year investment made in 1997, with a nominal return of 6 percent, yielded a real, after-tax return of less than 4 percent. Inflation, taxes, and taxes on inflation combined to rob investors with this investment profile of more than one-third of their original nominal return. Therefore, further tax rate reductions and particularly indexing gains for inflation are necessary steps to continue this positive pattern of declining real capital gains tax rates and maintain the technological explosion in the US.

By eliminating the tax on illusory inflation gains, indexing gains for inflation would remove the worst aspect of this detrimental tax on capital. This policy would improve efficiency and unlock billions of dollars worth of assets. It would increase fairness and directly benefit low and middle-income taxpayers, and especially the elderly.

Federal Reserve Board Chairman Alan Greenspan, who, as previously noted, has advocated completely abolishing the capital gains tax, has also supported indexing gains for inflation. When asked to prioritize between lowering the statutory tax rate and indexing gains for inflation, Chairman Greenspan responded as follows:

> Actually I'd go to indexing. And the reason I would is that it's really wrong to tax a part of a gain in assets which are attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So for the government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate. I would therefore say, that at a minimum, indexing capital gains at least eliminates that problem.[30]

Indexing gains for inflation would not be difficult and would provide considerable advantages over the present system. Some critics maintain that the policy would pose administrative problems. However, this argument has no merit. Since England and Australia have already indexed gains for inflation, successful examples exist showing that any such difficulties are surmountable.

Indexation would eliminate the indefensible practice of taxing illusory gains. Moreover, the policy would likely provide the government with an incentive to limit inflation. At a minimum, ending the unfair and destructive tax on inflation and indexing gains for inflation would stop the practice of rewarding a government that fostered inflation. In summary, by lowering effective capital gains tax rates, the policy of indexing gains for inflation would increase tax fairness, encourage investment, decrease the degree of the lock-in effect, improve economic efficiency, and stimulate greater economic growth.

---

[30] Alan Greenspan, Testimony before the Senate Banking Committee, February 25, 1997.

Taxpayers' Responsiveness to Capital Gains Tax Rates

Lock-in Effect

One way that capital gains taxes cause economic inefficiency is by inducing people to retain appreciated assets that they would otherwise sell absent the tax – the "lock-in" effect. People defer realizing gains for as long as it is beneficial to avoid the tax consequences of that action. In fact, for assets held until death, the tax code forgives any gain that is not subject to estate – "death" – taxes. High capital gains tax rates, therefore, prevent economically desirable and productive activity.

Unlike most other types of federal taxation, the capital gains tax is largely a voluntary tax. Many investors have substantial control regarding when, and even if, they will realize capital gains. Taxpayers owe the tax only after they sell an appreciated asset, and, consequently, can avoid incurring the tax by keeping the asset for as long as it is worthwhile to do so. The CBO has acknowledged that people act in this fashion. "Taxpayers can usually exercise considerable discretion over when to sell an asset and realize a gain. Because taxes on capital gains are only levied when a gain is realized, all investors have an incentive to postpone realizing gains."[31]

The lock-in phenomenon occurs, because the capital gains tax prevents investors from selling assets that they would exchange if it were not for the tax, thus precluding them from using the proceeds to fund new startup ventures. Because of this incarceration of capital in old investments, the capital gains tax is inefficient and retards economic growth. It leads investors to make decisions for tax reasons instead of for underlying economic factors. By liberating currently locked-in gains, unleashing a torrent of realizations, and diminishing the extent of this detrimental phenomenon in the future, lowering capital gains tax rates and indexing gains for inflation would increase efficiency and improve long-term economic growth.

The enormous value of unrealized capital gains reveals the extent of the lock-in effect. By one calculation, on average "only 3.1 percent of the stock of accrued gains was realized in any given year during the 1960-1984 period."[32] Moreover, some studies suggest that more than $7.5 trillion exist in unrealized capital gains. Therefore, lowering capital gains tax rates and indexing gains for inflation could "unlock" hundreds of billions of dollars of tied up assets.[33] For example in 1996, by one assessment, there was approximately $3.5 trillion in unrealized capital gains just in common stocks, excluding mutual funds and pensions.[34] With the dramatic rise in stock prices since 1996, even

---

[31] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 10.

[32] Robert Gillingham, John S. Greenlees, and Kimberly D. Zieschang, "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross-Section Data," Department of Treasury OTA Paper 66, May 1989, P. 29.

[33] Jude Wanniski, Testimony before the Senate Finance Committee, March 15, 1995.

[34] Lawrence Lindsey, "Irrational Exuberance And the Budget," *The Wall Street Journal*, July 24, 1997.

with the tremendous surge in capital gains realizations since the 1997 tax cut, that locked-in amount has increased to at least $4 trillion and probably more than $5 trillion. By freeing locked-in assets such as these, lowering capital gains tax rates and indexing gains for inflation would increase economic efficiency while substantially expanding the tax base. Investors would invest this emancipated capital in new companies, creating more jobs, developing innovative goods and services, and spurring greater economic expansion.

Rates, Realizations and Tax Revenues

The correct policy goal concerning capital gains tax rates is to remove artificial, government-imposed barriers to economic growth, not to maximize government revenue. However, capital gains tax rates have some effect on the federal budget. People respond to capital gains tax rates, with high rates preventing desirable exchanges and retarding economic growth. In contrast, lower tax rates on capital gains increase economic activity. This relationship affects the federal budget beyond the narrow scope of the revenue directly raised from capital gains taxes in addition to influencing capital gains tax revenue.

Many analysts, including some who recognize that lower capital gains tax rates would stimulate more economic activity, mistakenly only focus on the revenue directly generated from taxes on capital gains. They fail to consider that greater economic growth resulting from lower capital gains tax rates would increase tax revenues from other sources – corporate taxes, personal income taxes, payroll taxes, etc. – and also decrease government expenditures – unemployment, welfare, etc. Any such "static" evaluation of the budgetary implications of a reduction in capital gains tax rates that does not include these effects on other taxes and expenditures is incomplete and flawed.

When assessing the budgetary effects of any cut in capital gains tax rates, it is an egregious mistake to look at only the change in revenue generated solely from capital gains taxes. Unfortunately, most forecasters, especially those in official government agencies, commit this error. A more thorough "dynamic" analysis considers these other tax consequences resulting from greater economic activity.

The sensitivity of both capital gains realizations and tax revenue to changes in tax rates illustrates the taxpayer responsiveness to capital gains tax rate changes. As Table 3 reveals, because investors have discretion over when and even whether to pay the tax, high tax rates discourage realizations (the lock-in effect already discussed). Furthermore, lower rates stimulate economic growth leading to even greater realizations. Finally, cutting rates increases asset values by increasing their after-tax value and increasing demand for them by other investors. When owners of these assets sell them at their appreciated levels, realizations rise.

TABLE 3

CAPITAL GAINS REALIZATIONS IN CURRENT AND CONSTANT DOLLARS: 1994-1997

	Top Marginal Rate Applicable to Ordinary Capital Gains Gains	Current Dollar Realizations* (Amount Included in AGI is in parenthesis)**		Constant Dollar Realizations* (Amount Included in AGI is in parenthesis)**	
1974	35.0	30.2	(15.4)	78.5	(40.0)
1975	35.0	30.9	(15.8)	73.4	(37.5)
1976	35.0	39.5	(20.2)	88.7	(45.3)
1977	35.0	45.3	(23.4)	95.5	(49.3)
1978	33.8	50.5	(26.2)	99.2	(51.5)
1979	28.0	73.4	(31.3)	132.9	(56.7)
1980	28.0	74.1	(32.3)	122.8	(53.5)
1981	23.7	80.9	(34.7)	122.6	(52.6)
1982	20.0	90.2	(38.5)	128.5	(54.9)
1983	20.0	122.8	(52.4)	167.9	(71.6)
1984	20.0	140.5	(58.9)	185.1	(77.6)
1985	20.0	172.0	(72.1)	219.0	(91.8)
1986	20.0	327.7	(135.0)	406.7	(167.5)
1987	28.0	148.4		178.7	
1988	28.0	162.6		188.9	
1989	28.0	154.0		171.6	
1990	28.0	123.8		132.3	
1991	28.0	111.6		114.7	
1992	28.0	126.7		126.7	
1993	28.0	152.3		148.4	
1994	28.0	152.7		145.3	
1995	28.0	180.1		167.5	
1996	28.0	260.3		237.7	
1997	20.0	370.0		331.6	

Source: Internal Revenue Service, Statistics of Income Tax Returns (various years) and SOI Bulletin (various issues). The GDP Price Deflator was used to convert the current dollar data to constant 1992 dollars.

* Amounts in Billions of US Dollars.

** Prior to 1987, only a portion of long-term capital gain was included in AGI. During 1975-77, 50 percent of the long-term capital gains was included in AGI. That figure was reduced to 40 percent in1979 and remained at that level through 1986.

The combination of these effects causes cuts in capital gains tax rates to increase both realizations and tax revenue. A comprehensive study by the US Department of Treasury Office of Tax Analysis (OTA) concluded the following:

> [W]e find strong evidence of responsiveness to capital gains tax rates…[The analyses] show that the marginal tax rate on long-term gains has a significant and powerful negative impact both on the proportion of taxpayers realizing gains and on the value of capital gains declared by realizers…[T]he data continue to imply that the realizations response would be sufficient to **yield revenue increases from capital gains rate reductions**.[35] [Emphasis added]

Additional evidence shows that capital gains realizations are inversely related to capital gains tax rates. Gwartney and Holcombe estimate that the response of taxpayers to rate reductions is approximately one to one. This finding means that for every one percent drop in capital gains tax rates, capital gains realizations would increase by roughly one percent. Their study suggests that cutting the maximum capital gains tax rate from 20 percent to 15 percent (a 25 percent reduction in the top rate) would cause a rise in realizations of approximately 25 percent. Under the most conservative assumptions, the outcome would result in a negligible decrease in tax revenue. Less pessimistic assumptions imply no revenue loss at all or a revenue increase. More importantly, lowering capital gains tax rates would foster greater economic activity and would improve economic efficiency.[36]

Figure 5 shows that lower rates lead to increased realizations, and higher rates reduce them. After the 1986 capital gains tax rate increase became effective in 1987, inflation-adjusted realizations did not surpass their 1985 level ($219 billion) until 1996 ($237.7 billion). This decade-long stagnation in real gains occurred despite the substantial economic growth and record appreciation of assets during that period. For example, in real terms (after adjusting for inflation) from 1985 to 1996, the economy grew by more than 30 percent. In real terms during that time period, the Dow Jones Industrial Average roughly **tripled** in value! At the same time, the rise in inflation-adjusted realizations from $219 billion to $237.7 billion represented less than a 10 percent increase.

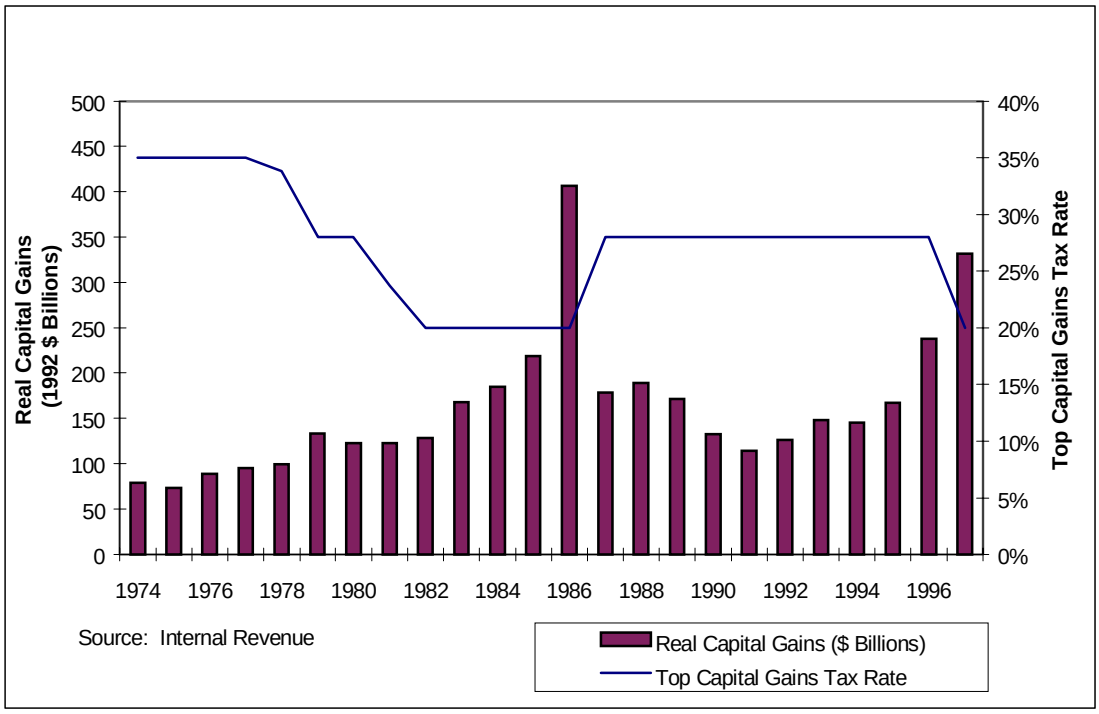
The most clear and convincing evidence of people's sensitivity to capital gains tax rates was the 1986 surge in realizations prior to the effective date of the tax increase. The enormous spike in realizations in 1986 occurred, because people sought to avoid higher capital gains tax rates in 1987. This tax increase severely depressed realizations for several years beginning in 1987.

---

[35] Gillingham, Greenlees, and Zieschang, P. 27.
[36] Gwartney and Holcombe, Pp. 5-7.

FIGURE 5

TAX RATES AND REAL CAPITAL GAINS REALIZATIONS: 1974-1997

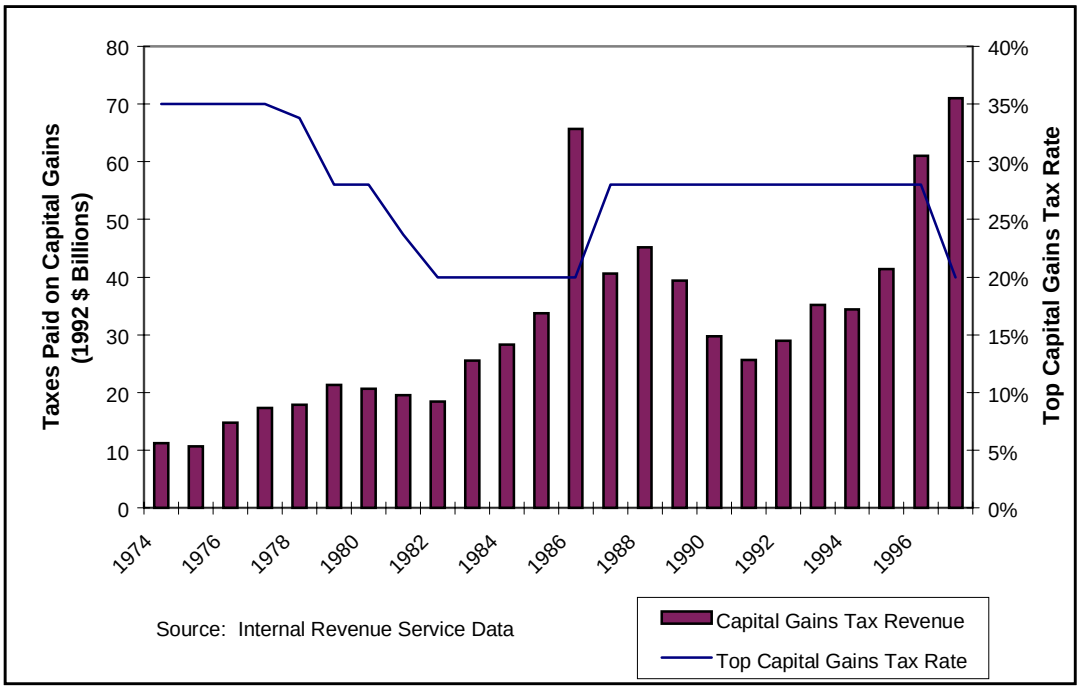


The astonishing escalation in realizations since the 1997 cut in capital gains tax rates provides the most recent example of lower capital gains tax rates unleashing a flood of capital gains realizations. There were $260 billion (current dollars) in realizations in 1996 before the tax cut. The decrease in the top capital gains tax rate from 28 percent to 20 percent prompted realizations to soar to roughly $370 billion (current dollars), an astounding 40 percent increase in just one year. This trend is likely to continue. Even the CBO forecasts that realizations for 1998 were higher still – $418 billion (current dollars). This rise represents more than another 10 percent increase compared to 1997, and, amazingly, over a 60 percent jump from the 1996 pre tax cut level.

Figure 6 illustrates the relationship between tax rates and capital gains revenues. Because lower capital gains tax rates bring about a surge in realizations, they also have historically produced greater government tax revenue. Higher capital gains tax rates have had the opposite effect. They have decreased real tax revenue. Despite the significant economic growth and tremendous asset appreciation since 1985, real tax revenue from capital gains in 1994 ($34.4 billion) was almost the same as it had been in 1985 ($33.7 billion).

FIGURE 6

TAX RATES AND REAL CAPITAL GAINS TAX REVENUE: 1974-1997



The 1997 tax cut furnishes the most recent example of lower capital gains tax rates increasing tax revenue. The DRI study by David Wyss concludes that over 12 years the 1997 legislation will **increase** tax revenue. The rise in asset prices and the more rapidly growing economy resulting from the cut in capital gains tax rates are the main sources of the increase in tax revenue. Wyss draws the following conclusions. "The primary contributor to higher tax revenues is the rise in asset values…. The impact is clear…. Over the 12-year period, the stronger growth adds $87 billion (1997 dollars) to federal tax receipts."[37]

The 1997 tax cut increased asset values, enhanced productivity, and **increased tax revenue.** In 1996 capital gains tax revenue was $67 billion (current dollars). It increased to $79 billion (current dollars) in 1997, roughly an 18 percent surge from 1996. The CBO, notoriously low in its estimates of rising capital gains tax revenue triggered by a cut in capital gains taxes, forecasts capital gains tax revenue for 1998 at $83 billion (current dollars). This number represents a 5 percent increase over 1997 and more than a 20 percent increase over the pre-tax cut revenue of 1996. More appropriate estimates put 1998 capital gains tax revenue closer to $90 billion (current dollars), more than 10 percent above 1997 revenue and over 30 percent above the pre-tax cut baseline of 1996. Cutting capital gains tax rates further likely would continue this trend. This outcome shows that the rate that would bring in the most tax revenue (the revenue-maximizing

[37] Wyss, Pp. 4-5.

rate) is less than the present maximum rate of 20 percent. David Wyss made the following observations. "By encouraging investment and raising asset values, **the capital gains cut is perhaps the only tax cut that truly pays for itself**. By raising investment spending and productivity, the cut is a true supply-side incentive."[38] [Emphasis added]

Despite the warnings of critics at the time of the 1997 tax cut that it would decrease federal revenue, the evidence refutes those spurious claims. Now, even opponents of tax cuts do not argue that the 1997 cut lowered tax revenue. Tax cut opponent William Gale made the following admission. "The cut in capital gains taxes in the 1997 tax act has had an ambiguous impact on capital gains revenue."[39] Therefore, cutting capital gains tax rates further would either increase tax revenue or have no appreciable impact on tax revenue, especially when properly accounting for the macroeconomic effects on both increasing revenue from other taxes and decreasing government expenditures. With minimal, if any, federal budget consequences, the advantages of further lowering capital gains tax rates support enacting that policy.

The impact on the federal budget of reducing capital gains tax rates and indexing gains for inflation or even of completely eliminating the tax would be minor. Capital gains taxes represent a small component of federal budget receipts. For 1996 (the last year for which final data are available), capital gains taxes ($67 billion) comprised less than 5 percent of total federal revenues ($1,453 billion). Even the considerable rise in capital gains tax revenue since 1997 will not have substantially changed that percentage.[40]

Forecast Errors

Table 4 shows that throughout the recent history of changes in capital gains tax rates, official government economic forecasters – the Joint Committee on Taxation (JCT) and the Congressional Budget Office (CBO) – have consistently erred about the effects of those policy changes on both realizations and tax revenues. These groups have incorrectly predicted large tax revenue windfalls from increases in capital gains tax rates and considerable tax revenue losses from cuts in capital gains tax rates. They have been substantially wrong on both counts. Most importantly, these forecasters practice static rather than dynamic scoring. They ignore the increase in other tax revenue – payroll taxes, corporate taxes, and personal income taxes – that result from lower capital gains taxes spurring more economic growth.

---

[38] Wyss, P. 1.

[39] William G. Gale, Testimony before the Senate Budget Committee, January 20, 1999.

[40] If the capital gains tax were fully abolished, the federal government would still annually collect 95 percent of its total tax receipts, even assuming there were no resulting increase in other tax revenue from greater economic growth. Of course, this change would improve economic efficiency and accelerate economic growth, causing other tax revenues to rise. Therefore, this policy would leave the government with markedly more than 95 percent of its receipts, while more importantly improving the country's economy.

TABLE 4

CAPITAL GAINS REALIZATIONS/REVENUE: ACTUAL vs. CBO FORECASTS

	Long-term Realizations			Tax Revenue		
	Actual	CBO	CBO Realizations Overstatement	Actual	CBO	CBO Revenue Overstatement
1989	154.0	225.0	71.0	35.3	51.0	15.7
1990	123.8	254.0	130.2	27.8	57.0	29.2
1991	111.6	268.0	156.4	24.9	60.0	35.1
1992	126.7	287.0	160.3	29.0	65.0	36.0
1993	152.3	295.0	142.7	36.1	66.0	29.9
1994	152.7	301.0	148.3	36.2	68.0	31.8
1995	180.1	315.0	134.9	44.5	71.0	26.5
Total	***1,001.2***	***1,945.0***	***943.8***	***233.8***	***438.0***	***204.2***

Source: CBO projections are from "Statement of Kenneth W. Gideon," Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Finance, U.S. Senate, March 28, 1990, chart 3, and Internal Revenue Service.

There are several examples of these forecasting errors. When the government reduced the top tax rate on capital gains to 28 percent in 1978, the JCT predicted that revenues would fall by $6.2 billion over five years. In actuality, capital gains tax revenue rose steadily until the rate increase in 1987. When policy makers lowered the maximum rate to 20 percent in 1982, the JCT again forecast a substantial decline in revenue. However, from 1981 to 1985, tax revenue more than doubled from $12.9 billion to $26.5 billion. Alternatively, the forecasters predicted a dramatic rise in tax revenue from the rate increase effective in 1987. The actual result was the opposite of that estimate. Revenues fell sharply, revealing a large overstatement of forecasted revenues from the tax rate increase.

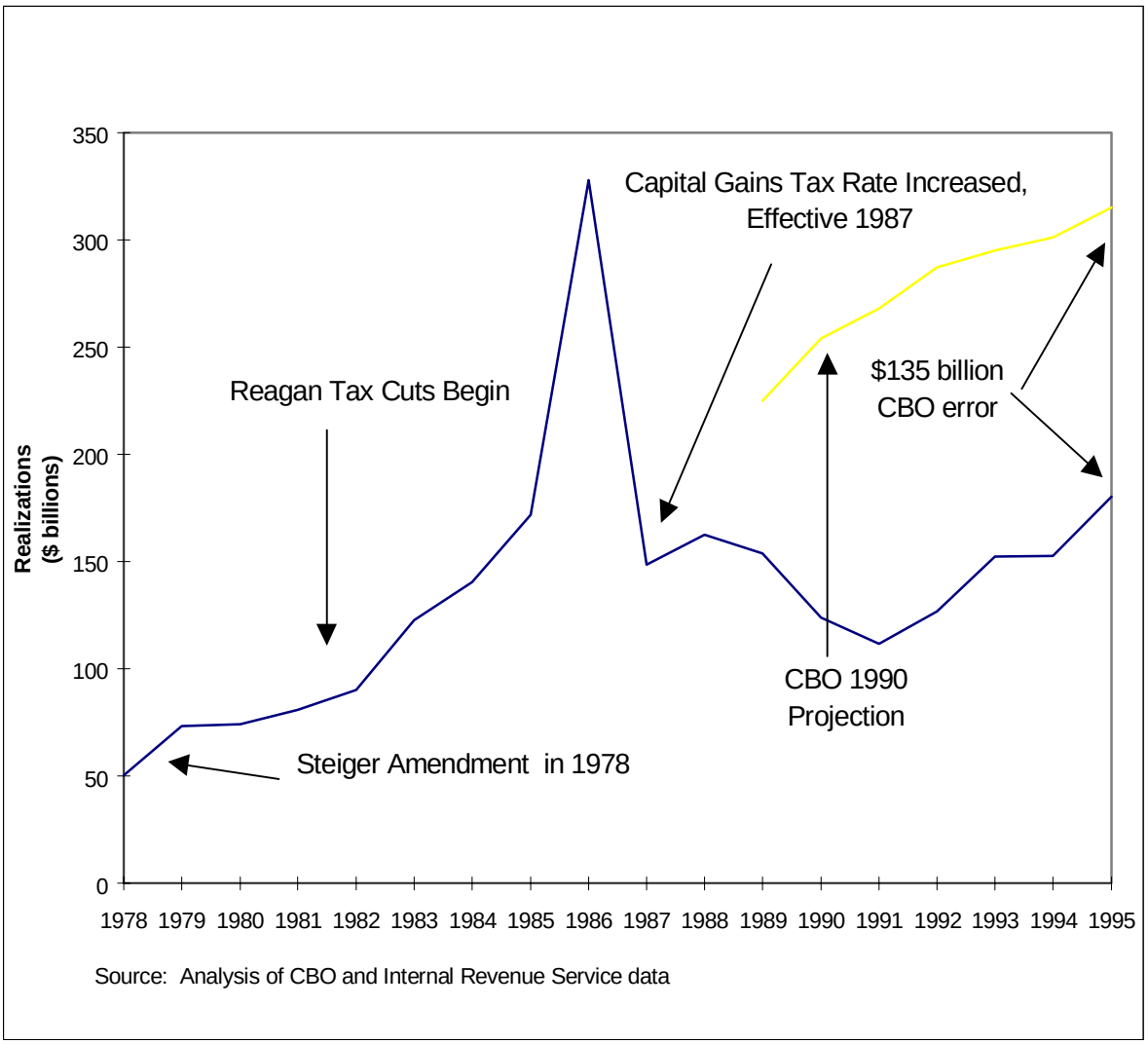
The predictions for realizations were no better than the estimates for tax revenue. In early 1990, the CBO forecast capital gains realizations of $269 billion for 1991, but actual realizations were roughly $112 billion, an error of **more than $150 billion!** As Figure 7 shows, the 1990 CBO forecast for 1995 realizations was still wrong by $135 billion. Cumulatively for the 1989-1995 period, the CBO overestimated realizations by a staggering $943.8 billion.

To date, government forecasters have not properly considered the behavioral responses to and macroeconomic implications of capital gains tax rate changes and have grossly erred when anticipating the results of those policies. Those who practice static scoring will continue to fare poorly in predicting budgetary responses to capital gains tax rate changes. The DRI study conducted by David Wyss emphasizes the need to use dynamic scoring. “The analysis indicates the importance of using dynamic rather than

static analysis in analyzing tax packages."[41] History shows that lowering rates leads to more realizations and greater tax revenue, and increasing rates effects the opposite results. This hard, empirical evidence – not outdated and disproved theoretical models – should serve as the guide for future policy considerations.

FIGURE 7

CAPITAL GAINS REALIZATIONS, TAX RATES & CBO FORECAST ERRORS



[41] Wyss, P. 5.

Beneficiaries of Lower Capital Gains Tax Rates

Much of the debate surrounding capital gains taxes frequently focuses on the issue of who would benefit from lowering rates and indexing gains for inflation. Critics of these policies argue that they would almost exclusively help the "wealthy." While it is certainly true that high-income taxpayers would be better off with these changes, that conclusion is simplistic and incomplete. A more thorough analysis shows that for a variety of reasons cutting rates and indexing gains for inflation would improve the welfare of citizens at all income levels.

The Elderly

Capital gains taxes impose a heavy cost on the elderly, because "bunching" – when taxpayers realize a large, long-term gain relative to their average annual income – is most common for those entering retirement. The elderly realize a high percentage of capital gains on assets they have held for many years and sell in order to finance retirement. The CBO concluded the following:

> Older people account for a disproportionately larger share of realized capital gains and the taxes paid on capital gains. People 65 years old and older made up 12 percent of all taxpayers in 1993, but they realized 30 percent of total net capital gains and paid 30 percent of the tax on capital gains. Taxes on capital gains accounted for 7 percent of the income taxes paid overall, but 18 percent of the taxes paid by those 65 years old and older and 5 percent of the taxes of those under 65.[42]

Lowering capital gains tax rates and indexing gains for inflation would dramatically benefit those 65 and over, because high effective capital gains tax rates adversely affect the elderly, not the "wealthy." People 65 and older who have held assets for a long time, including during the high inflation rate periods of the 1970s, face extraordinarily high real capital gains tax rates. As discussed earlier, in many cases a large portion of the nominal gains of these assets comes from inflation. Taxing nominal gains means imposing a tax on these phantom inflation gains.

Indexing gains for inflation would eliminate this discriminatory practice and unlock billions of dollars in assets held by the elderly who otherwise might opt to pass them at death to their heirs in order to completely avoid capital gains taxes. Inflation has a bigger impact on capital gains for the elderly than for others, because, as the CBO observed, "[T]he elderly are more likely to realize losses after adjustment for inflation."[43] Indexing gains for inflation would address this unfairness and provide substantial relief for the elderly. Finally, by enhancing economic growth, lowering capital gains tax rates

[42] CBO, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 3.
[43] CBO, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 31.

and indexing gains for inflation would help the elderly in the future. These changes would improve people's ability to save for retirement and increase the resources available to address the health and retirement needs of the aging population in the future.

Economic Growth, Workers, and Those with Low Incomes

Greater economic growth helps people across the income spectrum. Rather than the issues of budgetary effects or of how much certain people benefit, the proper subject of the policy debate should be how to improve efficiency and enhance economic expansion. Reducing capital gains tax rates and indexing gains for inflation would stimulate more business activity, thereby helping workers by increasing real wages and creating more jobs. David Wyss, Research Director for DRI, observed that, "The capital gains cut helps most people and hurts no one."[44]

By spurring job creation and causing increases in real wages, lowering capital gains tax rates and indexing gains for inflation would help non-investors and those without high incomes. Before the 1997 tax cut, two former Treasury economists, Gary and Aldona Robbins, estimated that that policy would create 720,000 new jobs by the year 2000.[45] By increasing capital investment and, thus, raising worker productivity, lowering capital gains tax rates and indexing gains for inflation would increase real wages over the long term, because wages rise with greater productivity.

High effective capital gains tax rates hurt low-income people, because investing in stocks or in business is one of the few ways they can accumulate wealth. Economist Jude Wanniski observed the following: "When the government puts a high tax on capital gains, the people who lose the most from a high rate are the poorest, the youngest, those at the beginning of their careers, those who are furthest from the sources of capital…. The people who ultimately benefit from a capital gains tax cut are those who have no wealth, but aspire to it." [46] Therefore, the tax most severely hurts those trying to create wealth, not those who already have it.

The Middle Income

Many people who do not have high annual incomes pay capital gains taxes. A May 1997 CBO study notes the following. "It is not true, however, that most people who have taxable capital gains have high incomes. Nearly two-thirds of tax returns reporting capital gains are filed by people whose incomes are under $50,000 a year."[47]

---

[44] David Wyss, Testimony before the House Committee on Ways and Means, March 19, 1997.
[45] Gary and Aldona Robbins.
[46] Jude Wanniski, Testimony before the Senate Finance Committee, February 15, 1995.
[47] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 2.

People without high annual incomes also realize a substantial portion of the dollar amount of capital gains and would directly benefit from a reduction in rates and indexation for inflation. Many people mistakenly suggest that those in the highest income brackets would receive nearly all of the dollar savings from such policies. By relying on income data that include the one-time capital gain, this method artificially raises annual incomes and labels almost everyone "wealthy" who has a substantial capital gain in any specific year. As Table 5 and Figure 8 illustrate, people with annual incomes (excluding capital gains) under $75,000 paid nearly half of the capital gains taxes. Moreover, Table 5 and Figure 9 show that people with annual incomes of less than $50,000 accounted for nearly 40 percent of the capital gains tax revenues.

TABLE 5

DISTRIBUTIONAL SHARE OF CAPITAL GAINS TAXES PAID

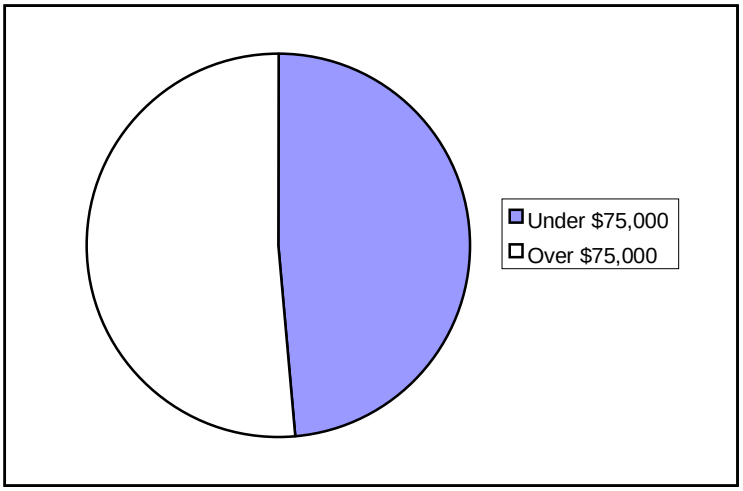
Distributional Share of Capital Gains Taxes Paid

Regular Income Before Claiming Capital Gains	Percent of Filers Who Declare Capital Gains	Cumulative Percentage	Percent of Total Value of Capital Gains	Cumulative Percentage
Under $30,000	41.18%	41.18%	29.83%	29.83%
$30,000 to $39,999	11.12%	52.31%	5.25%	35.08%
$40,000 to $49,999	9.28%	61.59%	4.63%	39.72%
$50,000 to $74,999	17.42%	79.01%	8.77%	48.49%
$75,000 to $99,999	8.67%	87.68%	6.01%	54.50%
Over $100,000	12.32%	100.00%	45.50%	100.00%

Source: The Heritage Foundation calculations; based on IRS Public Use File for 1993.

FIGURE 8

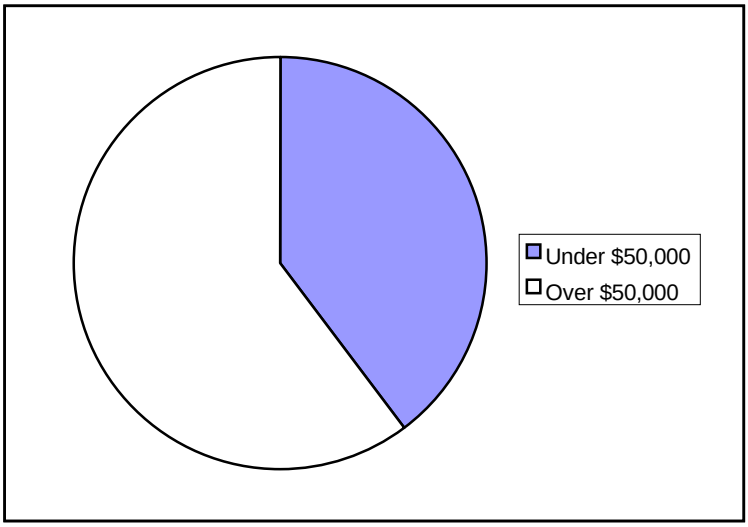
SHARE OF CAPITAL GAINS TAXES PAID BY THOSE WITH ANNUAL INCOME LESS THAN $75,000



Source: The Heritage Foundation calculations: based on IRS Public Use File for 1993.

FIGURE 9

SHARE OF CAPITAL GAINS TAXES PAID BY THOSE WITH ANNUAL INCOME LESS THAN $50,000



Source: The Heritage Foundation calculations: based on IRS Public Use File for 1993.

For many taxpayers large capital gains are rare and not part of their usual annual income flow. This situation reflects the bunching phenomenon described earlier. Incorporating capital gains in the income calculation gives the false impression that those numbers reflect people's normal annual incomes. Excluding capital gains reveals that people with usually middle-class incomes realize a significant amount of capital gains. The CBO acknowledges this flaw with annual data. "The disadvantage [of using yearly IRS returns] is that annual 'snapshots' can be misleading. For example, a taxpayer of modest income who sells a business may appear to have a very high income in that year."[48]

To a greater extent than they have previously, lower and middle-income people are investing in the stock market and are, therefore, subject to capital gains taxes. According to a 1997 survey released by the NASDAQ Stock Market, more than 40 percent of adult Americans owned stocks, double the percentage in 1990. According to the Federal Reserve Board's 1995 Survey of Consumer Finance, roughly 55 percent of shareholders have annual incomes of less than $50,000. Moreover, that survey found that nearly half of households with annual incomes between $25,000 and $50,000 owned some stock.[49]

Many of these middle-income taxpayers invest through mutual funds which, by law, must make annual capital gains distributions on which the investors have to pay taxes. In 1988 the amount that mutual funds paid in capital gains to shareholders, excluding institutional investors, represented just 3 percent of the total amount of capital gains. By 1994 that number had risen to 13 percent. With the continued dramatic proliferation of mutual fund ownership, that figure now is likely to be still higher.[50] Even if they have the desire or financial resources to forego these gains, mutual fund investors have almost no discretion over the timing of capital gains realizations. Moreover, middle-income taxpayers are unlikely to have substantial other financial resources to provide them with flexibility regarding the timing of any capital gains realizations. Therefore, middle-income taxpayers, especially those who invest in mutual funds, have limited ability to delay realizing capital gains and, consequently, paying taxes on those gains.

The Upper Income

Compared to people at other income levels, those in the upper-income brackets, and particularly those with the highest incomes, have greater flexibility and resources to minimize capital gains taxes that they pay. The CBO concluded the following: "In general, taxpayers have more of an incentive to postpone or avoid realizing capital gains if they face higher tax rates on realizations, have larger accrued gains, or are more likely

[48] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 10.
[49] Donald Lambro, "Bullish on the Future," *The Washington Times*, March 5, 1998, P. A16.
[50] Diana B. Henriques and Floyd Norris, "Rushing Away From Taxes," *The New York Times*, December 1, 1996.

to leave an inheritance. Another consideration is the ability of asset holders to defer income from gains. Those who have relatively little income from other sources are likely to find it harder to postpone realizations."[51]

In contrast to people with low and middle incomes, high-income investors are less likely to use mutual funds and are better able to minimize and even legally avoid paying capital gains taxes. Gwartney and Holcombe concluded that the reaction to the 1987 capital gains tax rate increase shows that those with upper incomes are particularly sensitive to capital gains tax rates and are extremely prone to lock-in gains.

> **Measured in constant dollars, the capital gains realized by both the top 1 percent and top 5 percent of income recipients in 1994 were only three-fifths (61 percent) of their 1985 level. This reduction in capital gains realizations came during a decade when rising incomes, and especially rising equity values in the stock market, should have led to sharply higher capital gains. However, the higher tax rate provided a disincentive for the realization of the capital gains.**[52] [Original emphasis]

Particularly during the last ten to fifteen years, leading Wall Street financial institutions have developed and successfully marketed many complex financial instruments to help those with the highest incomes limit their capital gains tax liabilities. Those at other income levels obviously do not have the resources to achieve these ends. Economists of divergent philosophies have observed this phenomenon. According to David Bradford, an economist at Princeton University, "The simple fact is that anyone sitting on a big pot of money probably isn't paying capital gains taxes…. And the Government can adopt rule after rule – but the people who will get stuck paying capital gains taxes will be ordinary investors who own mutual funds."[53] William Gale, of the Brookings Institution, echoed Bradford's sentiments. "How fair is a tax that the wealthy can apparently avoid but the middle class gets stuck with? I don't see any fairness in that."[54]

High capital gains tax rates give people the incentive to find legal methods to avoid incurring those taxes. Those with the means and resources to achieve that end will do so, because intelligent financial minds will continually devise and sell financial products to help upper-income people accomplish that goal. Gale observed the following: "In a world where the distinctions between financial instruments are blurred, or where different instruments are combined in new ways, the practitioners of financial engineering will always be a step – or, more likely, a mile – ahead of the regulators."[55]

---

[51] CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," P. 11.
[52] Gwartney and Holcombe, P. 13. As both Figures 5 and 7 show, capital gains realizations declined sharply following the 1986 rate increase. The Gwartney-Holcombe analysis illustrates the primary reason for this fall was a sharp reduction in realizations by high-income taxpayers.
[53] Henriques and Norris.
[54] Henriques and Norris.
[55] Henriques and Norris.

Lowering capital gains tax rates and indexing gains for inflation would unlock billions of dollars of assets held by high-income taxpayers and diminish the relative benefit to these people of avoiding the tax through complicated financial structures. Such policies would result in greater capital gains taxes paid by these taxpayers. Additionally, the portion of capital gains taxes paid by upper-income taxpayers would rise.

In 1988 the CBO concluded that the share of total capital gains tax revenue paid by high-income taxpayers decreases when the tax rate is high and increases when the rate is low. The portion of gains realized by upper-income groups fell when total gains were declining or stable and increased when gains were rising significantly. When the maximum tax rate was roughly 27 percent in 1968, the top 1 percent of income earners accounted for 50 percent of realized long-term gains. That number fell to only 33 percent between 1975 and 1978, when the top tax rate was approximately 49 percent. That figure dramatically rose to roughly 55 percent between 1982 and 1985 after the government cut the maximum capital gains tax rate to 20 percent.[56]

Those who argue that reducing capital gains tax rates and indexing gains for inflation would cause a large windfall for high-income taxpayers ignore history. Such policies would markedly change the behavior of people. This phenomenon is particularly true for those people with high incomes, because they are extremely sensitive to changes in marginal capital gains tax rates.

[56] CBO Paper, "How Capital Gains Tax Rates Affect Revenue: The Historical Evidence," March 1988, P.xiv.

Conclusion

- Economic growth is the proper focus for the evaluation of capital gains taxation. Rather than attempting to maximize the revenue from capital gain taxes, policy makers should seek to promote economic growth.

- Lower capital gains taxes promote economic growth by (a) stimulating savings and reducing the cost of capital, (b) encouraging new business start-up firms and other entrepreneurial activity, and (c) increasing the prices of stocks and other assets. These factors are particularly important in high-technology fields. The current tax code favors consumption over investment. The multiple taxation of returns to investment retards both innovation and growth.

- The optimal tax rate – the rate that maximizes economic growth – is always less than the revenue-maximizing rate. The empirical evidence indicates that the revenue-maximum capital gains tax rate is approximately 15 percent. Thus, the optimal tax rate for capital gains has to be less than 15 percent.

- The current system taxes phantom gains that reflect inflation. In many cases, inflation results in tax rates that exceed 100 percent of real capital gains. These exorbitant rates are grossly unfair and exacerbate the lock-in effect. Indexing capital gains for inflation would be the single most powerful and effective policy to reduce inefficiency, while increasing both savings and tax fairness.

- Contrary to the conventional wisdom, the primary beneficiaries of lower capital gains tax rates and indexation of capital gains would be the elderly along with low and middle-income taxpayers. Because they often sell assets that they have worked their entire lives to develop, the elderly realize a large share of the total capital gains realizations and, therefore, pay a large share of capital gains taxes. Compared to those with higher incomes, low and middle-income taxpayers possess less financial flexibility, and, consequently, have less ability to adjust their investments in order to reduce capital gains tax liabilities.

Prepared by Lawrence Whitman, Senior Economist to the Chairman, (202) 224-0376.

References

Blinder, Alan S. "The Level and Distribution of Economic Well-Being." *The American Economy in Transition*, edited by Martin Feldstein (Chicago: University of Chicago Press, 1980).

CBO Paper, "How Capital Gains Tax Rates Affect Revenue: The Historical Evidence." March 1988.

CBO Paper, "Indexing Capital Gains." August 1990.

CBO Paper, "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains." May 1997.

DRI/McGraw Hill, "The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks." April 1997.

Feldstein, Martin and Joel Slemrod. "Inflation and the Excess Taxation of Capital Gains on Corporate Stock." *National Tax Journal*, 31, June 1978.

Gale, William G. Testimony before the Senate Budget Committee. January 20, 1999.

Gillingham, Robert John S. Greenlees, and Kimberly D. Zieschang. "New Estimates of Capital Gains Realization Behavior: Evidence from Pooled Cross- Section Data." Department of Treasury OTA Paper 66, May 1989.

Gompers, Paul A. and Josh Lerner, "What Drives Venture Capital Fundraising?" NBER Working Paper 6906, January 1999.

Greenspan, Alan. Testimony before the Senate Banking Committee, February 25, 1997.

Gwartney, James D. and Randall G. Holcombe, "Optimal Capital Gains Policy: Lessons from the 1970s, 1980s and 1990s." Joint Economic Committee Study, June 1997.

Henriques, Diana B. and Floyd Norris, "Rushing Away From Taxes." *The New York Times*, December 1, 1996.

Jorgenson, Dale. *Postwar US Economic Growth*, Vol. 1 of *Productivity* (Cambridge, Mass: MIT Press, 1995).

Judd, Kenneth. "The Optimal Tax Rate for Capital Income is Negative." NBER Working Paper 6004, April 1997.

Lambro, Donald. "Bullish on the Future." *The Washington Times*, March 5, 1998.

Lang, Mark H. and Douglas A. Shackelford. "Capitalization of Capital Gains Taxes: Evidence From Stock Price Reactions to the 1997 Rate Reduction." Working Paper No. W6885, National Bureau of Economic Research, January 1999.

Lindsey, Lawrence. "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions." *National Tax Journal*, September 1987.

Lindsey, Lawrence. "Irrational Exuberance And the Budget." *The Wall Street Journal*, July 24, 1997.

"New Entrepreneurs Appear Vital to Healthy Economic Growth," *The Wall Street Journal*, June 24, 1999, Business Bulletin, P. A1.

Robbins, Gary and Aldona Robbins. "Putting Capital Back to Work for America." Institute for Policy Innovation Working Paper, no. 134, May 1994.

Schmalbeck, Richard. "The Uneasy Case for a Lower Capital Gains Tax." *Tax Notes*, July 9, 1990.

Sinai, Allen. Testimony before the House Ways and Means Committee. January 24, 1995.

Sinai, Allen. Testimony before the Senate Finance Committee. March 13, 1997.

Wanniski, Jude. Testimony before the Senate Finance Committee. February 15, 1995.

Wanniski, Jude. Testimony before the Senate Finance Committee. March 15, 1995.

Wyss, David. Testimony before the House Committee on Ways and Means. March 19, 1997.

Wyss, David. "Capital Gains Taxes and the Economy: A Retrospective Look." Standard & Poor's DRI, June 1999.