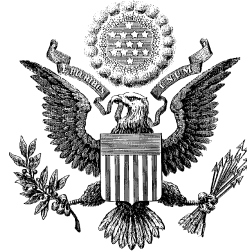


The Economic Effects of Capital Gains Taxation

A Joint Economic Committee Study



Chairman Jim Saxton

**Joint Economic Committee
United States Congress**

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Abstract

There is broad recognition that the current tax system is systematically biased against saving, investment, and work effort. One form of bias is the multiple taxation of saving and investment under various provisions of the current income tax structure. Proposals to mitigate this tax bias have been offered by the Clinton Administration as well as by Members on both sides of the political aisle. One proposal that has attracted bipartisan support in the past is the reduction of the capital gains tax rate. This paper weighs the statistical evidence on capital gains tax reduction and finds that such a change would have a positive impact on economic and employment growth. In addition, a capital gains tax reduction would partly abate the problem of taxing inflationary gains.

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THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION

EXECUTIVE SUMMARY

Between June 1981 and December 1986, the federal government allowed taxpayers to exclude 60 percent of capital gains from taxation. However, the Tax Reform Act of 1986 eliminated this exclusion, raising the maximum capital gains tax rate from 20 to 28 percent, a 40 percent increase. The increase was largest for middle income taxpayers, whose tax rate increased from 8.7 to 15 percent, a 72 percent increase. A capital gains tax reduction would help promote economic growth, benefit taxpayers across the income spectrum, and mitigate the unfair effects of taxing inflation-generated gains.

Macroeconomic Effects. Economist Allen Sinai maintains that a capital gains tax reduction would lower the cost of capital, boost investment, and stimulate economic growth. He estimates that a capital gains tax reduction could:

- ⇒ increase real gross domestic product (GDP) by an average of \$51 billion annually;
- ⇒ create 500,000 new jobs by the year 2000; and
- ⇒ increase real business spending by an average of nearly \$18 billion annually.

The effects of increased investment and economic growth would reverberate throughout the entire economy in the form of higher wages and rising living standards. In addition, the United States taxes capital gains more harshly than its major international competitors. Reducing the capital gains tax rate could increase U.S. global competitiveness.

Tax Revenue. The historical evidence suggest that capital gains tax reductions tend to increase tax revenue. When capital gains tax rates were lowered in 1978 and again in 1981, revenue climbed steadily. Conversely, when the tax rate was increased in 1987, revenue began declining despite forecasters predictions it would increase. For instance, capital gains tax revenue in 1985 equaled \$36.4 billion after adjusting for inflation, yet \$36.2 billion was collected in 1994 under a higher tax rate. In other words, tax revenue in 1994 was slightly less than it was in 1985 even though the economy was larger, the tax rate was higher, and the stock market was stronger in 1994.

Who Would Benefit? A recent NASDAQ Stock Market survey suggests that the notion that all investors are affluent gentlemen coupon-clippers is no longer true. The survey found that:

- ⇒ stock ownership doubled over the past seven years to 43 percent of the adult population;
- ⇒ 47 percent of all investors are women;
- ⇒ 55 percent are under the age of 50; and
- ⇒ 50 percent are not college graduates.

The survey results suggest that a capital gains tax reduction would directly benefit many Americans across the income spectrum. More importantly, a tax cut would benefit all Americans by promoting economic growth, thus boosting workers' wages and living standards.

Tax Fairness. The treatment of capital gains is generally unfair and strongly discourages saving and investment -- two activities crucial to economic growth.

- ⇒ Taxpayers must pay capital gains on illusory, inflation-generated gains. In years of high inflation, this means people may pay capital gains taxes on capital losses.
- ⇒ The effective capital gains tax rate often exceeds the statutory maximum due to various phase-out provisions in the tax code.
- ⇒ Saving is subject to three, and sometimes four, levels of taxation.

Reducing the capital gains tax rate would mitigate the problem of taxing inflationary gains and would help reduce the bias against saving and investment which prevails under the current tax code.

THE ECONOMIC EFFECTS OF CAPITAL GAINS TAXATION

There is broad recognition that the current tax system is systematically biased against saving, investment, and work effort. One form of bias is the multiple taxation of saving and investment under various provisions of the current income tax structure. Proposals to mitigate this tax bias have been offered by the Clinton Administration as well as by Members of Congress on both sides of the political aisle. One proposal that has attracted bipartisan support in the past is the reduction of the capital gains tax rate. In 1989, for example, the U.S. House of Representatives passed a capital gains tax reduction with bipartisan support, though it was not passed in the Senate. This paper weighs the statistical evidence on capital gains tax reduction and finds that such a change would have a positive impact on economic and employment growth. It would also partly abate the unfair effects of taxing inflation-generated gains.

I. BACKGROUND

A capital gain is the increase in the value of a capital asset realized over its cost basis. For example, an asset purchased for \$1,000 and sold for \$1,500 generates a capital gain of \$500. This nominal gain is subject to the capital gains tax. Because capital gains are not adjusted for inflation, much of the tax is paid on illusory, inflation-generated gains.

The Revenue Act of 1978 allowed taxpayers to exclude 60 percent of capital gains from income taxation (a 50 percent exclusion was allowed since 1942). The Economic Recovery Tax Act of 1981 reduced the top tax rate on regular income from 70 to 50 percent, yielding a maximum effective capital gains tax rate of 20 percent (0.5×0.4). The 60 percent exclusion was eliminated under the Tax Reform Act of 1986, thus raising the maximum tax rate on capital gains to 28 percent, a 40 percent increase. The increase was largest for middle income taxpayers whose tax rate increased from 8.7 to 15 percent, a 72 percent increase. The 1986 Act capped the statutory rate for capital gains at 28 percent so that subsequent increases in the income tax would not raise the top capital gains tax rate. The maximum statutory rate of 28 percent remains in place, though a variety of proposals have been introduced to lower it below 20 percent.

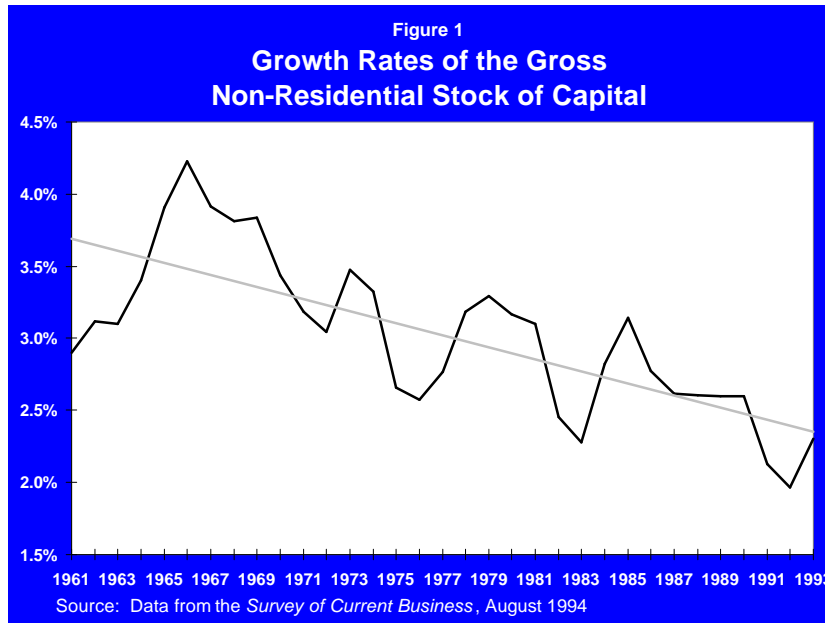
II. MACROECONOMIC EFFECTS

Except for a brief recession in 1990-91, the U.S. economy has enjoyed a 15-year expansion that is still underway. However, the growth rates of the economic upswing that began in 1991 have been relatively low compared to other post-war expansions. As a result, American incomes and living standards have been growing more slowly.

These low growth rates can be partly attributed to counterproductive tax policies that undermine long-term growth by discouraging saving and investment. Although broad tax reform is needed to address the deficiencies in the tax code, many economists believe that reducing the capital gains tax rate is an important step in the right direction. A capital gains tax reduction would enhance incentives to save and invest by increasing the after-tax return from investment. The effects of a capital gains tax reduction should not be overstated; nonetheless, its beneficial effects on the economy would make a significant contribution to long-term growth.

Increasing Investment and Economic Growth

Economic growth depends on two factors: the quantities of available inputs, such as capital and labor, and the productivity of those inputs. Economic growth cannot occur unless the quantity of inputs increases, productivity improves, or both. Investment in capital is therefore crucial to economic growth for at least two reasons. First, by contributing to capital formation, investment increases the amount of capital available in the economy. Second, investment enhances labor productivity because capital and labor are productive complements. The critical link between investment and economic growth is a widely accepted economic principle.



Unfortunately, the level of investment in the United States compares unfavorably with that of other countries and with the United States' own history. Annual U.S. investment is only half the level it was in the 1960s and 1970s. In addition, net private domestic investment dropped from an average of 7.4 percent of gross domestic product (GDP) between 1960 and 1980 to an average of only 3.0 percent since 1991.¹ Consequently, the growth rate of the capital stock in the United States has also been declining. Figure 1 shows a clear downward trend in the

growth rate of the non-residential stock of capital. This downward trend has serious implications for the economy given the strong relationship between investment and economic growth.

The diminishing growth of investment can be partly attributed to high costs of capital. The cost of capital measures the return an investment must yield before a firm or an individual is willing to undertake the investment. High capital gains tax rates lower the return on investment, thus increasing the cost of capital and depressing overall investment in the economy. Conversely, a capital gains tax reduction would lower the cost of capital and stimulate investment.² The effects of increased capital formation would reverberate throughout the economy in the form of higher wages, rising living standards, job creation, and economic growth.

Furthermore, the U.S. capital gains tax rate exceeds that of any industrialized nation except that of the United Kingdom and Australia (however, even these countries index gains for inflation, whereas the United States does not). Because the United States must compete internationally for capital, high capital gains tax rates place the United States at a disadvantage relative to its competitors. Some of the United States' major competitors, such as Germany and Hong Kong, exempt long-term gains from taxation altogether; and other countries, such as Japan, tax capital gains very lightly. As a result, these countries typically experience higher saving, investment, and productivity growth rates than the United States. The data indicate that a lower capital gains tax rate would help improve U.S. global competitiveness.

Statistical Studies

Several studies have attempted to measure the macroeconomic effects of a capital gains tax reduction. Two of the most recent studies were conducted by DRI/McGraw-Hill and by Allen Sinai, chief global economist at Primark Decision Economics, formerly with Lehman Brothers. Both studies estimate the impact of a 50 percent capital gains exclusion for individuals and a 25 percent tax rate for corporations (the existing rate is 35 percent). The studies conclude that a capital gains reduction of this size would benefit the economy.

¹ Margo Thorning, "Trends in Investment and Tax Policy: Time for a Change?" *Business Economics* 30 (January 1995), p. 23.

² The cost of capital is also affected by interest rates and depreciation costs. Some of the fluctuations in Figure 3 reflect changes in investment due to fluctuations in these variables.

*Allen Sinai*³

Dr. Sinai estimates that reducing the capital gains tax rate would lower the cost of capital, thus increasing business capital spending by approximately \$17.6 billion per year. The higher levels of investment and capital formation would generate increased economic activity, raising the level of real GDP by an average of \$51 billion annually. The increase in entrepreneurial activity and productivity would generate close to a half million new jobs by the year 2000.

In addition, the value of the stock market would rise, leading many investors to shift their assets toward equities. This shift would raise household net worth by an average of 2.1 percent per year. Dr. Sinai estimates that the national saving rate would increase by about \$44.1 billion per year, partly because of the increased income generated from additional economic activity, and partly because of the increase in personal and corporate saving which occurs when capital gains are taxed at a lower rate. The increased saving would help keep interest rates from rising in the face of increased economic activity. Dr. Sinai concludes that a “Capital gains tax reduction increases savings, capital spending and capital formation, economic growth, jobs, productivity and potential output.” He notes that “The increases relative to what might have happened otherwise are definitely significant, but small to modest in magnitude.”

Dr. Sinai notes that more targeted capital gains relief, such as an increase in capital gains allowed on home sales, should also stimulate economic activity, but the magnitude of the effects would be drastically reduced. He states that a capital gains reduction targeting the sale of homes would increase housing activity, “but much less benefit would accrue to savings, in general, capital formation, productivity and the maximum sustainable rate of economic growth.” The major findings of Dr. Sinai’s study are summarized in Table 1.

Real GDP		Employment/Unemployment	
level, (in 1992 \$-billion)	\$51	payroll, millions	0.356
growth, percentage points	0.1	unemployment rate	-0.2
Business Capital Spending		Productivity Growth	
total, (in 1992 \$-billion)	\$17.6	percentage points change	0.1
Hourly Compensation		S&P 500	
percentage points change	0.1	percentage change	0.8
National Savings		Household Net Worth	
(in \$-billion)	\$44.1	percentage change	2.1
Federal Tax Receipts³		Cost of Capital	
change from baseline, OTA	\$17.2	pretax equity, percent change	-6.8
change from baseline, JCT	\$4.5	composite, percent change	-2.7
Source: Testimony of Allen Sinai before the Senate Finance Committee, March 13, 1997.			
¹ Assumes a 50-percent exclusion of long-term capital gains for individuals and a 25 percent capital gains tax rate for corporations effective January 1, 1997.			
² Estimates are preliminary and subject to change			
³ OTA - Office of Tax Analysis, U.S. Department of Treasury; JCT - Joint Committee on Taxation.			
Estimates with unlocking and macroeconomic feedback effects. Numbers depend on estimates of unlocking effect.			

³ Written testimony by Allen Sinai prepared for the Senate Finance Committee, March 13, 1997.

DRI/McGraw-Hill⁴

The DRI study, summarized in Table 2, estimates that cutting the capital gains tax rate would lower the net cost of capital, thus raising the level of business spending by about \$18 billion in 2007. Over a 10-year period, the capital stock would rise 1.2 percent above its baseline level, increasing productivity by roughly 0.4 percent. Real GDP could be 0.4 percent higher than in the baseline due to the effects of increased investment. The study notes: “The evidence suggests to almost all economists that a capital gains cut is good for the economy and roughly neutral for tax collections.”

Real GDP (percent change from baseline)	0.4
Real Capital Spending (percent change)	1.5
Capital Stock (percent change from the baseline)	1.2
Productivity (percent change)	0.4
Net Cost of Capital (percent change)	-3.0
Total Federal Tax Receipts (in \$-billion)	\$7
¹ Based on 50 percent exclusion of long-term capital gains for individuals and 25 percent tax rate for corporations.	

These conclusions largely conform to the findings of other studies which have analyzed the macroeconomic effects of a capital gains tax reduction. Most economists now agree that reducing the capital gains tax rate would encourage investment, boost productivity, raise living standards, and stimulate economic growth. However, some analysts argue that the macroeconomic effects of a capital gains tax reduction would be minimal unless the saving rate increases to provide additional resources for investment. It is argued that the saving rate is unlikely to increase as a consequence of a capital gains tax reduction since empirical studies have found only a weak relationship between saving rates and rates of return.

However, empirical studies which seek to measure the response of the saving rate are inadequate for two main reasons. First, saving is taxed at several levels, the capital gains tax being only one of these levels. Most studies analyze only the effects of a reduction in one level of taxation but ignore other taxes which may be rising. As a result, there are offsetting factors which are not included in the models. An example of this occurred in the 1980s when falling income tax rates accompanied a decline in the saving rate. The 1980s, however, marked a period in which other taxes were rising. For example, the Social Security Amendments of 1983 enacted a phase-in for the taxation of Social Security benefits. Middle-income individuals who earned interest from saving could be pushed into the phase-in level, thus subjecting them to taxation. In these circumstances, this would be a disincentive to saving. In addition, rising payroll tax rates more than offset the reduction in income tax rates. The higher level of payroll taxes reduced most taxpayers’ after-tax income, out of which people could save, thus dampening the saving incentives associated with the income tax reduction.⁵

The second reason that empirical studies may be flawed is that they use data from the National Income Accounts which measures saving on an income-flow basis. In other words, they measure how much of an increase in income is saved rather than consumed. Income-flow models cannot measure saving which arises from an increase in wealth. For example, the increase in the value of assets in the stock market is treated as an increase in wealth, not income. Saving which arises from increasing wealth are not captured by many models. This is an

⁴ DRI/McGraw-Hill, “The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks,” (April 1997).

⁵ Another important reason why saving may have fallen is the 1982-83 recession which lowered individuals’ incomes. It is believed that individuals reduced their saving in order to be able to maintain the same level of consumption.

important point to note because a capital gains tax reduction is more likely to increase saving through wealth effects as opposed to income effects.

Business Creation and Entrepreneurship

Capital gains taxation further effects economic and employment growth through its impact on entrepreneurial activity and business creation. Entrepreneurship is the driving force of a market economy. It is crucial to job creation, innovation, and productivity. Entrepreneurship is affected by, among other things, the strength of the incentives that motivate entrepreneurs to undertake innovative projects and the ability of the entrepreneur to raise enough capital to finance projects. The taxation of capital gains discourages innovation, risk-taking, and capital investment, thus diminishing entrepreneurial activity in the economy.

Capital gains taxation effects entrepreneurship through its impact on venture capital, an important source of funding for entrepreneurial projects. High capital gains tax rates lower the potential return from backing innovative companies, thus restricting the amount of venture capital available to new firms. Some analysts argue that most venture capital comes from tax-exempt sources such as pension funds and foreign investment; therefore, a capital gains tax reduction would not have much effect on venture capital.

However, several studies indicate that informal venture capitalists are extremely important sources of investment and are especially critical to the formation of new companies. Professors John Freear and William Wetzel, Jr. of the University of New Hampshire found that private individuals are a crucial source of funding for new technology-based firms, accounting for 48 percent of seed capital funds. Their study states that "At the seed stage, private individuals invested more funds, in more rounds, for more firms than any other single source."⁶ Formal venture capital becomes more important during later stages of development.

Another study, conducted by Coopers & Lybrand, concludes: "Creating new jobs - especially in young technology companies - requires risk capital...The risk capital invested in technology companies is provided primarily by investors subject to capital gains taxation. [Furthermore,] risk capital investors seek capital gains, not dividends."⁷ The importance of informal investors to the venture capital process suggests that a capital gains tax reduction would effect the amount of venture capital available to new companies.

The taxation of capital gains may further limit the amount of entrepreneurial activity in the economy by reducing the incentives to entrepreneurship. Israel Kirzner, a professor at New York University, describes entrepreneurship as a discovery process. In other words, the entrepreneur is an innovative, resourceful, risk-taking individual who discovers otherwise overlooked opportunities. Whereas most individuals are motivated by a known set of economic incentives, such as wages or promotion potential, the entrepreneur is motivated by the potential return that may be earned from entering into a situation with *unknown* outcomes. This is why entrepreneurs are described as risk-takers: they are motivated by the uncertain return that may potentially be earned from discovering a previously unnoticed opportunity.

If the potential returns are taxed heavily, the entrepreneur's motivation is reduced. Hence, high capital gains tax rates may divert innovative, would-be entrepreneurs toward different career paths. The economy is harmed by the reduction in entrepreneurial activity, not only because business and job creation declines, but also because possible improvements to living standards are left undiscovered.⁸

⁶ John Freear and William E. Wetzel, Jr., "Who Bankrolls High-Tech Entrepreneurs?" *American Council for Capital Formation Center for Policy Research*, (undated).

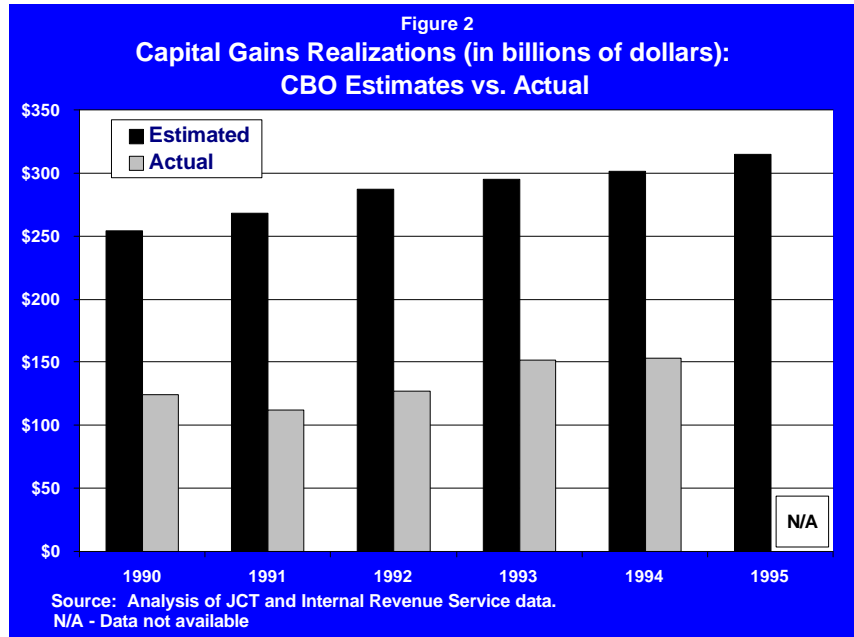
⁷ Coopers & Lybrand, "Generating Economic Growth through Young Technology Companies," (undated).

⁸ Israel Kirzner, *Discovery and the Capitalist Process*. (Chicago: University of Chicago Press, 1985), pp. 93-118.

III. TAX REVENUE

In an attempt to estimate the revenue effects of a capital gains tax cut, the Joint Committee on Taxation (JCT) used Congressional Budget Office (CBO) estimates of capital gains realizations under the 28 percent tax rate for the 1990-95 period. The JCT concluded that a capital gains tax reduction would cost the government billions of dollars.

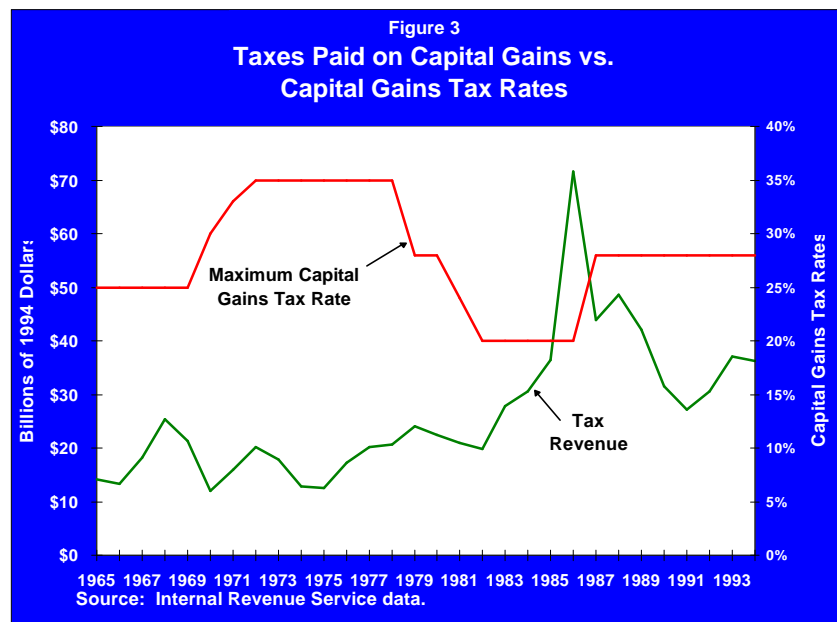
This JCT analysis, however, was based on grossly inaccurate data. Figure 2 illustrates the difference between actual capital gains realizations and CBO estimates. For the period 1990-94, CBO overstated capital gains realizations by \$737 billion. The use of a massively overstated baseline led forecasters to overestimate the extent of revenue loss associated with a tax cut.



These substantial CBO errors occurred for two primary reasons. First, high capital gains tax rates cause realizations to decline because the penalty associated with selling assets is high. CBO did not adequately account for this behavioral response in its estimation process. Second, the CBO analysis did not account for the macroeconomic effects described in the previous section. In other words, CBO assumed that a change in the capital gains tax rate is neutral in its effect on the economy. For these reasons, CBO massively overstated the projected levels of realization.

Historical Evidence

Historical evidence undermines the claim that capital gains tax reductions lower revenue. Figure 3 shows that, historically, taxes paid on capital gains have tended to *increase* after a reduction in the capital gains tax rate. When capital gains tax rates were lowered in 1978 and again in 1981, revenue climbed steadily despite government forecasters' claims that it would fall. Conversely, when the tax rate increase was enacted in 1987, revenue began declining, although forecasters predicted it would increase.



For instance, capital gains tax revenue equaled \$36.2 billion (0.5 percent of GDP) in 1994 (the last year for which finalized IRS data are available). In contrast, \$36.4 billion (0.6 percent of GDP) was collected in 1985, after adjusting for inflation. Thus, tax revenue in 1994 was slightly lower than in 1985 even though the tax rate was higher, the economy was larger, and the stock market was stronger in 1994. The historical data suggest that the government could collect more revenue if the capital gains tax rate were reduced.

Effects on Tax Revenue

The result that tax revenue tends to increase following a reduction in the tax rate may seem counterintuitive; however, there are many offsetting factors which must be considered. In the static analysis, tax revenue inevitably falls because the same level of realizations is being taxed at a lower rate. In addition, tax receipts may fall if taxpayers reclassify regular income as capital gains in order to take advantage of the lower rate.

On the other hand, a reduction in the capital gains tax rate creates three effects which tend to increase tax revenue. The first is the unlocking effect, which expands the tax base because realizations increase in response to the lower tax rate. The magnitude of the unlocking effect is quite controversial and will be discussed in greater detail in the next section. The second is the dynamic effect, which measures the increase in tax revenue generated from the impact of lower tax rates on economic growth. The third effect measures the increased tax revenue resulting from an increase in the value of existing assets. When capital gains tax rates are lowered, the value of existing assets necessarily increases. Tax revenue rises as owners of stock pay taxes on the higher value of their assets when realized.

The impact on tax revenue depends on the relative magnitude of each of these offsetting factors. In the past, government forecasters have used a static analysis which does not consider the macroeconomic effects or the effects of an increase in the value of assets. In general, more comprehensive studies find that a reduction in the capital gains tax rate will be revenue neutral, and may even generate small revenue gains. The DRI/McGraw-Hill study finds that the positive revenue effects outweigh the negative, and therefore federal tax revenue should increase by approximately \$7 billion over 10 years. The results of the DRI study are summarized in Table 3.

**Table 3. Estimated Impact of Capital Gains Tax Reduction
on Federal Tax Revenue for Select Years (billions of 1997 dollars)¹**

	1998	2002	2007	1998 - 2007
Static Effect	-14	-16	-20	-168
Unlocking Effect ²	15	2	2	47
Asset Prices	13	9	8	95
Income Reclassification	-2	-2	-2	-21
Macroeconomic Effect	0	4	11	54
Total	12	-3	-1	7

Source: DRI/McGraw-Hill, "The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks," Table 1, (April 1997).

¹ Effects of a 50 percent exclusion of capital gains for individuals and a 25 percent tax rate for corporations.

² DRI uses a conservative estimate of 5 percent additional unlocking over the 10-year period.

Unlocking Effect

When capital gains tax rates are high, investors avoid paying the tax by holding onto assets they would have otherwise chosen to sell. This creates a "lock-in effect," which lowers capital gains realizations by shrinking the tax base. CBO failure to adequately account for this behavioral response caused it to underestimate the extent of lock-in and overestimate capital

gains realizations as shown in Figure 2 above. Economists estimate that trillions of dollars in equity are currently locked into assets because investors refuse to pay a high tax on their profits. Reducing the capital gains tax rate would unlock a portion of this capital, allowing the government to tax the increased realizations.

Although analysts agree on the existence of the unlocking effect, its magnitude and duration are controversial. Estimates of the unlocking effect depend on assumptions made about taxpayer responsiveness to changes in the tax rate. CBO estimates have found a low level of responsiveness, leading some analysts to conclude that the unlocking effect is insignificant. However, other studies have found a high degree of taxpayer responsiveness. An analysis by economists at the Office of Tax Analysis (OTA) at the U.S. Department of Treasury states that while no study can provide definitive conclusions:

...we find strong evidence of responsiveness to capital gains tax rates. [Our findings] show that the marginal tax rate on long-term gains has a significant powerful negative impact both on the proportion of taxpayers realizing gains and on the value of capital gains declared by realizers. That is, despite theoretical misgivings that many analysts have expressed, the data continue to imply that the realizations response would be sufficient to yield revenue increases from capital gains reductions.⁹

The results of various studies differ due to divergent methodologies. CBO uses an approach which estimates aggregate responsiveness, while OTA focuses on individual taxpayer behavior. Many analysts believe that the former approach understates the unlocking effect and the latter overestimates it; the true measure may be somewhere in between. The important point to note is that all studies find some evidence of unlocking, suggesting that capital gains realizations do increase when the capital gains tax rate is reduced. Furthermore, a study by economists Robert Gillingham and John Greenlees analyzed both methods and concluded: "Existing analyses do not provide conclusive evidence on the revenue effects of changes in the taxation of capital gains...The weight of the evidence from both [approaches] does not suggest, however, that a reduction in the capital gains rate from existing levels would decrease tax revenue."¹⁰

A study by the National Bureau of Economic Research indicates that when the unlocking effect is taken into account, the revenue-maximizing capital gains tax rate falls somewhere between 9 and 21 percent. This rate does *not* account for the increased revenue generated from the asset value and dynamic effects discussed previously.¹¹

IV. WHO WOULD BENEFIT?

Earlier legislation to reduce the capital gains tax rate was defeated in large part because opponents of a tax cut portrayed it as a windfall for the rich. It is obvious that affluent investors would benefit from a capital gains tax reduction, but benefits would also accrue to individuals across the income spectrum. The DRI/McGraw-Hill study notes: "Often overlooked benefits flow to all workers and middle income citizens, and the overall economy wins. The middle class will benefit from greater appreciation in their pensions...Small businessmen will gain from more generous tax treatment of the gains on their enterprise. And all employees will see wage gains

⁹ 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 Papers*, (May 1989), p. 27.

¹⁰ Robert Gillingham, and John Greenlees, "The Effect of Marginal Tax Rates on Capital Gains Revenue," *National Tax Journal* 45 (June 1992), p. 167.

¹¹ Testimony by Mark A. Bloomfield prepared for the Senate Finance Committee, February 15, 1995, p. 10.

“tied to investment-driven higher productivity.”¹² DRI’s research director, David Wyss, notes that “The capital gains cut helps most people and hurts no one.”¹³

Furthermore, the notion that all investors are affluent gentlemen coupon-clippers is no longer true. Over the past decade, the stock market has seen a surge of middle income investors. A survey released earlier this year by the NASDAQ Stock Market found that stock ownership among Americans has doubled in the past seven years to 43 percent of the adult population. The survey also found that:^{14,15}

- ⇒ 47 percent of the investors are women;
- ⇒ 55 percent are under the age of 50; and
- ⇒ 50 percent are not college graduates.

Mutual funds have become especially popular with middle income Americans as a source of investment for pension funds and as an alternative to traditional bank accounts and government securities, which generally yield lower returns. According to the survey, the proportion of American adults investing in mutual funds has tripled over the past seven years from 13 to 40 percent. Another study conducted for the mutual fund industry found that 29 percent of mutual fund shareholders have household incomes below \$40,000; 38 percent have incomes between \$40,000 and \$75,000; and 33 percent have household incomes over \$75,000.¹⁶

These results suggest that a capital gains tax reduction would directly benefit many Americans across the income spectrum. A stronger economy also would generate indirect benefits for individuals who do not participate in the stock market. However, these indirect gains are much more difficult to quantify. Consequently, it is important that the capital gains debate is not relegated to a discussion of numbers and distributional tables.

Shortcomings of Distributional Tables

Policy makers have become heavily reliant on distributional tables which illustrate the effect of a proposed tax change on the tax liabilities and tax burdens of different income groups. As mentioned earlier, past legislation to reduce the capital gains tax rate was defeated largely on the basis of distributional analysis. Distributional tables must be interpreted with great caution.

Michael Graetz of Yale University, formerly the Deputy Assistant Secretary at the Treasury Department’s Office of Tax Policy, warns that distributional tables should not guide tax policy.¹⁷ Distributional tables are necessarily based on many assumptions and over simplifications that cannot capture the wide variety of behavioral and economic responses which occur in reality. For instance, most distributional tables only represent tax payments, but do not reflect the fact that low and middle income individuals are the major recipients of government transfer

¹² DRI/McGraw-Hill, “The Capital Gains Tax, Its Investment Stimulus, and Revenue Feedbacks,” (October 1995), p. 3.

¹³ Testimony by David Wyss prepared for the House Committee on Ways and Means, March 19, 1997.

¹⁴ Marcy Gordon, “Stock Market Looks More Like Face of America, Survey Says,” *The Associated Press Business News*, February 21, 1997.

¹⁵ The survey, conducted by Peter D. Hart Research Associates, was based on 20-minute interviews with a national sample of 1,214 investors. The margin of error is plus or minus 3.2 percentage points.

¹⁶ The 1996 study, conducted by the Investment Company Institute, was based on telephone interviews with a randomly selected sample of 1,165 mutual fund shareholders in mid-1995. The survey data does not include individual households that only own mutual funds in 401(k) employer sponsored retirement plans.

¹⁷ Michael J. Graetz, *Distributional Analysis of Tax Policy*, edited by David F. Bradford. (Washington D.C.: The AEI Press, 1995), pp. 15-78.

payments. Thus, the numbers overstate the true tax burden on these individuals. Consequently, the assumptions and simplifications used to construct the tables often lead to misleading results.

Graetz points out that the three government agencies responsible for constructing distributional tables (CBO, JCT, and OTA) implement divergent methodologies based on their own judgments and interpretations of the theoretical issues. The divergent methodologies produce conflicting tables which confuse the policy-making process and can significantly skew the results to bolster a particular political view. The inaccuracies are not necessarily a consequence of intent, but of the elusive nature of the impact of tax changes on the economy.

Graetz suggests that distributional analysis is best explained through words, not numbers, and heavy reliance on these imperfect tables may compromise the soundness of the affected tax legislation. Distributional tables should not be ignored -- they do contain important information when interpreted properly. However, it is extremely important to recognize that they do not relay a complete or perfectly accurate analysis.

V. TAX FAIRNESS

Opponents of a capital gains tax reduction argue that capital gains are already subject to preferential treatment, and a further rate reduction would only motivate many taxpayers to reclassify regular income as capital gains in order to take advantage of lower tax rates. However, there are many provisions in the tax code which discriminate against saving and investment and outweigh the preferential treatment of capital gains.

First, taxpayers purportedly benefit from a provision which allows them to defer tax payment on capital gains until the gains are realized. Whereas most interest income is taxed as it accrues, a capital gain is not taxed until the asset is sold and the gain is realized. However, the benefit of deferral is at least partially offset since the money associated with capital gains is subject to several levels of taxation: it is taxed when earned as individual income, when claimed as corporate income, when realized as a capital gain, and if held until death, it may be subject to estate taxes.

Second, many claim that capital gains are awarded preferential treatment because the tax is forgiven if the asset is held until death. This provision benefits a relatively small portion of the population since most people save to finance their retirement, to guard against unforeseen mishaps, or to achieve a desired goal such as purchasing a home or college education. These individuals save because they plan to realize their earnings during their lifetimes, and accordingly, they are unlikely to benefit from the death provision. Even those who do hold their assets until death may not escape taxation entirely if their assets become subject to the estate tax.

Third, capital gains are supposedly given preferential treatment since the statutory capital gains tax rate is capped at 28 percent, as opposed to regular income, which is capped at a rate of 39.6 percent. This benefit is diminished since the effective tax rate often exceeds 28 percent due to various phase-out provisions in the tax code. In addition, the realization of a capital gain may push individuals into a higher income tax bracket, thus further increasing their tax liability.

Finally, the most inequitable provision of capital gains taxation is the failure to index gains for inflation. Since capital gains are not adjusted for inflation, individuals often pay taxes on inflation-generated gains. As a result, the effective tax rate may exceed the statutory maximum. In years of particularly high inflation, the effective tax rate exceeded 100 percent; consequently, many individuals have paid capital gains taxes on capital *losses*.

Figure 4 on the following page illustrates the undue burden created by taxing inflationary gains. It shows the total tax paid on an average stock purchased in June of different years and sold in June of 1994. The bottom region of each bar reflects the portion of the tax paid on real gains, while the top region shows how much tax was paid on inflation.

The taxing of inflationary gains is unfair and counter-productive because it intensifies the lock-in effect. Many investors choose to hold onto their assets, not only to avoid paying high capital gains taxes, but also to avoid paying taxes on illusory gains. If capital gains were indexed, much of this capital would become unlocked, allowing the government to tax the increased realizations.

Finally, it should be noted that the concern over income reclassification (classifying regular income as capital gains) is misplaced.

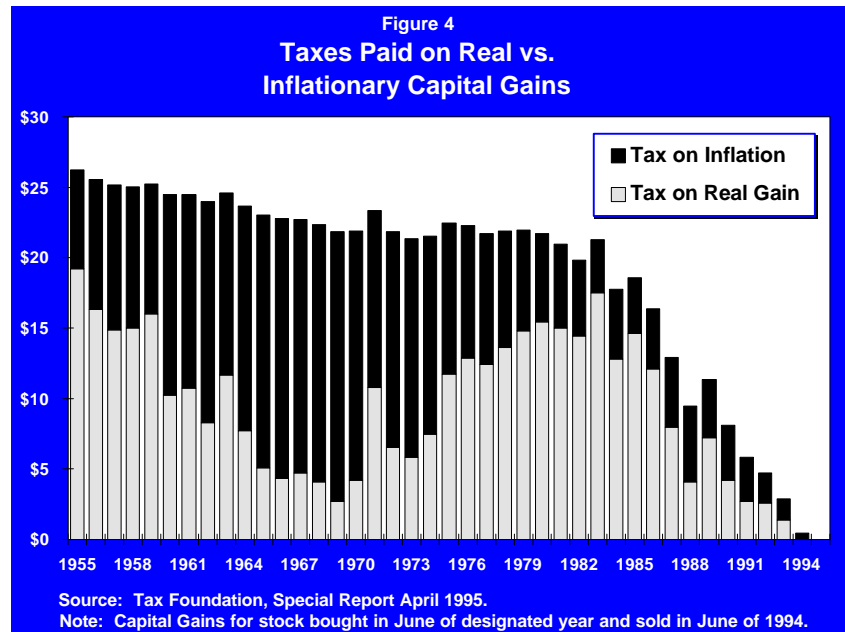
Income reclassification would not be the consequence of lower capital gains tax rates; it is already the consequence of a complicated tax system which treats various types of income differently depending on their source and who receives them. Taxpayers already have an incentive to take advantage of tax loopholes to avoid paying high taxes on their earnings. Possibly the only solution that would eliminate tax arbitrage is the transition to a flatter, less complicated tax structure which closes loopholes and reduces individuals' ability to exploit the system.

VI. CONCLUSION

Saving and investment are crucial to economic growth and rising living standards. However, high costs of capital, double and triple taxation of saving, and taxation of inflationary gains discourage these activities, thus lowering economic efficiency and long-term growth prospects. While broad tax reform is needed to address the deficiencies of the existing tax code, many economists believe that reducing the capital gains tax rate is the single most effective policy measure which can be enacted immediately to promote efficiency and economic growth.

In the past, attempts to stimulate long-term economic growth through a capital gains tax reduction were thwarted by inaccurate estimates of revenue losses and misleading distributional tables. This discussion should focus on the macroeconomic effects of cutting the capital gains tax rate rather than on the questionable distributional effects. It has been estimated that reducing the effective capital gains tax rate would add \$51 billion per year to real GDP, raise productivity growth by 0.1 percentage points per year, and create a half million new jobs over the next three to four years. A capital gains tax cut would also stimulate business creation and help equalize the inequities that prevail under the current tax code.

A meaningful debate should therefore incorporate the macroeconomic effects of a capital gains tax reduction and concentrate on the positive growth effects of a tax cut. When these effects are taken into account, it becomes increasingly apparent that a capital gains tax reduction would benefit the government as well as taxpayers in all income brackets.



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