MUTUAL FUND INVESTORS: A REFLECTION OF MIDDLE AMERICA

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Joint Economic Committee
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Summary

For twenty years, American households have increased their holdings of mutual funds and other financial assets despite periods of inflation, disinflation, booms, bankruptcies, commodity price shocks, and financial crises at home and abroad. During the last ten years, lower inflation, lower interest rates and demographic factors have further boosted the demand for mutual funds.

Mutual funds are the primary financial assets of many middle-income households. More than 80 percent of mutual fund owners have annual household incomes below $100,000; their median financial assets are $80,000. Mutual fund assets make up 21 percent of all retirement assets.

Now is the right time to re-examine the taxation of investment returns on mutual funds. This study describes who owns mutual funds, what forces underlie growth in mutual fund ownership, and what effects changes in the capital gains taxation of mutual fund distributions could have.

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I. INTRODUCTION

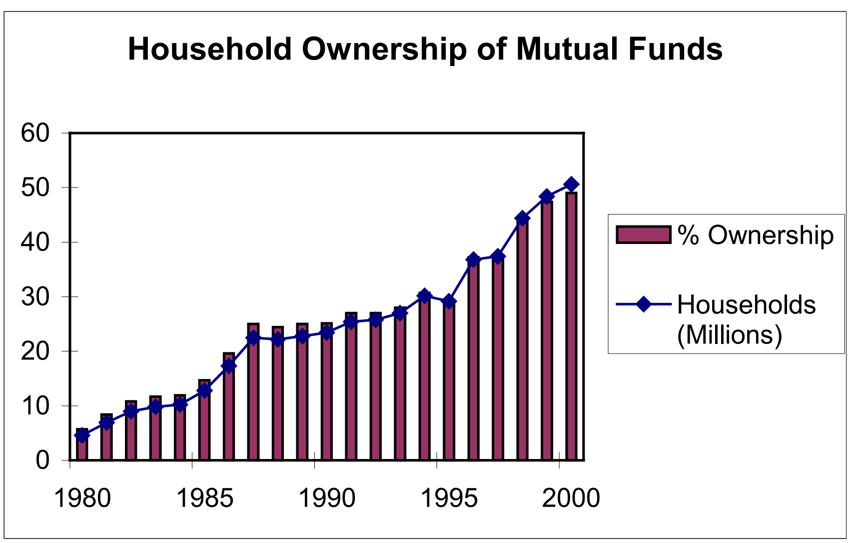
A. Growing Ownership of Mutual Funds

Mutual finds are the primary financial investment vehicle for many middle-income households. While lacking the time and sophisticated tools for diligent investment research that the professional portfolio manager has, the small investor can build adequately diversified portfolios through mutual funds. Equity (stock) mutual funds in particular have traditionally been a good route to building wealth

Many mutual funds, particularly equity funds, can earn large capital gains on their investments, and they are required to distribute these gains to their investors. It is therefore important to think about how capital gains taxation affects mutual fund investors. This report provides part of the answer by describing who owns mutual funds, what forces underlie growth in ownership, and what effects changes in the capital gains taxation of mutual fund distributions could have.

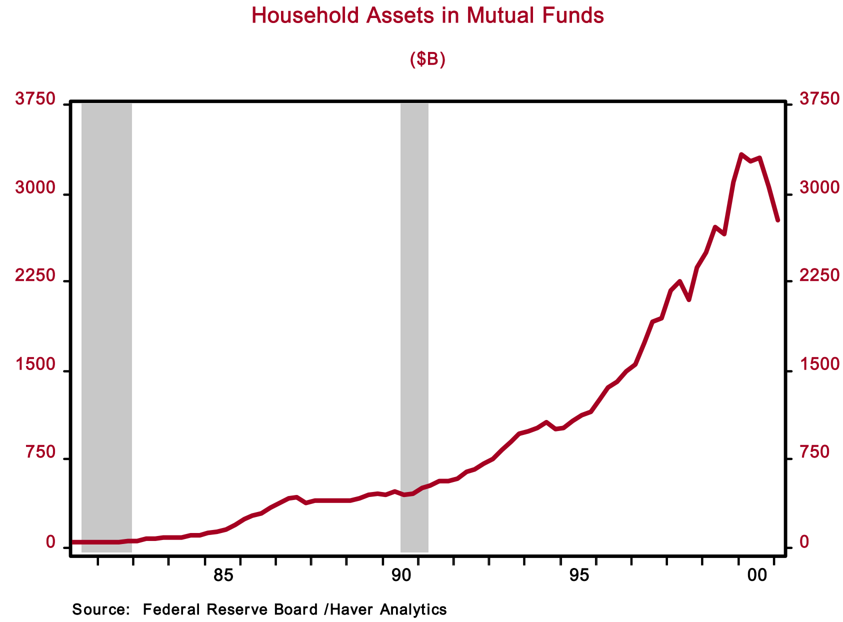
Over the past twenty years there has been strong, long-term growth both in the number of U.S. households that invest in mutual funds and in the amount they invest (Figures 1 and 2).[1] The growth has reflected gains in stock prices as well as the general decline in interest rates and inflation. Lower inflation, and resulting lower nominal interest rates, has led to stronger and steadier periods of economic growth. Such growth has helped produce attractive returns on financial assets relative to inflation-hedge assets such as gold or real estate.

Figure 1



[1] ICI (2000), p. 45.

Figure 2



Gray shading denotes official recession periods.

B. Importance of Equity Mutual Funds

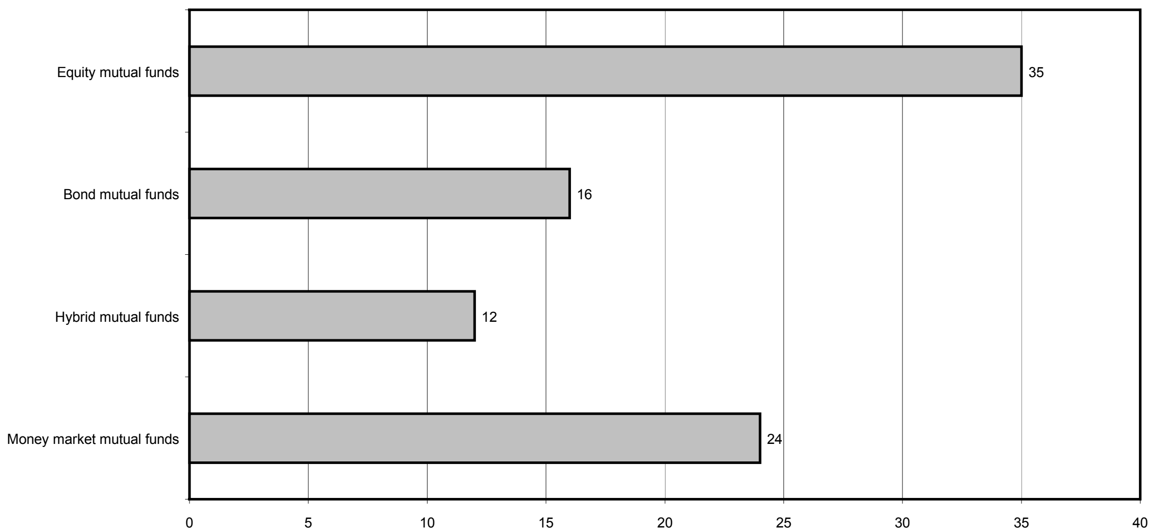
Equity funds are a big part of the mutual fund universe. In 2000, 71 percent of mutual fund investors (36 million) owned equity funds.[2] Equity fund assets totaled $3.96 trillion.[3] Thirty-five percent of all U.S. households owned equity funds as of June, 2000 (Figure 3). There has only been a modest fall off in equity fund holdings with the volatility in the equity markets last year. From 1999 to 2000 equity fund holdings share of total mutual funds did decline from 59 to 57 percent although fund assets only fell $80B to $4.0 trillion. The decline in equity funds was made up by a rise in taxable and tax-exempt money funds.[4]

Currently, people who own shares of stock directly, outside of mutual funds, are taxed only on the capital gains from the sale of their shares. The tax provisions that govern mutual funds, however, require mutual fund investors to pay taxes on capital gains on the shares of stock sold by their mutual funds during the year even if the investors do not sell any shares of their mutual funds. A change that allows mutual fund investors to defer payment of capital gains taxes until they cash out would increase the ability of millions of Americans to save for retirement.

[2] ICI, "U.S. Household Ownership of Mutual Funds in 2000," *Fundamentals,* Vol. 9, August 2000, p.4.
[3] ICI (2001) p.64.
[4] ICI (2001) p.64.

Figure 3

Percent of all U.S. Households Owning Mutual Funds by Type of Fund (2000)



II. WHY DO PEOPLE OWN MUTUAL FUNDS?

A. Characteristics of Mutual Funds as Financial Assets

As financial assets, mutual funds offer households two special characteristics. The first is the ability to alter the pattern of income to fit the pattern of spending over time. Purchases of financial assets today from current income provide a means of saving for retirement or targeted future expenses such as a house down payment or college tuition.

Financial assets also offer households the potential to increase their net worth over time by investing today for returns tomorrow. In the low inflation environment of recent years, for example, investors have relied more heavily on mutual funds to increase their financial net worth than real or tangible assets. Mutual funds, therefore, exist within a broader portfolio of financial and tangible assets. How much of household assets are allocated to mutual funds reflects the advantages and disadvantages of mutual funds.

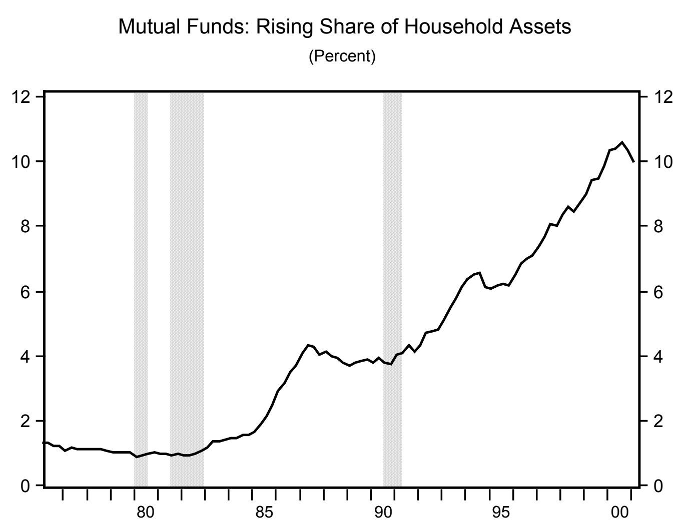
Mutual funds provide three benefits to investors. First, they provide investment management and asset diversification. Mutual funds pool investment money from numerous investors and invest in a diversified portfolio of securities to minimize risk and maximize returns. Through mutual funds investors move to minimize systemic liquidity risk, that is, the risk to investors of significant economic change while holding long-term investments. Diversification among asset types helps to minimize broad market risk. Second, mutual funds may have lower transaction costs due to discounts on large trades. Third, mutual funds provide investors with liquidity, allowing them to liquidate their mutual fund shares at little or no cost.

The trade-off between investing in a personal account and investing in a mutual fund depends on the trade-off between diversification benefits, transaction cost savings, and risk-sharing advantages on the one-hand, and the fund charges (loads, 12b-1 and management fees), including differential taxation regimes, on the other. Households should prefer the mutual fund structure as long as the cost of owning a mutual fund, including fund charges and taxes on income and capital gains is less than the cost of purchasing those services through an alternative financial vehicle. [5]

Household ownership of mutual funds continues to grow, thereby continuing a trend going back to 1989. In the latest (1998) Federal Reserve Survey of Consumer Finances, ownership increased for all but one (55-65) of the age groups in the survey**.** [6] In addition, Survey results showed significant growth of household ownership of equities, mutual funds, tax-deferred retirement accounts and other managed assets. The percent of households owning mutual funds reached 16.5 percent in 1998(excluding money market mutual funds or funds held through retirement accounts or managed assets).[7] In contrast, the share of financial assets held in traditional, primarily bank and thrift, transactions-type accounts fell.

Mutual funds have become an important vehicle for low- and middle-income households to invest in financial markets and save for the future. In fact, a rising share of household assets is held in mutual funds[8] (see Figure 4). In addition, mutual funds have begun to play an increasingly important role in financial intermediation and the allocation of capital in our economic system. Mutual funds hold almost twenty-two percent of U.S. equities.[9]

Figure 4



[5] Chordia (1996), p. 4.
[6] Kennickell and others (2000), p. 12.
[7] Kennickell and others (2000), p. 8.
[8] Federal Reserve (2000).
[9] Federal Reserve (2000).

B. Mutual Funds and Long-Term Saving

The primary goal of mutual fund investors is income for retirement, with income to pay educational expenses also an important goal. Ninety-eight percent of investors claim that their mutual fund investments are for the long term and 86 percent of equity fund investors claim that they are not concerned about short-term fluctuations in their mutual fund investments. [10] The emphasis on long-term saving is evidenced by the observation that the vast majority (63 percent) of investors holding equity funds outside employer-sponsored retirement plans did not make a single equity fund transaction outside these plans in 1998.[11]

Retirement plans are very important to mutual fund ownership. Fully 72 percent of mutual fund investors own funds through employer-sponsored retirement plans. A 1999 study revealed that 28 percent of investors surveyed own funds solely outside employer-sponsored retirement plans. Another 34 percent of investors own funds both inside and outside employer-sponsored retirement plans. [12]

Mutual fund investors are familiar with the fluctuations of financial markets, and invest for the long haul. A 1998 survey found that 50 percent of mutual fund owners first purchased mutual funds before 1990 and therefore have experienced the impact of recession, several interest-rate cycles, and more than a few international financial crises. Another 36 percent of mutual fund owners bought their first mutual fund between 1990 and 1995 and therefore have experienced more than one financial crisis. Only 14 percent of mutual fund owners had purchased their first mutual fund in the two years prior to the survey. [13]

III. WHO OWNS MUTUAL FUNDS?

A. Basic Statistics

Mutual fund investors are average Americans. For all types of mutual funds, data from 1998 indicate that the typical investor has a median age of 44 years, median household income of $55,000 and median financial assets of $80,000. Approximately 50 percent do not have college degrees; 17 percent are retired. Median total mutual fund assets were $25,000 and the median investor owned four mutual funds.[14]

Investors in equity mutual funds tend to be somewhat older than investors in mutual funds generally, and to have higher incomes and financial assets. Their median

[10] ICI (1999), p. 56.
[11] ICI and SIA (1999), p.45.
[12] Profile of Mutual Fund Shareholders 1998, p.7.

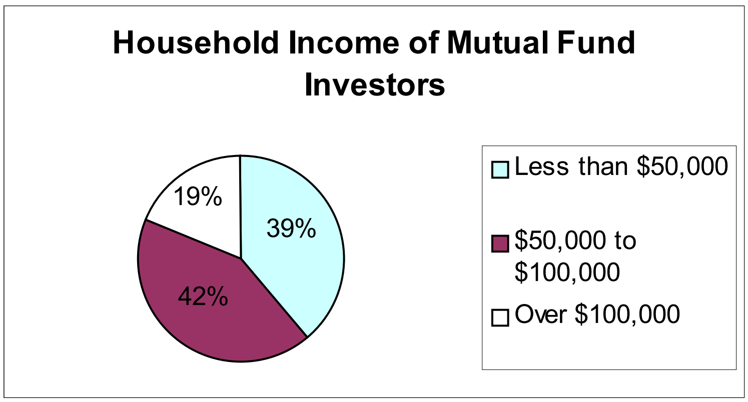
[13] ICI (1999), p. 49.
[14] ICI (2001), p.45-46.

age is 47 years, median household income is $60,000 per year, and median financial assets are $87,500. More are retired (20 percent) than are mutual fund owners generally.[15]

B. Income Level: Widespread Ownership Among Middle-Class Households

According to the Investment Company Institute (ICI), as of June 2000, 81 percent of households (41.0 million) that owned shares in mutual funds had annual household incomes under $100,000 (see Figure 5).[16] In contrast, only 77 percent of households that held stock directly had income under $100,000. Therefore, the distribution of mutual fund ownership is less top-heavy in terms of income. In other words, of households with income between $100,000 and $250,000, 53.1 percent owned equities directly and only 40.7 percent owned equity mutual funds.[17] Therefore, taxes due on unrealized gains on mutual funds, as a percentage of total wealth, may be a greater burden on the middle class compared to the affluent.

Figure 5



To indicate further how broad ownership of mutual funds is among middle-class households, consider that 49 percent of households with annual incomes between $35,000 and $50,000 own mutual funds. Among households with incomes between $50,000 and $75,000, the proportion rises to 66 percent, and for households with incomes between $75,000 and $100,000 the proportion of ownership rises to 77 percent.[18]

Most mutual fund investors have financial assets below $100,000. In fact, thirty-five percent have less than $50,000 in total financial assets.[19] For these households, the median household income is $40,000 with median financial assets of $17,000. For the 25 percent of investors that have household financial assets between $50,000 and $100,000, median household income is $60,000 with a median age of 41 years. These survey results reinforce the view that the vast majority of mutual fund investors are middle-income households with modest wealth.

[15] Investment Company Institute and Securities Industry Association (1999), p. 15.
[16] ICI (2000), p. 2.
[17] New York Stock Exchange, Shareownership 2000, Table 12, p.29.
[18] ICI, *Fundamentals*, v. 9, no.4, August 2000, p.2.
[19] ICI*, 1998 Profile,* p.43and 44.

C. Age

For all types of mutual funds, 1998 data indicate that the typical investor has median age of 44 years. Approximately 17 percent are retired. [20] For investors in equity mutual funds, the median age is 47 years, and 20 percent are retired.[21] It appears that young people tend to stick to mutual fund investments that have less variability, such as money market funds until they accumulate enough wealth they can afford to allocate more of this wealth to equity funds for the long term.

For all types of mutual funds, investors with less than $50,000 of income had a median age of 41. Investors with household income between $50,000 and $100,000 had a median age of 43 years.[22] As expected, income tends to increase with age up to a certain point.

Most mutual fund investors are of the baby boom generation (ages 34 to 52 at the time of the survey) with the "silent generation" (age 53 and older at the time of the survey) making up the next largest group at 27 percent.[23] These generational cohorts are typically not affluent. The median age of the silent generation shareholder is 61 years old with household income of $47,000. After a lifetime of work, the median level of household financial assets was $200,000. For the baby boomer shareholders, median income level was $62,000 and the median level of household financial assets was $90,000. [24]

D. Regional Distribution of Ownership

Mutual fund owners are dispersed throughout the United States. According to a survey by the Investment Company Institute, 31 and 30 percent of mutual fund investors come from the Midwest and South respectively. Fewer shareholders reside in the West (21 percent) or the Northeast (18 percent). This geographic breakdown can be compared to the actual population distribution. Compared to the overall share of the regions in population[25], for example, the Midwest is far over represented (population share is 22.9 percent) compared a survey percentage of 31 percent. Meanwhile, the Northeast and West are within one percent of their population share based upon year 2000 Census population estimates. The South is modestly underrepresented.

E. Individual versus Institutional Ownership

Some mutual funds allow their shares to be bought only by institutions—corporations, banks, insurance companies, and so on. One reason for excluding individuals from buying shares in such funds is that tax rules governing individuals and

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[20] ICI (2001), 2001, p.46.
[21] ICI and SIA (1999), p. 42.
[22] ICI (1999), p.39.
[23] ICI (1999), p.31.
[24] ICI (1999), p. 32.
[25] U.S. Census 2000 PHC-T-2. Ranking Tables for States: 1990 and 2000, April 2, 2001.

institutions are different, and some mutual funds tailor their investments to take advantage of tax provisions available only to corporations. Institutions, of course, make much larger single investments, thereby allowing economies of purchasing and lower transaction costs.

Household ownership remains large: in 1999, households owned 80 percent of all mutual funds, while institutions held 21 percent.[26] However, over the past five years, household ownership has been on the increase.

IV. FORCES UNDERLYING THE LONG-TERM GROWTH IN MUTUAL FUND OWNERSHIP

Household demand for mutual funds and other financial assets is based upon economic influences like those for demand for other goods. Five economic forces underlie household ownership of financial assets at the microeconomic level.[27]

- (1) Gains in personal income in recent years have provided the funding for mutual fund purchases. Higher real (inflation-adjusted) incomes allow people to save more through mutual funds and other types of investments, if they wish.
- (2) Gains in wealth have prompted households to allocate more of their holdings to mutual funds. Household wealth has grown with declines in inflation and interest rates as well as continued economic progress.
- (3) The aging of the baby boom generation has driven the underlying demand for financial assets in general and mutual funds in particular. This demand for financial assets has been reinforced by the recent history and prospect for future gains in real household net worth.
- (4) Expected rates of return on assets have been an obvious influence in the past two decades. The rapid gains in the Dow and Standard & Poor's 500 indexes during the second half of the 1990s led to a rapid rise in mutual fund ownership. Mutual fund assets of all types have risen along with the S&P 500 index over the past twenty years. The S&P 500 index has been a highly visible daily reminder of the opportunities for gain missed by not being in the stock market through direct ownership of stocks or through equity mutual funds.
- (5) Increased consumer confidence, especially about personal finances, provided an important positive psychological boost to equity fund investors. Consumer confidence can fluctuate, as seen by the sharp declines in mid-1990. Record levels of consumer confidence in the late 1990s accompanied a record pace of mutual fund purchases.

Two legislative initiatives by Congress have also boosted household ownership. First, the expansion of tax incentives for IRAs in 1981 and 1997 stimulated demand. Second, there was a distinct shift of corporate and non-profit organizations' pension

[26] ICI, *Mutual Fund Factbook (2001)*, p.41.
[27] Macroeconomic forces also influence mutual fund growth. See Reid, Brian, "The 1990s: A Decade of Expansion and Change in the Mutual Fund Industry," ICI Perspective, V. 61, No. 3, July 2000.

funds from defined benefit plans to defined contribution plans through 401(k) and 403(b)s, for example, also boosted demand and mutual fund growth. These investment vehicles fall under tax provisions that do not annually subject capital gains distributions to taxation.

Let us review the evidence on mutual fund ownership and these five forces.

A. Personal Income

In a study on mutual fund ownership, researchers at the Federal Reserve found that the proportion of families having financial assets rose with income. [28] They also found that the median value of financial assets rose strongly with income. Median real family income grew from $41.4 thousand to $48.9 thousand between 1981 and 1999.[29]

B. Wealth

Although home ownership was formerly the primary type of long-term saving for many American households, in recent decades they have made a clear shift toward financial assets in their portfolios. From 1989 to 1999, financial assets grew from 614 percent to 71.7 percent of total assets.[30] With the growth of wealth, households will chose to distribute that wealth over a wide variety of financial assets including mutual funds.

Part of the growth represents saving for retirement. Households have increased their retirement savings from $4.0 trillion in 1990 to $11.5 trillion in 2000.[31] Of the latter amount, $2.5 trillion, or 21 percent, was in mutual funds (Figure 6). This $2.5 trillion is 35 percent of all mutual fund assets. Mutual fund retirement assets come from two main sources: employer-sponsored defined-contribution plans, and Individual Retirement Accounts (IRAs). Mutual fund assets held in employer-sponsored retirement accounts totaled $1.22 trillion in 2000, a decline of $45 billion, or 4 percent, from 1999. Mutual funds accounted for approximately 14 percent of the overall employer-sponsored market at the end of 2000.

Defined-contribution plans, especially 401(k) plans, are the most important source of fund assets in the employer-sponsored plan market. At the end of 2000, approximately 51 percent of mutual fund assets in retirement plans were held in IRA accounts, 31 percent in 401(k) plans, and the rest in 403(b) and other retirement accounts.[32]

Although the Tax Reform Act of 1986 significantly reduced incentives for new contributions to IRAs,[33] assets in IRAs continued to grow during the 1980s and 1990s

[28] Kennickell and others (2000), p.8.
[29] Economic Report of the President, (Jan. 2001), p.314.
[30] Federal Reserve (2000).
[31] ICI Fundamentals (June, 2001), p. 3
[32] ICI Fundamentals(June, 2001), p.1 and p.7.
[33] The Tax Reform Act of 1986 established income and contribution limits that restricted the number of eligible participants. Contributions to IRAs were approximately $38 billion in 1986 and just $8.2 billion in 1998.

from good returns on investment and rollovers from employer-sponsored plans. In addition, legislative changes in the late 1990s introduced new types of IRAs, notably the Roth IRA. The mutual fund industry's share of the IRA market has increased from 14 percent in the mid 1980s to 46 percent at the end of 2000. At the end of 2000, IRAs held 18 percent of mutual fund assets, employer-sponsored plans accounted for another 18 percent of assets, and the remaining 64 percent of assets were held in non-retirement accounts.

Figure 6

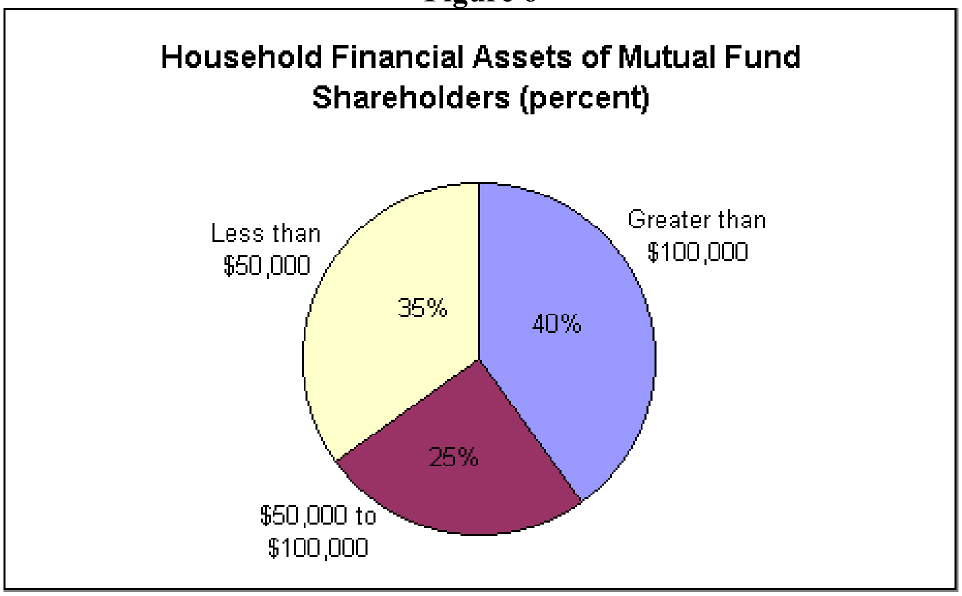
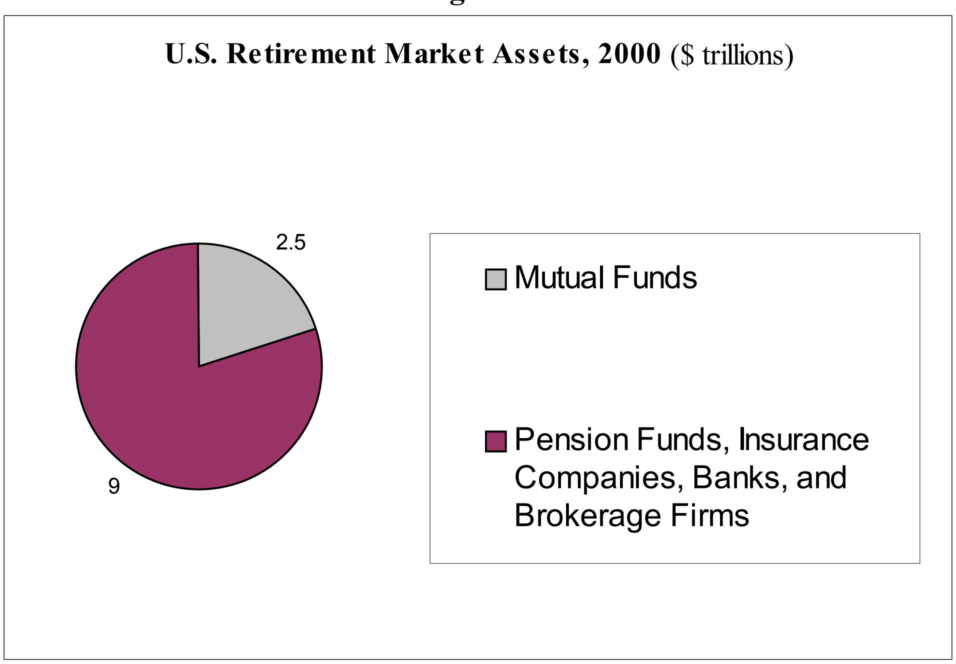


Figure 7



C. Demographics

The aging of the unusually large baby boom generation has increased the desire of its members to save. In the 1990s, baby boomers provided a long-term upward push to equity markets by buying stocks directly and through equity mutual funds to help finance their eventual retirement. This demographic push is expected to continue for the next twenty years. Many households have also used equity mutual funds to generate income for the college tuition of children or grandchildren.

D. Expected Rate of Return

Expected returns on financial assets have benefited from a general decline in inflation as well as prolonged economic growth during the last two decades. These two developments improved the outlook for equity and bond markets and thereby boosted equity prices and bond fund sales. Long-term inflation expectations declined as the Federal Reserve succeeded in its battle against high inflation. Reduced inflation expectations translated into better total returns for financial assets such as stocks and bonds relative to real assets such as housing. In a number of regions of the country, especially those tied to the information economy boom, returns on housing investments also skyrocketed in the 1990s, the low inflation environment notwithstanding. As a result, mutual fund sales, especially in the late 1990s, were driven by the gains in the S&P index (Figure 8) that, in turn, reflected the influence of lower interest rates, lower inflation and steadier economic growth than in the 1970s.

Lower inflation and interest rates fed into a rising stock market. In turn, the rising stock market became associated with an increase in the number of mutual fund accounts as well the higher percentage of the total financial assets of households accounted for by mutual fund holdings. There are influences here in both directions. Rising equity markets attract investors while increased investor buying drives up equity prices. Therefore it is better to recognize the positive correlation between the series rather than claim that one factor causes the other.

For households, this background provided justification for a restructuring of asset allocations in favor of mutual funds. Since their peak in the late 1970s, time deposits have become less and less of a share of the household financial pie (Figure 9). Checkable deposits also have been declining as a share of household financial assets throughout the last fifteen years.

Figure 8

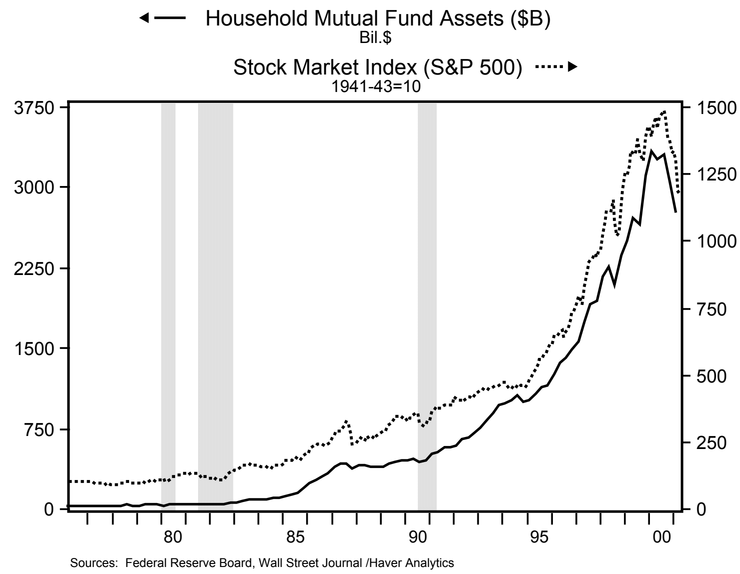
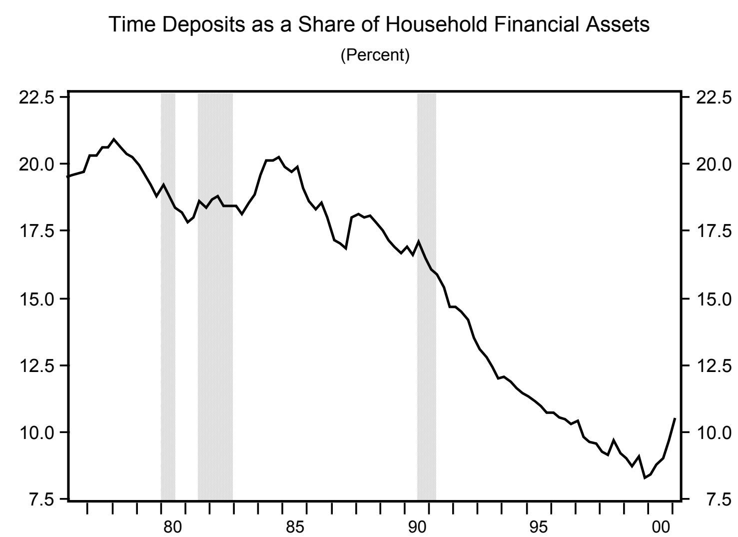


Figure 9



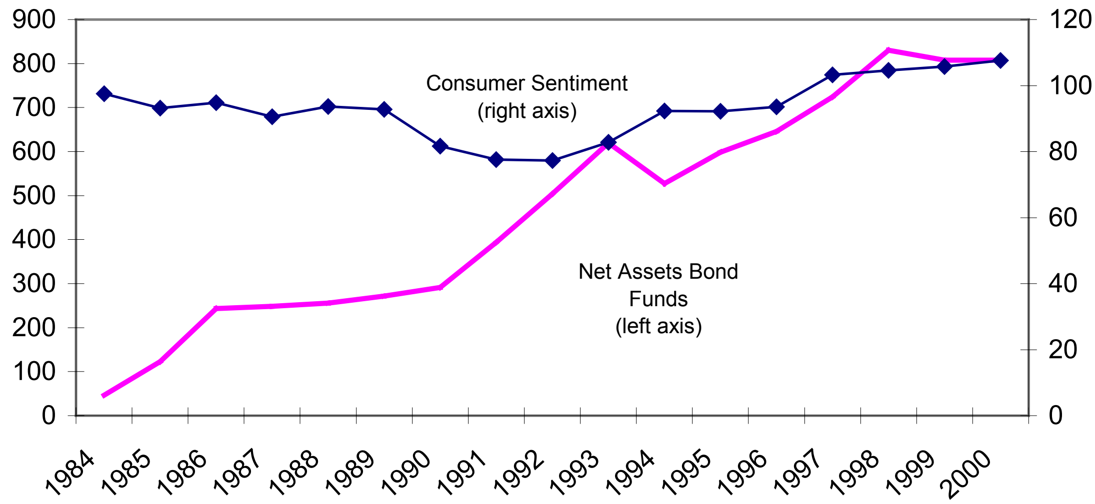
Gray shading denotes official recession periods.

E. Consumer Confidence

Consumer confidence influences a household's willingness to take risks and postpone present consumption to invest in the future. Higher levels of consumer confidence have been related to higher levels of household ownership in mutual funds during the past decade. For example, as illustrated in Figure 10, higher levels of consumer confidence linked to expectations of lower inflation appear to be tied to rising bond fund purchases in the 1990s even in an environment of above-average equity gains and prosperity. Equity mutual fund holdings grew in the 1990s as well.

Figure 10

High Levels of Consumer Confidence Contribute to Financial Asset Holdings



V. CYCLICAL PATTERNS OF INVESTOR CHOICE AFFECTING MUTUAL FUNDS

Besides being influenced by the long-term factors discussed in the previous section, mutual fund investment is also influenced by cyclical factors. Investors' purchases and redemptions of mutual fund shares follow typical financial market patterns.[34] From 1991 to 2000, gross redemptions, as a share of assets, averaged 32.3 percent a year. The peak for the decade was 41.6 percent in 2000 and the low was 26.7 percent in 1992. (Note that *on net,* mutual fund assets increased over the decade because gross redemptions were more than offset by gross purchases and appreciation.)

To get a sense of the cyclical volatility and longer-term patterns of redemptions, we can review a breakdown of investor purchases and redemptions of equity funds from 1991 to 2000. As Figure 11 shows, redemption rates rose with the onset of financial difficulties in 1994 (a period of rising interest rates). Redemption rates are therefore sensitive to influences in financial markets and the wider economy.

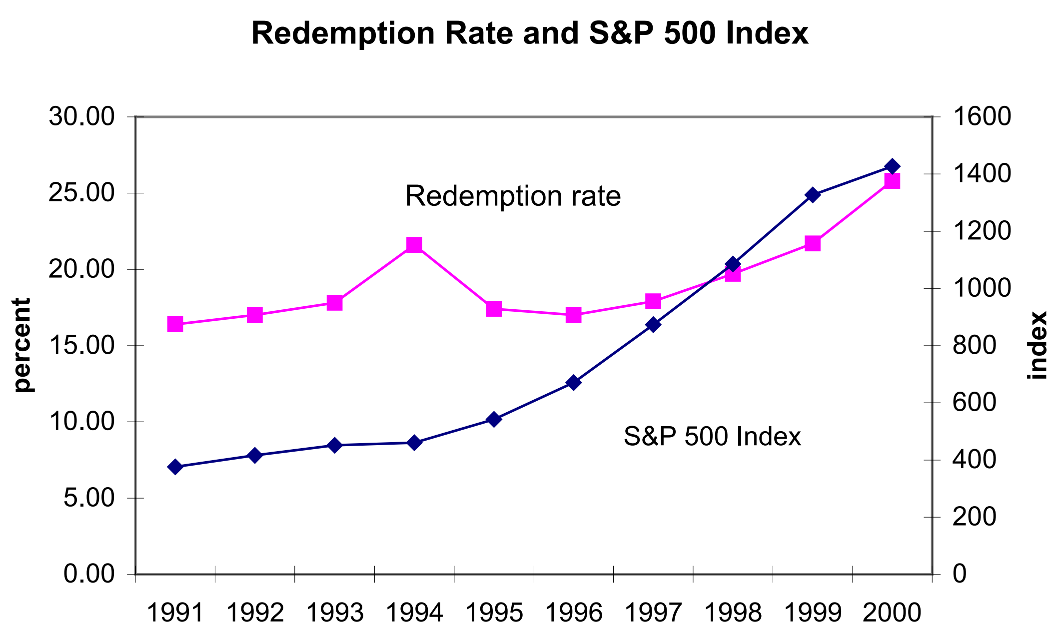
These results suggest that mutual fund turnover is modest and does not reflect the extremes of either a day-trading mentality or a pure buy-and-hold strategy among investors. Moreover, several prominent mutual funds have taken steps to discourage

[34] Collins (2001), p. 6.

short-term trading. However, the length of time the typical mutual fund investor owns shares in a mutual fund cannot be measured directly. Moreover, the redemption rate is subject to a number of influences that reduce the value of the average rate as an indicator of future values. Redemption rates cannot be used to measure the holding period for the typical fund investor. A small number of investors can and likely do generate a disproportionate percentage of the total redemptions, thereby masking the activity of the typical investor.

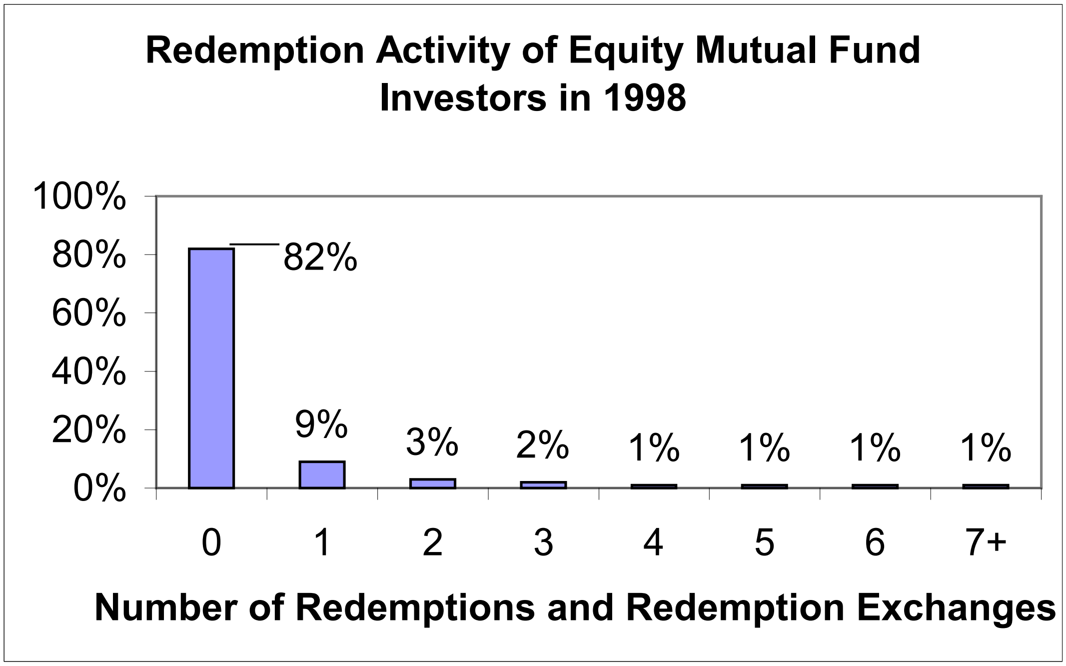
Data on redemption activity from a survey (see Figure 12)[35] conducted jointly by ICI and the Securities Industry Association indicated that 82 percent of equity fund investors did not make a single redemption during the 12-month period ending January 1999.[36] Nine percent of equity fund investors redeemed their fund shares once during 1999. Only one percent made more than six redemptions. Of those that did redeem shares, many did so to use funds for major purchases, such as for a house or auto down payment or to pay an educational loan.

Figure 11



[35] Redemption Activity of Mutual Fund Owners, Fundamentals, March, 2001, Vol. 10, No.1, p.3.
[36] ICI (2001) Mutual fund Fact Book p.81.

Figure 12



VI. TAX DISADVANTAGES OF MUTUAL FUND OWNERSHIP

Mutual funds are a popular vehicle for saving and investment of middle-income households. However, household portfolio choices are significantly impacted by the presence of differential taxation. Of immediate interest is the tax treatment of capital gains and its impacts on the incentives for households to invest and save.[37]

A. Lack of "Horizontal Equity" in Taxing Capital Income

Different types of capital income face different tax burdens. The "horizontal equity" standard suggests that the marginal dollar of taxable income be taxed equally no matter what the source of capital income. This is not the current practice in mutual fund taxation.

As an earlier staff report by the Joint Economic Committee noted,

> Taxation of capital gains has been part of the U.S. tax system since the ratification of the 16Th Amendment to the Constitution in 1913, which allowed for the taxation of individual income. Since that time, debate has engulfed issues surrounding if, when and how capital gains should be taxed. One such debate has focused on the realization of capital gains.

[37] For a careful review of current practice and suggested policy options on mutual fund taxation see Fichtner (2000, 2001).

> Realization of capital gains is the point in time at which ownership of capital assets, or various rights to capital assets, is exchanged for money. Although many economists argue that capital gains should not be taxed at all, some economists argue a completely opposite position and suggest that capital gain taxes should be levied on *unrealized* capital gains. Unrealized capital gains are the increases in the value of capital assets, for example stock prices that are not sold for cash but are retained.[38]

Taxation of unrealized capital gains creates perverse incentives. As is well known, open-end mutual funds, sold to the public with no limit on the number of shares in the fund, regularly realize and distribute a large portion of capital gains to investors. This occurs, in part, because portfolio managers have the perverse incentive to realize gains, when existing individual investors may not want to, so that the mutual fund avoids the sudden distribution of capital gains to new investors. [39] This incentive could be significantly reduced under the deferral proposal included in H.R. 168.

Closed-end funds are sold directly on the stock exchanges and are limited in the number of shares offered to the public. Capital gains for closed-end fund investors are realized in two ways. This tax treatment is the same as that for open-ended mutual funds. First, when the investor sells the fund, any capital gains are treated like direct ownership of equities for tax purposes. In addition, even if the shareholder does not sell, capital gains distributions are also made by closed-end funds, usually toward the end of the year. The portion of a capital gains distribution reported by the fund as "short-term" generally is taxed to shareholders as ordinary income (in taxable accounts). The portion reported as "long-term" is taxed, under current law, at a maximum federal income tax rate of 20 percent.

B. An Example of How Taxes Affect Mutual Fund Returns

Results of a recent study[40], given in Table 1, show a significant tax impact on investor returns and the variation of after-tax returns between different investment styles. The tax impact provides a significant disincentive to saving. Three investment options are represented. First, the pretax investment option assumes assets are in a tax-deferred account. Second, the post tax option applies to those investors who plan to pass on their assets through their estates. Finally, for many mutual fund investors, the liquidation method, sale prior to death of investor, is the most likely option. In this case, the median $21.89 end-of–period value of their investment is reduced to just $16.04 for low tax rate investors, $12.04 for mid-tax investors and only $8.93 for high tax investors when those investors liquidate their shares to make payment for a home or college tuition.

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[38] Fichtner (2001), p.3.
[39] Barclay and others (1998), pp.4, 10-11, 33., see also Dickson and Shoven, (1995) and Bergstesser and Poterba
[40] Dickson and Shoven (1995).

Table 1: Mutual Fund Returns, 1963-1982
(Nominal value of a $1 investment; pre-tax S&P 500 index = $22.13)

Investment style	*Regime*	*Treasury bills*	*Median*
Pretax	Not applicable	**6.91**	**21.89**
Post-tax	Low tax	**4.97**	**16.51**
	Mid tax	**3.69**	**12.75**
	High tax	**2.53**	**9.82**
Liquidation	Low tax	**4.97**	**16.04**
	Mid tax	**3.69**	**12.04**
	High tax	**2.53**	**8.93**

Taxation of unrealized capital gains forces taxpayers either to sell capital assets or to channel money from some other productive source to pay the tax bill. This is not only unfair, but also inefficient, since it reduces resources devoted to productive activity. Fortunately, the current tax system *generally* does not impose such an onerous tax on investors by taxing their unrealized capital gains. However, this tax treatment does apply to many investors in mutual funds. This tax bias against mutual fund shareholders is an exception to the rule of taxation of realized capital gains.The issue is in how "realization" is defined in the tax law. For mutual fund investors, realization occurs both when the manager of the fund sells equities held in the fund, and when the investor sells his own mutual fund shares.

Compounding the problem for mutual fund investors, net redemptions lead to capital gains realizations for both redeeming and holding investors.[41] Over time, net redemptions track the expected growth rate of equity markets as well as the volatility of the market. As a result, increases in market volatility lead to increases in net redemptions and the greater likelihood of capital gains realizations for investors who continue to hold the fund. In years such as 2000, increased volatility and increased redemptions bring about a greater tax burden on investors already disadvantaged by poor investment performance.[42]

C. Deferring Taxation of Mutual Funds' Capital Gains Distributions

Deferring taxation of capital gains that mutual funds distribute to their investors may not substantially reduce federal revenue. One reason is that almost half of household mutual fund assets are in retirement accounts, which are already allowed to defer taxation until shareholders begin cashing out to finance their retirement. In addition, individual mutual fund assets grew 12.75 percent a year from 1994 to 1999, suggesting that the growth in mutual fund assets would offset part of the estimated static loss.

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[41] Dickson, Shoven and Sialm (2000).
[42] Barclay and others (1998), p. 16.

VII. CONCLUSIONS

For the past twenty years, investors have continued to increase their holdings of mutual funds despite inflation and disinflation, booms and bankruptcies, commodity price shocks, globalization of financial markets and the revolution in information technology. Investors have voted with confidence with their savings in the rising earnings and dividends of U.S. corporations for the long-term. Lower inflation, interest rates and the pressure of demographics have boosted the demand for mutual funds. The time is ripe to evaluate the tax implications of capital gains tax rules on the returns to mutual fund investors over the long run and to alter those rules to improve the living standards of mutual fund investors.

To evaluate the impact of tax reform we need to know who mutual fund investors are. This paper has focused on that issue. Mutual fund investors are predominantly middle class. The typical owner of an equity mutual fund is 47 years old and earns $60,000 per year. Median financial assets are $87,500. Sixty-eight percent are married and 20 percent are retired.

Mutual fund investors own a variety of funds, with strong emphasis on equity funds. Capital gain distributions are typically associated with equity mutual funds. Therefore, it is particularly relevant to note that 88 percent of investors owned equity funds in 1998.

Wealth is modest for most mutual fund owners. For the average of equity fund owners, median mutual fund assets are $29,500 with holdings spread among four different mutual funds. The typical equity mutual fund owner first purchased a fund in 1988.

These characteristics define the broad base of households that are likely to benefit the most from tax reform. Tax reform will provide a meaningful benefit to middle-income Americans and would improve their standard of living over the long run.

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