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National Center for Policy Analysis

POLICY BACKGROUNDER No. 103
For people with limited time and a need to know.

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Budget Summit Issue:

WOULD A CAPITAL GAINS TAX CUT INCREASE OR REDUCE GOVERNMENT REVENUE?

"Last year's forecasts ranged from a $60 billion revenue loss to a $60 billion revenue gain."

"This year's forecasts ranged from a $34 billion revenue loss to a $185 billion revenue gain."

Background. Last year the House passed a capital gains tax cut (Jenkins/Archer bill) which subsequently died in the Senate. The Joint Committee on Taxation (JCT) predicted the bill would *reduce* federal revenues by about $60 billion over the next decade.[1] The National Center for Policy Analysis (NCPA) predicted the bill would *increase* federal revenue by $60 billion.[2] Congressional opponents of a capital gains tax cut agreed with the JCT. Congressional supporters agreed with the NCPA.

The Bush Proposal. This year, President Bush introduced a new proposal for a capital gains tax. Ironically, the proposal was especially tailored to fit the JCT's forecasting methods — virtually guaranteeing a forecast of increased federal revenues.[3] The JCT, however, changed its forecasting assumptions and predicted a $34 billion[4] loss over the next ten years. The U.S. Department of the Treasury predicted a $24 billion gain.[5] The NCPA predicted a $185 billion gain.[6] The range of forecasts varies by $219 billion.[6]

Importance of the Issue: Economics. In budget negotiations, President Bush and congressional leaders have agreed that any budget package must (1) increase federal revenue and (2) contain incentives for new investment. The agreement assumes that policymakers know how a policy change will affect federal revenues and the economy. With respect to capital gains legisla-

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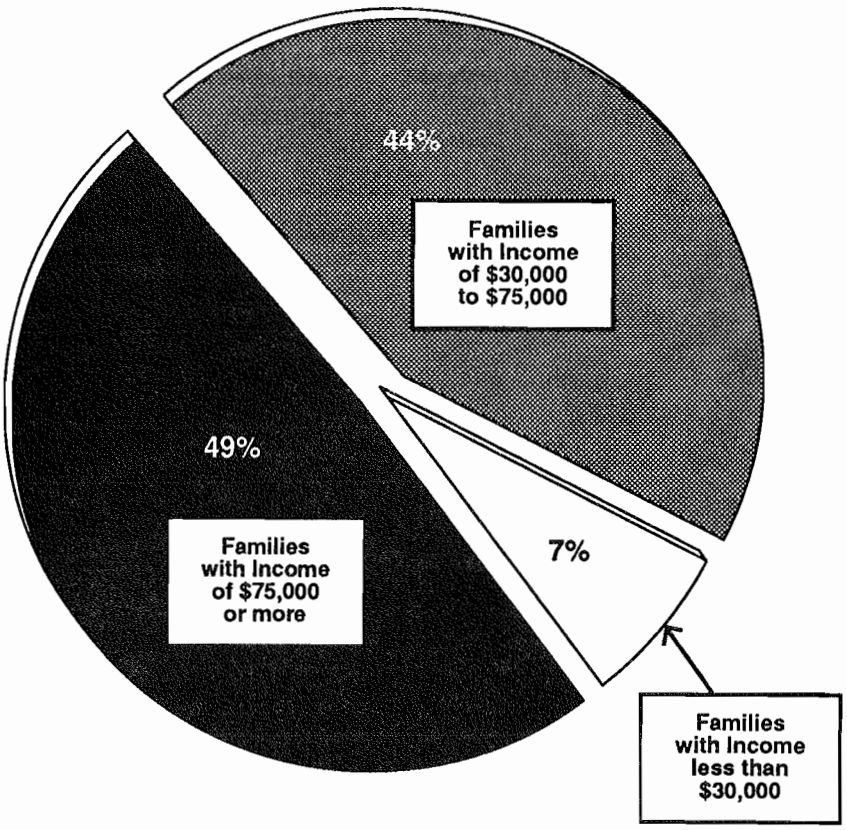
"In no other area of policy have economic forecasts differed so much or been accompanied by so much rhetoric and emotion."

tion, this assumption is clearly wrong. In no other area of policy have economic forecasts differed so much and been accompanied by so much rhetoric and emotion.

Importance of the Issue: Fairness. Higher-income taxpayers have more capital gains income on the average. In any given year, about 76 percent of people with an income of $200,000 have a capital gain, and the average gain is about $440,000.[7] Opponents of a capital gains tax cut argue that the cut would not only lead to a loss of revenue but also would amount to a giveaway to the rich. But the converse is equally true. If the tax cut produces *more* revenue, most of the new revenue will come from wealthy taxpayers. [See graphic.]

"If a capital gains tax cut produces more revenue, most of it will come from wealthier taxpayers."

IF THE BUSH CAPITAL GAINS PROPOSAL INCREASES GOVERNMENT REVENUE, WHO WILL PAY THE NEW TAXES?



Distribution of increased tax payments in 1995.

Source: Aldona Robbins and Gary Robbins, "The Bush Savings Plan," NCPA Policy Report No. 152, National Center for Policy Analysis, June 1990.

What History Shows. History is on the side of the proponents of a capital gains tax cut. Even a casual examination of the evidence shows a clear, unmistakable, *inverse* relationship between capital gains tax revenue and the capital gains tax rate:[8]

"Historically, a cut in the capital gains tax rate has always produced more total tax revenue."

- From 1968 through 1978, a steady rise in the maximum tax rate on capital gains occurred because of the effects of bracket creep. Yet the amount of revenue the federal government collected from the tax was almost one-half its 1968 level by 1970 and did not regain the 1968 level until 1976.

- Following a 1978 reduction in the maximum capital gains tax rate, federal capital gains revenues rose steadily from $9.1 billion in 1978 to $12.5 billion in 1980.

- Following the 1981 cut in the maximum capital gains tax rate from 26.67 percent to 20 percent, capital gains tax revenue almost doubled in four years — rising from $12.7 billion in 1981 to $24.5 billion in 1985.

What the Scholarly Studies Show. Numerous studies of the capital gains tax have been performed by scholars in and out of government — economists whose judgment has not been clouded by the political views of their employers. Harvard economist Lawrence Lindsey recently reviewed the academic literature on the effects of the capital gains tax rate increase that resulted from the Tax Reform Act of 1986.[9] Lindsey found that, with only one exception, the studies predicted that the increase would reduce long-term government revenue.[10] Lindsey's own estimate is that federal revenue would be maximized by a capital gains tax rate of about 15 percent.

"Almost all scholarly studies show that a cut in rates produces more revenue."

Why Economic Forecasts Differ: Static vs. Dynamic Assumptions. The Reagan economic program was based on the idea that changes in tax rates cause people to change their behavior. If the tax rate on investment income is lower, people have incentives to save more and invest more. They also have incentives to engage in less tax avoidance and tax evasion. Thus at lower tax rates there will be more income to tax, while at higher tax rates there will be less.

"The static forecasts of government agencies assume taxes do not affect economic behavior."

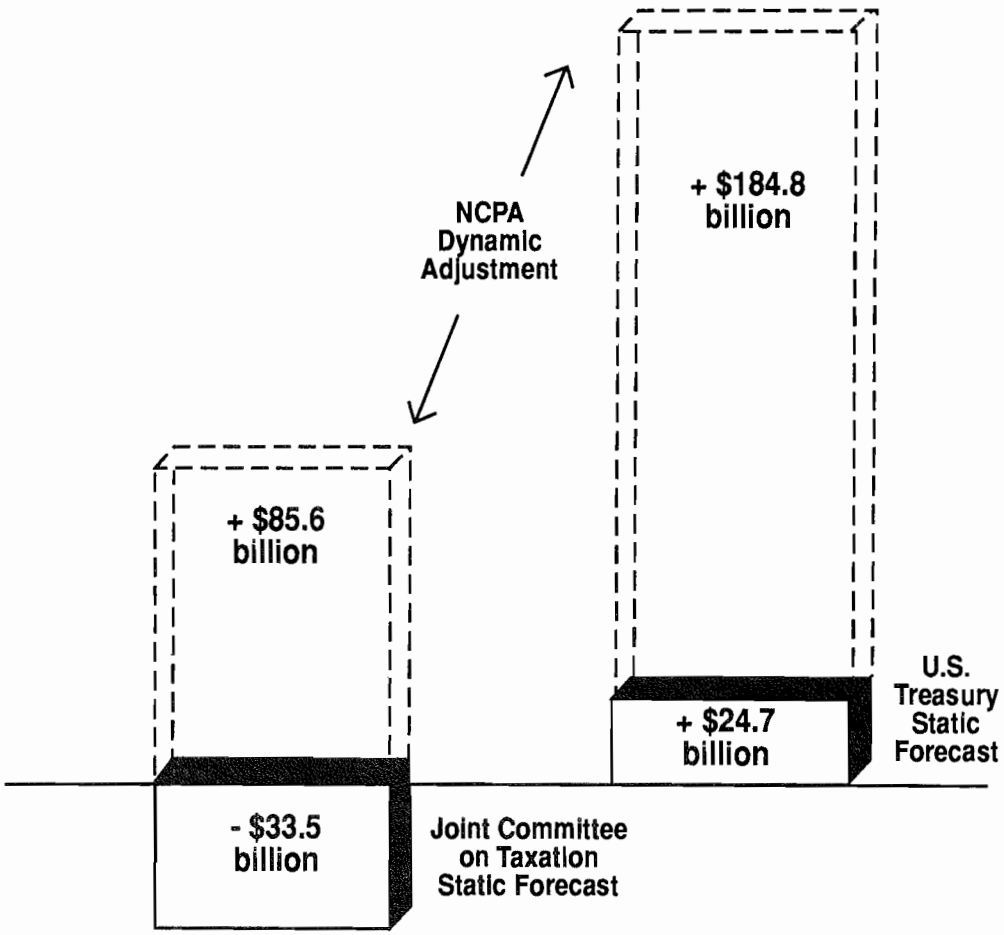
These insights are accepted by almost all professional economists. Yet they typically are ignored by the Congressional Budget Office (CBO), the Joint Committee on Taxation (JCT) and even the

U.S. Department of the Treasury.[11] Forecasts of these agencies usually are based on *static*, rather than *dynamic*, assumptions.

In ignoring the effect of a capital gains tax cut on investment, the government's major economic forecasting agencies ignore the very reason why a capital gains tax cut is being proposed. This practice is not only conceptually indefensible, but it also leads to serious forecasting mistakes. Even using very conservative assumptions about the increase in the capital stock, it is clear that *dynamic economic changes swamp all other effects and all other forecasting differences*. [See graphic and Boskin letter attached.]

"The dynamic effect on economic growth swamps all other forecasting differences."

THE BUSH CAPITAL GAINS PROPOSAL
EFFECTS ON FEDERAL REVENUE
1990 - 2000



Why Economic Forecasts Differ: The Effects on Economic Growth. Static analysis makes another implicit assumption: that capital gains tax rates are solely an issue between the federal government and people who have capital gains. The rest of us have no reason to care (except insofar as we benefit from increased government revenues). Once we admit that capital gains tax rates affect savings and investment behavior, however, *all* of us have a reason to care.

- If lower capital gains tax rates cause people to save more and invest more, there will be greater economic growth — causing *everyone's* income to rise.

- If economic growth is higher, more will be collected in all federal taxes, including Social Security (FICA) taxes, corporate income taxes and federal excise taxes. [See sidebar.]

"Both the Treasury and the Joint Committee on Taxation assume capital gains tax rates have no effect on the U.S. economy."

EFFECT ON FEDERAL REVENUE OF THE BUSH CAPITAL GAINS TAX CUT 1990 THROUGH 2000 ($ billions)

Type of Tax	JCT Static Forecast	Treasury Static Forecast	NCPA Dynamic Forecast
Personal Income Tax	**- $33.5**	**+ $24.7**	**+ $79.9**
Social Security (FICA) Tax	**0**	**0**	**+ 53.5**
Corporate Income Tax	**0**	**0**	**+ 41.2**
Other Federal Taxes	**0**	**0**	**+ 10.2**
Total	**- $33.5**	**+ $24.7**	**+ $184.8**

The Art of Selective Forecasting. There are five key economic effects of a capital gains tax rate change. Some are positive; some are negative. Forecasters do not have to "cook the books" in order to produce a positive or negative forecast. They can simply focus on some effects and ignore others. [See sidebar.] The five economic effects are as follows:[12]

- **Rate Effect:** Other things equal, a lower tax rate will produce *less* revenue.

- **Induce Sales Effect:** At lower tax rates, sales of assets become more attractive. Increased sales will produce *more* revenue.

- **Conversion Effect:** If capital gains are taxed at a lower rate than ordinary income, people have an incentive to convert ordinary income into capital gains income. To the extent they are successful, revenues will *fall*.

- **Countermeasures Effect:** The alternative minimum tax and certain other measures limit the advantage of a lower tax rate. These measures cause revenue to *rise*.

- **Economic Growth Effect:** A capital gains tax cut creates incentives to invest, and more investment leads to greater economic growth. The growth effect produces *more* revenue in future years.

All of the government forecasts of the past decade have ignored one or more of these effects and all have ignored the effect of a tax change on economic growth.

Do Economists Disagree as Much as the Politicians? No. Economists at the CBO, the JCT and the Treasury Department's Office of Tax Analysis do not deny that a capital gains tax cut will stimulate investment and economic growth. They simply leave this consideration out of their formal forecasts.

"Pushing rhetoric and politics aside, there is not much difference in the opinions of professional economists."

- The Congressional Budget Office's own research shows that a 25 percent capital gains tax would collect just as much revenue as a 33 percent tax because of behavioral responses.[13] Yet this insight is missing in the CBO's formal forecasts.

- Studies by the Treasury's own economists show that a capital gains tax cut would stimulate investment and economic growth.[14] Yet these insights are missing in the Treasury's formal forecasts.

"Over the last decade, capital gains tax forecasting has become a political football."

HAS CAPITAL GAINS FORECASTING BECOME A POLITICAL FOOTBALL?

Date	Forecast[1]
1978	**Considering only one of five economic effects, the Treasury predicts the 1978 capital gains tax cut will lose revenue.**
1985	**Considering two of five effects, the Treasury says the 1978 tax cut increased revenue.**
1986	**Considering three of five effects, the JCT predicts the 1986 increase in capital gains taxes will also increase revenue.**
1989	**Considering two of five effects, the Treasury predicts the Jenkins/Archer tax cut will in crease revenue.**
	Considering three of five effects, the JCT predicts revenue losses.
1990	**Considering four of five effects, the Treasury predicts the Bush capital gains tax cut will increase revenues.**
	Considering four of five effects (but changing its forecasting methods), the JCT predicts revenue losses.

[1]There are five economic effects of a change in the capital gains tax. The fifth effect, the effect on economic growth, was ignored in all of the above forecasts.

Source: Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990, Table I.

"There are increasing complaints about the quality of agency forecasts on Capitol Hill and in the Administration."

Increasing Complaints About Agency Forecasts. Major government economic agencies' forecasts are being viewed with increasing suspicion, both by Congress and by Bush Administration economists.

- In a highly unusual move, the Chairman of the Council of Economic Advisors (CEA) sent a letter to Congress complaining that the JCT and Treasury forecasts ignored scholarly studies, historical evidence and their own internal studies.[15]
- In a separate letter to Congress (cosigned by the Under Secretary of the Treasury!), the CEA chairman submitted his own estimate of the growth effects of a capital gains tax cut.[16] [See attachment.]

"Since government forecasting agencies seldom reveal their assumptions. they can change assumptions from one day to the next, without fear of exposure."

The Need For Reform in Federal Forecasting Agencies. The Administration and Congress cannot enact wise policies without accurate, reliable information. Right now they are not getting that information from the CBO, the JCT or the Treasury's Office of Tax Analysis. Although these agencies operate with taxpayer's money, they usually do not publicly reveal the assumptions behind their forecasts. Thus they can adopt one set of assumptions today and a contradictory set tomorrow — depending on personal preferences or political pressure.

John C. Goodman
President
National Center for Policy Analysis

- 30 -

FOOTNOTES

[1]See Testimony of Acting Secretary (Tax Policy) Dennis E. Ross before the Senate Finance Committee, March 14, 1989.

[2]Gary Robbins, "Taxing Capital Gains," National Center for Policy Analysis, NCPA Policy Report No. 102, October 1988.

[3]Reported by Evans and Novak.

[4]This number is a ten-year forecast arrived at by extending the JCT's five-year forecast.

[5]This number is a ten-year forecast arrived at by extending the Treasury's five-year forecast.

[6]Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990.

[7]John Goodman, Aldona Robbins and Gary Robbins, "Elderly Taxpayers and the Capital Gains Tax Debate," National Center for Policy Analysis, NCPA Policy Report No. 153, July 1990, Tables X and XI.

[8]Based on U.S. Department of the Treasury data reprinted in Ronald Utt, "Capital Gains Taxation: The Evidence Calls for a Reduction in Rates," *Heritage Foundation Backgrounder,* No. 704, May 2, 1989, Table 3, p. 10.

[9]The Tax Reform Act of 1986 increased the maximum capital gains tax rate from 20 percent to 33 percent.

[10]Predicted revenue losses for the federal government for the period 1987 through 1991 ranged from $27 billion to $105 billion as a result of the increase in capital gains tax rates. See Lawrence B. Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates under Various Assumptions," *National Tax Journal,* Vol. 40, No. 3, September 1987.

[11]These agencies consider only portfolio adjustments to a tax change. They ignore the effects of increased investment. See Aldona Robbins and Gary Robbins, "The Bush Savings Plan," National Center for Policy Analysis, NCPA Policy Report No. 152, June 1990.

[12]See Robbins and Robbins, "The Bush Savings Plan."

[13]Congressional Budget Office, *How Capital Gains Rates Affect Revenue: The Historical Evidence* (Washington, DC: U.S. Congressional Budget Office, March 1988); and Lawrence Lindsey, *The Growth Experiment* (New York: Basic Books, 1990.) P. 143.

[14]"Report to Congress on the Capital Gains Tax Rate Reductions of 1978," U.S. Department of the Treasury, September 1985; Michael R. Darby, Robert Gillingham and John S. Greenlees, "The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," *Treasury Bulletin,* June 1988; Robert Gillingham, John S. Greenlees and Kimberly D. Zieschang, *New Estimates of Capital Gains Realization Behavior: Evidence From Pooled Cross-Section Data,* May 1989, U.S. Department of the Treasury, Office of Tax Analysis, OTA Paper 66; and Gerald E. Auten, Leonard E. Burman and William C. Randolph, *Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data,* May 1989, U.S. Department of the Treasury, Office of Tax Analysis, OTA Paper 67.

[15]Letter from Michael J. Boskin (Chairman of the Council of Economic Advisors) to Senator Lloyd Bentsen (Chairman of the Senate Committee on Finance) dated March 6, 1990.

[16]Letter from Michael J. Boskin and Robert R. Glauber (Under Secretary for Finance, Department of the Treasury) to Senator Lloyd Bentsen dated March 6, 1990.

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

March 6, 1990

Dear Mr. Chairman:

In the debate over the revenue impact of restoring a tax differential for capital gains, the full economic benefits of lower capital gains tax rates have been neglected. As a matter of standard procedure, neither Treasury nor the Joint Committee on Taxation (JCT) account for the beneficial effect of a capital gains tax cut on economic growth. Though the impact of a capital gains cut on growth is difficult to measure precisely, and this is one reason neither Treasury nor the JCT currently make such estimates, reasonable estimates yield revenue dividends which more than offset any static estimate of revenue loss.

- A conservative estimate is that the President's proposal would lower the cost of capital for businesses by 3.6 percent. The lower cost of capital will increase investment and, therefore, productivity and economic growth.

- Over the next 5 years, the lower cost of capital arising from the President's proposal can be reasonably expected to increase GNP by a total of $61 billion. This would yield roughly $12 billion in extra revenue over the 5 years. Even using the extremely pessimistic JCT estimates and making lower-bound assumptions, the capital gains tax cut would increase revenue over the next 5 years, once economic growth is considered.

- Over the next 10 years, the lower cost of capital arising from the President's proposal can be reasonably expected to increase GNP by a total of $274 billion. The revenue dividend from this increased growth would be about $55 billion, swamping any estimate of revenue losses that ignores the effect on economic growth.

- This is a conservative estimate of the likely beneficial effects on GNP, because a capital gains tax cut encourages the entrepreneurial, highly productive, investments that contribute most strongly to growth. In addition, restoring the capital gains differential will help "unlock" investors, allowing them to move to more productive investments. Estimates based only on the reduced cost of capital do not include these important effects on the mix of investment in the economy.

- Reducing the tax rate on capital gains will lower the double taxation of equity incomes, reducing the tax bias against equity finance and encouraging business saving.

The Tax Reform Act of 1986 was an historic achievement. President Bush strongly supports the principle of that tax reform: a broader base and lower tax rates. However, the Administration firmly believes that lowering the capital gains tax rate will correct a significant flaw in our current tax structure. It is our opinion that a cut in the capital gains tax rate will reduce the tax bias against equity finance, decrease the cost of capital for American firms, increase investment, spur entrepreneurial activity, and accelerate economic growth.

Sincerely,

Michael J. Boskin
Chairman
Council of Economic Advisers

Robert R. Glauber
Under Secretary for
Finance
Department of Treasury

The Honorable Lloyd Bentsen
Chairman, Committee on Finance
United States Senate
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ABOUT THE NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute, funded exclusively by private contributions. The NCPA originated the concept of the Medical IRA (which has bipartisan support in Congress) and merit pay for school districts (adopted in South Carolina and Texas). Many credit NCPA studies of the Medicare surtax as the main factor leading to the the 1989 repeal of the Medicare Catastrophic Coverage Act.

NCPA forecasts show that repeal of the Social Security earnings test would cause no loss of federal revenue, a capital gains tax would increase federal revenue, and the federal government gets virtually all the money back from the current child care tax credit. These forecasts are an alternative to the forecasts of the Congressional Budget Office and the Joint Committee on Taxation and are frequently used by Republicans and Democrats in Congress. The NCPA also has produced a first-of-its-kind, pro-free-enterprise health care task force report, representing the views of 40 representatives of think tanks and research institutes.

The NCPA is the source of numerous discoveries that have been reported in the national news. The NCPA discovered that:

- Blacks and other minorities are severely disadvantaged under Social Security, Medicare and other age-based entitlement programs;
- Special taxes on the elderly have destroyed the value of tax-deferred savings (IRAs, employee pensions, etc.) for a large portion of young workers; and
- Man-made food additives, pesticides and airborne pollutants are much less of a health risk than carcinogens that exist naturally in our environment.

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