

BRIEF ANALYSIS

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Poor Gain (Proportionately) the Most From Capital Gains Tax Cut

As Congress considers whether to reduce the tax on capital gains, much of the debate has focused on who would benefit from such a reduction. Opponents claim that those with high incomes would gain disproportionately.

An economic analysis concludes that a lower capital gains tax rate would increase savings and act as an engine of economic growth. After all effects are considered, some income groups gain more or less relative to other income groups, but all income groups would be net gainers from the type of capital gains tax cut proposed. More significantly, as a percentage of income, families in the lowest-income group would gain the most.

Background. Capital gains were taxed at lower rates than other forms of income from the 1920s until the passage of the Tax Reform Act of 1986. During his presidency, George Bush proposed lowering the maximum tax on capital gains from 28 percent to 15.4 percent for assets held more than three years, 19.6 percent for assets held more than two years and 23.8 percent for assets held more than one year. This proposal was initially opposed by some congressional Democrats who claimed that it benefited upper-income taxpayers at the expense of those with lower incomes. Later they proposed a trade-off linking a capital gains tax reduction to a tax increase on higher incomes. However, no capital gains tax relief was adopted as part of the 1990 tax bill. President Clinton expressed support for some sort of capital gains tax relief, but none was included in the 1993 tax bill, either.

Supporters of a reduction in the capital gains tax rate contend that it would increase the value of real estate and other assets (benefiting all holders of assets), stimulate savings (lowering the cost of capital and stimulating investment) and encourage entrepreneurship (leading to economic growth).

Most economists believe that such a tax cut would mitigate the "locked-in effect" of investors holding onto

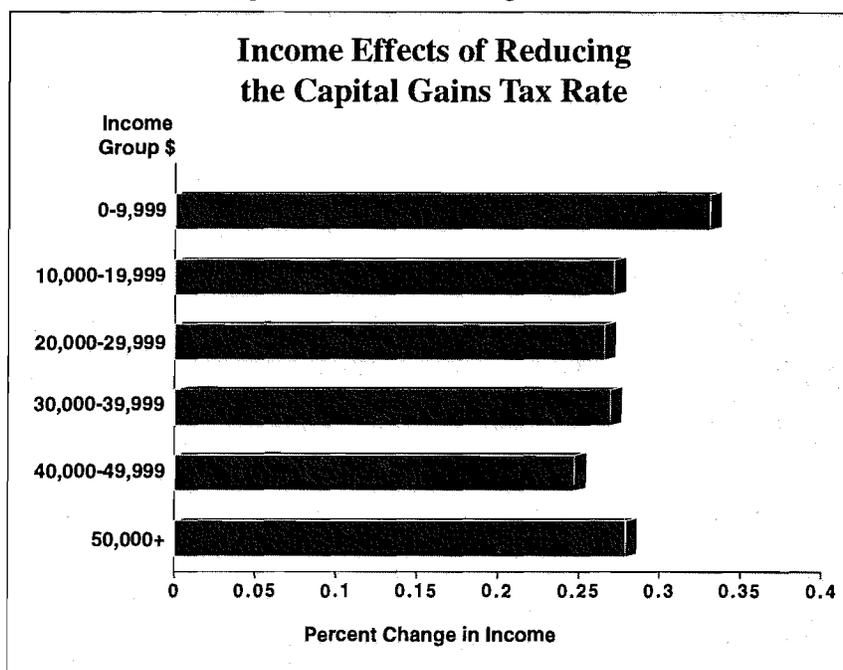
assets they already own which have increased in value, rather than selling them, paying the capital gains tax and purchasing new assets. This effect may cause a misallocation of risk and may reduce savings.

Additionally, a number of studies have found that a capital gains tax cut would actually increase federal revenues. For example, a study published by the National Center for Policy Analysis estimated that adop-

tion of the Bush proposal would have produced \$185 billion in additional federal tax revenue over the following decade.

The Economic Model. Both the direct and indirect effects of a reduction in the capital gains tax rate were analyzed using what economists call a Computable General Equilibrium (CGE) model. The representation of the U. S. economy used for this study incorporates data from 14 primary production sectors, 14 consumption sectors, a foreign sector and government. It divides households into six income groups.

Tax rates in the model were changed to study the effects throughout the economy of the capital gains cut proposed by President Bush. Although the reduction now under consideration differs in detail from the Bush proposal, its effects would be similar.



Who Benefits? Upper-income groups would receive substantial benefits from a capital gains tax cut, but so would other income classes. Not only would all income groups realize capital gains at a greater rate, their incomes also would increase due to the growth of the economy as a whole. Taking both direct and indirect benefits into account, the model indicates:

- The greatest *total* gains in income go to the highest-income group (earning \$50,000 or more), which is not surprising since higher-income families tend to own the most capital.
- However, the highest *percentage* gains in income go to the *lowest*-income families (\$0-\$9,999).

The relatively high percentage gain in income (0.33 percent) to the lowest income group is due to several factors. For instance, many farmers who fall into this group are land rich and income poor. The reduction in capital gains taxes allows them to benefit from using their land for forestry as well by selling it. (In forestry, *all* income is taxed as a capital gain.) The expansion of the forestry sector is associated with an expansion of the logging and wood product sectors, which benefits workers in these sectors, who tend to be in the lowest-income group. Expansion in many sectors necessitates increased production of machinery in the manufacturing sector. Many service sectors also expand, with resulting benefits to workers.

The overall results of the reduction in capital gains tax rates are somewhat mixed.

- The lowest-income group (\$0-\$9,999) has the greatest percentage gain, and the percentage gain in income declines with increasing income among the three lowest-income groups (\$0-\$9,999, \$10,000-\$19,999 and \$20,000-\$29,999).
- The percentage change in income is greater for the \$30,000-\$39,999 group than for the \$20,000-\$29,000 group, but smaller than the percentage gain of the two lowest-income groups.
- The smallest percentage change in income is for the second highest-income group (\$40,000-\$49,999).
- And the highest-income group (\$50,000 plus) enjoys a percentage increase in income second only to the lowest-income group.

Production Expands. Among the 14 production sectors in the model, the reduction in capital gains taxes would spur the growth of logging the most (5.8 percent). This is not surprising since in forestry all income, not just capital income, is subject to the capital gains tax rate.

Producers in this sector would be likely to increase output considerably despite the fact that the tax-inclusive price of their products would fall by 8.4 percent.

Moreover, expansion of the machinery and finance sectors would assure increased future economic growth because capital in these sectors is taxed at a relatively high rate compared to capital in other sectors, and these two sectors represent the bulk of net investment. This makes them very important for economic growth.

Savings Increase. The computer simulation of a capital gains tax rate reduction shows that output would increase in every sector of the economy and that savings would increase substantially (0.26 percent). Savings increases because it can be used for investment, and households would enjoy greater after-tax returns due to the decrease in the capital gains tax rate.

This increase in savings is associated with an increase in production-sector financial services and consumer financial services. The increases in savings and consumer financial services, like the expansion in the producer financial services and manufacturing sectors, bode well for future economic growth.

After savings and financial services, the largest increase in output occurs in the housing sector (0.24 percent). Gains in personal income associated with reduced capital gains taxes lead to higher demand for housing, reinforced by savings increases and a fall in interest rates.

Effect on Government Revenues. Another objection that is raised to the capital gains tax reduction is that it would reduce government revenues. In this model, government revenues do fall, but only by 1.40 percent. The loss is small because the initial revenue reduction associated with the tax cut is offset by increased revenue associated with the general increase in economic activity as secondary effects of the tax reduction expand the economy overall.

Conclusion. The model indicates that all income groups would experience higher income as a result of a reduction in the capital gains tax rate, with the lowest-income families enjoying the highest gains. Further, the lower rate would encourage saving and stimulate economic growth, yielding an increase in tax revenues that would almost completely offset any revenue loss from the tax cut.

This Brief Analysis was adapted from Barry J. Seldon and Roy G. Boyd, "A General Equilibrium Analysis of a Reduction in Capital Gains Taxes," Public Finance Quarterly, Vol. 23, No. 2, April 1995, pp. 193-216.