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The Case for a Capital Gains Tax Cut

The 1986 Tax Reform Act increased the maximum tax rate on capital gains income from 20 percent to 28 percent. This 40 percent tax hike has reduced government revenues, discouraged entrepreneurship and caused many investors to hold on to assets they would prefer to sell.

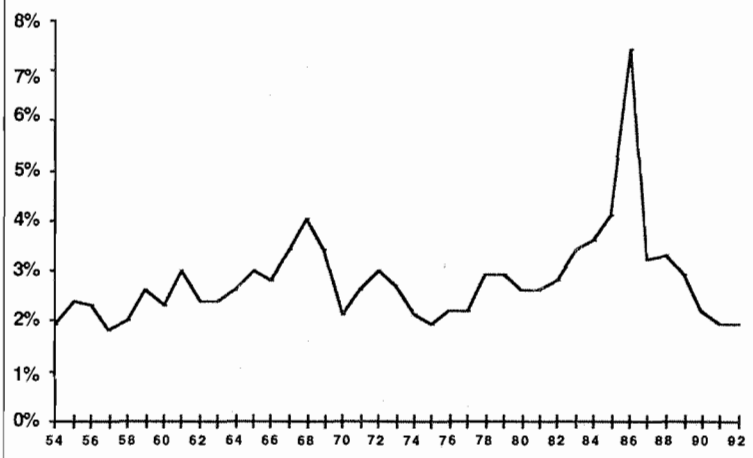
As a result, support for change is growing. On September 27, 1994, every Republican candidate for the House of Representatives signed a "contract" that proposes indexing capital gains for inflation and effectively cutting the capital gains tax rate in half for all taxpayers. Similar reforms are supported by many Democrats and such business organizations as the U.S. Chamber of Commerce. Let's see why.

The Case for Indexing. Because tax brackets and the personal exemption are indexed to inflation, people who receive wage income cannot be pushed into a higher tax bracket by the effects of inflation alone. No similar protection exists for those who receive investment income.

Because investors must pay taxes on gains that merely reflect the effects of inflation, the effective tax rate on their real gains can be extraordinarily high. For example, someone who invested in common stock in 1970, did as well as the Dow Jones Industrial Average and sold the stock in 1980 would have had a capital gain of 18.4 percent. During this same period the price level more than doubled, so the nominal gain actually represented a real loss of 44 percent. Nevertheless, the investor would have been assessed a capital gains tax. The purpose of indexing is to ensure that only real gains are taxed.

FIGURE I

Capital Gains Realizations as a Percent of GDP



Source: Congressional Budget Office and Internal Revenue Service.

The Case for Lower Tax Rates. The vast majority of assets have value only because they are expected to produce future income. For example, bonds will produce interest income and stocks will produce dividends and retained earnings. Since this income will be taxed as it is realized, there is no need to tax the owners of these assets at the time the assets are bought and sold. It impedes the efficient transfer of assets from those who value them less to those who value them more, and it makes investments in all income-producing assets less attractive.

Economic Effect: "Unlocking" Investments. The current taxation of inflationary gains, together with high statutory capital gains tax rates, creates a powerful "lock-in" effect. Since selling is taxed and possessing is not, high capital gains taxes encourage investors to hold rather than sell — thereby avoiding the tax indefinitely. Assets that are held until death avoid capital gains taxes altogether.

When investors lock in their assets this way, government loses revenue it would have gotten if tax rates were lower, and the capital market loses efficiency because the flow of assets to those who value them the most is impeded.

Economic Effect: More Revenue for Government. Capital gains are realized at the time assets are sold. It is clear from the history of asset sales that investors are highly sensitive to the tax on capital gains. As Figure I illustrates, investors rushed to sell assets in advance of increases in the capital gains tax in 1969 and 1987. This led to a bulge in sales in 1968 and again in 1986. After the tax increase, however, asset sales fell. Conversely, cuts in the capital gains tax in 1978 and 1981 led to increased sales, as the lock-in effect abated.

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This history has been repeatedly ignored in Washington, DC. In 1986, the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) misled many members of Congress by predicting that the increase in the maximum capital gains tax rate from 20 percent to 28 percent would not deter asset sales and would increase government revenues. In fact:

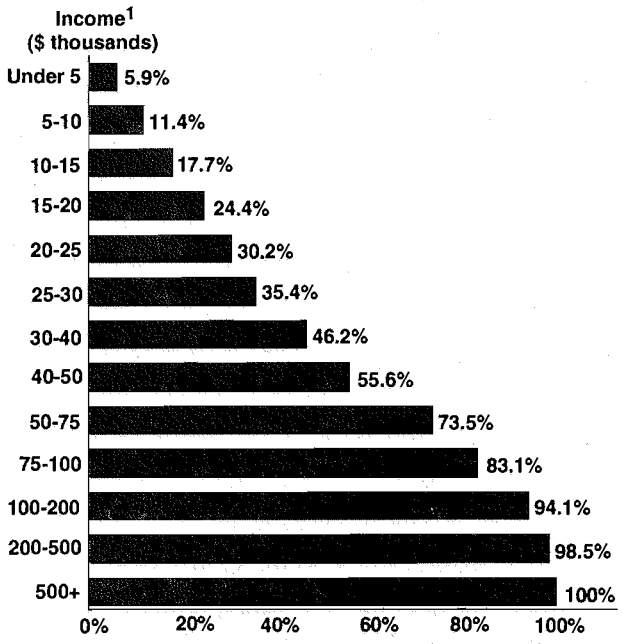
- Capital gains realizations in 1992 (the latest year for which statistics are available) were $116.5 billion, far lower than the $165.5 billion in 1985.
- At 40 percent higher tax rates, capital gains tax revenue of $26.8 billion in 1992 was about 13 percent higher than the $23.7 billion collected in 1985, but after adjusting for inflation, the collections represented a 13 percent decrease.

Economic Effect: More Investment. Capital gains taxes affect investment decisions. In particular, they reduce the amount of capital available for investments with higher risk potential, such as new start-ups and companies in emerging sectors. As a result, the capital gains tax tends to be a direct tax on the entrepreneurship that all economists recognize as essential to growth.

Economic Effect: Benefits for All Income Groups. Despite the strong evidence that lower capital gains tax rates buoy the economy, many in Congress continue to resist cutting the rate for fear they will be accused of cutting taxes only for the wealthy. Yet, as Figure II illustrates, the bulk of taxpayers realizing capital gains are those with middle incomes.

FIGURE II

Cumulative Percentage of Taxpayers Reporting Capital Gains in 1992



[1] Adjusted Gross Income.
Source: Internal Revenue Service.

- Well over half of all taxpayers with capital gains in 1992 had adjusted gross incomes of less than $50,000.
- More than 73 percent had incomes of less than $75,000.

Economic Effect: Economic Growth. All Americans would benefit from the stronger economic growth that would result from lower taxes on capital gains. Earlier this year a study by the Institute for Policy Innovation predicted that:

- A 50 percent capital gains exclusion (effectively cutting the tax rate in half) plus prospective inflation indexing would lower the cost of capital by 5 percent, thereby inducing investors to increase the capital stock by $2.2 trillion by the year 2000.
- This larger stock of capital would create 721,000 new jobs and increase total GDP cumulatively by almost $1 trillion by the year 2000.

Financing the Tax Cut. Expansion of economic activity would increase the overall tax base of the economy by more than enough to compensate for any loss in federal revenue from the tax changes described above. Indeed, the indexing feature alone is probably enough to ensure that the proposal increases revenue. Since only new investments would be indexed, most taxpayers would want to realize their existing gains and invest in new inflation-indexed assets.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett, an economist at the Alexis de Tocqueville Institution.