



Joint Economic Committee

Republicans

Senator Sam Brownback *Ranking Member*
Representative Kevin Brady *Senior House Republican*

Republican Staff Commentary

The Rationale for Low Capital Gains Tax Rates

November 16, 2010

Historically, both income and capital gains taxes have fluctuated significantly, but capital gains rates have generally been lower than regular income tax rates.

“Arguments for lower tax rates on gains are that they promote saving and investment and channel more resources into new ventures. In addition, a preferential rate on nominal gains provides a rough adjustment for the fact that some gains reflect inflation instead of real increases in purchasing power.”ⁱ

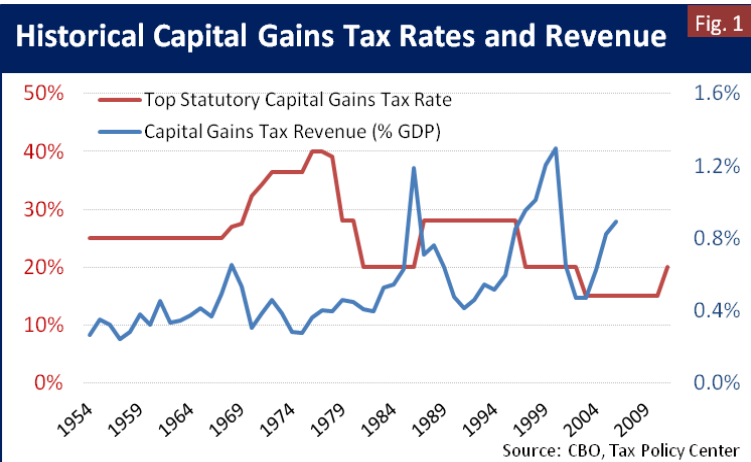
--Congressional Budget Office

Policymakers have chosen to tax capital gains at lower rates than wages for a number of reasons, including:

- Recognition of the positive effects investment has on productivity, output, employment, and wages and a desire to minimize tax-induced investment deterrence.
- The inflationary erosion of capital gains such that a potentially large portion of any capital gain reflects inflation, rather than a real increase in purchasing power.
- A desire to maintain an efficient allocation of capital by minimizing the lock-in effect (whereby taxes prevent or postpone asset sales) as well as other, primarily tax-induced actions.

Timing and Avoidance Limit Government’s Control of Capital Gains Taxes

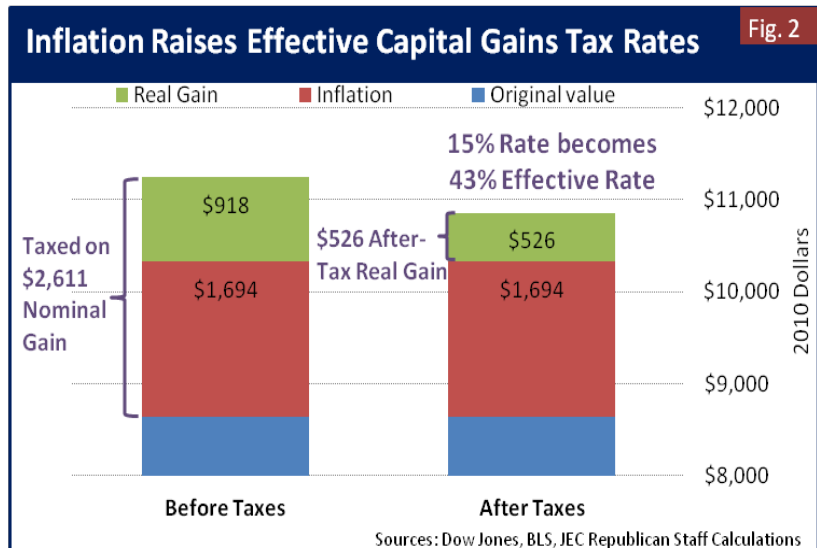
Compared to ordinary income taxes, investors have a much higher degree of control over the taxes they pay on capital gains. Capital gains taxes are due only after an asset is sold, so investors can choose when to sell their assets and when to pay taxes. Additionally, investors have the ability to offset capital gains and the taxes owed on them by selling assets with capital losses. To avoid capital gains taxes altogether, investors can choose not to sell their assets at all, but rather to donate them to charity or pass them on through bequests which escape capital gains taxes. As taxes rise, so too will the proportion of capital that avoids taxation through bequests or charitable donations.



Decisions on investment in capital gains and the timing of capital gains realizations are highly sensitive to changes in tax rates. As Figure 1 shows, revenues from capital gains taxes have not gone hand-in-hand with tax rates. Rather, higher capital gains tax rates have generally corresponded with lower capital gains tax revenues and lower capital gains rates have corresponded with higher tax revenues.

Inflation Erodes Gains, Resulting in Higher Effective Tax Rates

In part due to a desire to simplify tax calculations, capital gains are taxed on the nominal gain, rather than the inflation-adjusted gain. The lower rates on capital gains are meant, in part, to reflect the fact that a significant portion—perhaps all—of capital gains are likely due to inflation. As inflation raises the nominal price of assets over time, the effective tax rate on real capital gains can be much higher than the stated rate. For example, if an individual invested \$10,000 in the Dow Jones Industrial Average on January 2, 2003 and sold this investment on November 1, 2010, he would have gained \$2,611 in nominal terms.ⁱⁱ Of this, \$1,694 would be due to inflation and \$918 to real gains (Fig.2). Taxes would be due on the full \$2,611 nominal gain, however, which means that a 15% rate on the nominal gain is equivalent to a 43% effective rate on the real gain. After \$392 in taxes, the individual is left with a real gain of \$526—about 20% of the gain upon which he was taxed.



It can even be the case that capital gains taxes are owed on assets that have no real capital gain or that may even have a real capital loss. If the investment in the example above had instead been purchased on January 3, 2005, a November 1, 2010 sale would have yielded a nominal gain of \$377 dollars, but a real loss of \$1,184. Adding insult to injury, the \$57 in capital gains taxes due on the nominal gain (an infinite effective rate since the real gain was negative) would bring the total real loss to \$1,241.

Static Forecasting Wrongly Predicts Tax Revenues

When estimating the effects of various tax and spending measures, the forecasts upon which policymakers rely largely ignore most of the economic effects of those tax and spending changes. In part due to the difficulty of accurately estimating feedback effects, forecasters essentially assume that individuals and businesses will not change anything about their behavior in response to the higher tax rates. But both logic and history show that this is not the case—individuals and businesses respond noticeably to taxes, and these responses have significant economic effects.

Static assumptions by the Administration estimate that raising the top tax rate on capital gains and dividends from 15% to 20% will generate an additional \$33 billion in revenues between 2011 and 2020. But this ignores any effects that the higher tax rates will have on investment and the economy. Capital gains taxes, through their negative effect on the level of savings and investment, impose negative spillover effects on the economy. Lower savings and investment means lower capital formation, lower productivity, lower wages, and less job creation. All of these factors lead to lower GDP and less tax revenue. The precise magnitude of this effect is subject to debate, but many studies have found that the negative spillover effects of even a small increase in the capital gains tax rate are large enough to offset any new revenues and may even *reduce* tax revenues.

Without specifically estimating the effects of the impending rise in the capital gains tax rate, the Heritage Foundation conducted a dynamic analysis estimate of the magnitude of various levels of effects. If the negative impacts of raising the capital gains tax rate from 15% to 20% for high-income taxpayers were to reduce GDP by one percentage point (about \$141 billion in 2009), the resulting loss in tax revenues from lower GDP would far exceed the gain in revenues from the higher rate by a magnitude of more than 8,000%—lost revenue over the next ten years would equal \$2.8 trillion compared to a gain of only \$33 billion from the higher rates.ⁱⁱⁱ Even if the reduction in GDP were as little as one one-hundredth of a percentage point (0.01%, or about \$1.41 billion in 2009), the higher tax rate would not generate any additional revenue because the resulting loss in revenues caused by lower GDP would offset the additional revenues gained from the higher tax rate.

“As a result of higher tax rates on those people in the highest tax brackets, there will be less employment, output, sales, profits and capital gains—all leading to lower payrolls and lower total tax receipts. There will also be higher unemployment, poverty and lower incomes, all of which require more government spending. It’s a Catch-22.”^{iv}

--Art Laffer

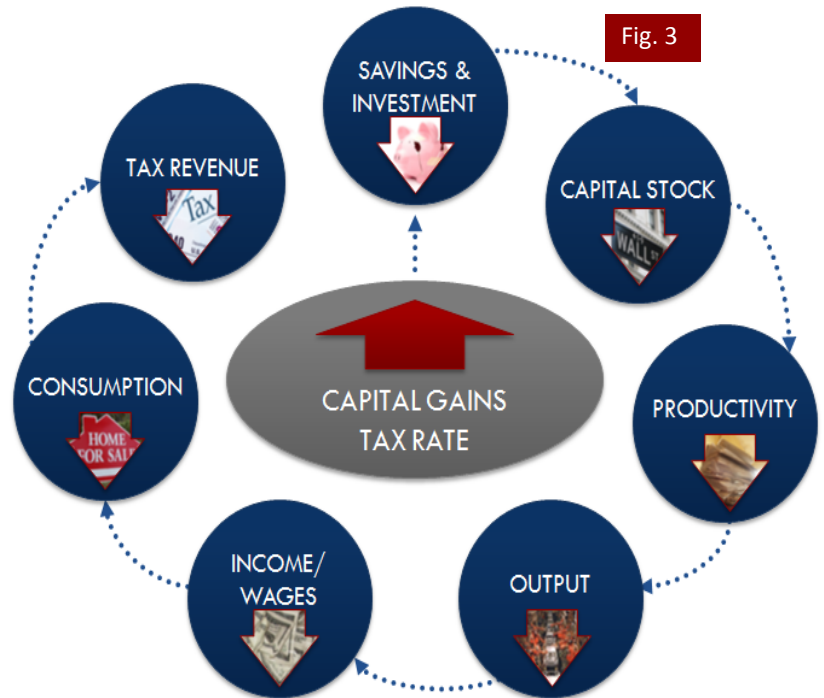


Fig. 3

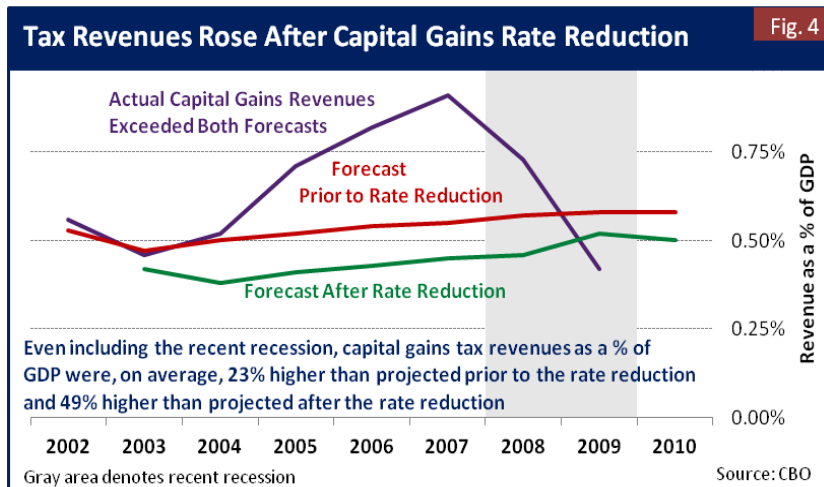
Other studies have specifically estimated the impact of scheduled and proposed tax increases. A study by the American Council for Capital Formation estimated allowing the capital gains tax rate to rise for all taxpayers, as scheduled in 2011, will reduce the annual growth rate of GDP by 0.05 percentage point per year (a 1.7% decline in long-term growth, or \$7 billion annual reduction in the level of GDP).^v In turn, the federal budget deficit will rise by more than \$1 billion per year and there will be 231,000 fewer jobs annually. Eliminating the capital gains tax altogether would reduce revenues by \$23 billion per year. But in exchange for a \$23 billion revenue loss, GDP growth would be higher by 0.23 percentage points per year (a 7.7% increase) and annual employment would rise by 1.3 million.

Another dynamic analysis by the Institute for Research on the Economics of Taxation found that more than 90% of the projected new revenue from raising the capital gains and dividend tax rates on upper-income earners will be lost due to the resulting lower economy-wide incomes.^{vi} When adding in the negative effects of the higher capital tax rates on reduced income, payroll, corporate, excise, capital gains, and estate taxes, as well as lower tariff revenue, and then accounting for the positive budgetary effects caused by lower federal wages, the net impact would be a revenue *loss* of \$17.4 billion. Raising the top tax rate to 24% (which is what the capital gains tax rate will rise to after the 3.8% healthcare surtax is added in 2013) would increase the revenue loss to \$32.8 billion.

Ironically, raising the top tax rate on capital gains in the name of reducing budget deficits and helping “pay for” new health care spending will actually increase deficits and diminish the fiscal outlook of the U.S. and its ability to pay for the massive new health care expansion.

History as a Record

Failure of static estimates to capture the true economic and budgetary effects of capital gains tax increases is evident in past projections surrounding changes in the capital gains tax rate. Figure 4 shows actual and forecasted capital gains tax revenues prior to and after the reduction in capital gains tax rates—from 15% and 20% to 0% and 15%—in 2003. The red line shows CBO’s January 2003 forecast for capital gains tax revenues prior to the rate reduction. The green line shows that, in January 2004, CBO lowered its forecasted revenues in response to the reduction in tax rates. While static assumptions assumed that capital gains realizations would remain the same, and that the lower rate would generate less revenue, the lower rate actually caused capital gains realizations to rise significantly. The result (the purple line) was significantly higher capital gains revenues than projected both prior to and after the rate reduction. Even taking into account the steep decline in capital gains revenues that occurred during the recent recession (which CBO did not foresee in its 2003 and 2004 projections), actual revenues as a percent of GDP exceeded projected revenues prior to the rate reduction by 23%. And actual revenue exceeded revenues projected after the rate reduction by 49%.



Even including the recent recession, capital gains tax revenues as a percent of GDP exceeded projected revenues prior to the rate reduction by 23%. And actual revenue exceeded revenues projected after the rate reduction by 49%.

In an effort to find new tax revenues to pay for new spending and reduce massive budget deficits, certain policymakers have taken to exploiting federal forecasting methodology that fails to recognize the economic reality of many policies. Ignoring the long-term consequences of the policies they advocate, many politicians are relinquishing long-term economic growth and the welfare of future generations in exchange for political favor today. This tactic threatens to undermine the prudent and thoughtful work of our forefathers who helped create this, the most prosperous nation on earth.

ⁱ Congressional Budget Office, “How Capital Gains Tax Rates Affect Revenues: The Historical Evidence,” March, 1988, <http://www.cbo.gov/ftpdocs/84xx/doc8449/88-CBO-007.pdf>

ⁱⁱ The Dow Jones Industrial Average reached a high of 8,633 on January 2, 2003; 11,244 on November 1, 2010; and 10,867 on January 3, 2005.

ⁱⁱⁱ Foster, J.D., “Obama’s Capital Gains Tax Hike Unlikely to Increase Revenues,” The Heritage Foundation, March 24, 2010, <http://www.heritage.org/research/reports/2010/03/obamas-capital-gains-tax-hike-unlikely-to-increase-revenues>

^{iv} Laffer, Arthur, “The Soak-the-Rich Catch-22,” The Wall Street Journal, August 2, 2010, <http://online.wsj.com/article/SB10001424052748703977004575393882112674598.html>

^v The American Council for Capital Formation, prepared by Allen Sinai, Decision Economics, Inc., “Capital Gains Taxes and the Economy,” September 21, 2010, http://www.accf.org/media/dynamic/4/media_487.pdf

^{vi} Institute for Research on the Economics of Taxation, “The Effect of the Capital Gains Tax Rate on Economic Activity and Total Tax Revenue,” October 9, 2009, <http://iret.org/pub/CapitalGains-1.pdf>