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DO'S AND DON'TS FOR CAPITAL GAINS TAX RELIEF

The budget deal between President Clinton and Republican Congressional leaders includes, among its many components, capital gains tax relief. This was a key demand of Republican negotiators. Largely at the insistence of Congressman Bill Archer (R-TX), chairman of the House Ways & Means Committee, the agreement does not specify the details of the capital gains tax cut but leaves that responsibility in the hands of Congress's tax writing committees.

The tax writing committees will produce a good capital gains proposal if several questions can be answered in the affirmative:

- Does the proposal substantially cut the capital gains tax rate?
- Does it take effect quickly rather than being phased in slowly?
- Does it apply to capital gains realized by corporations as well as by individuals?
- Does it apply to all assets, not just to particular assets that policy makers favor?
- Is it free of "take backs", changes that would adversely alter the current-law tax treatment of capital gains?

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A serious constraint the committees will face in crafting meaningful reform of the capital gains tax is that they need to keep the estimated revenue cost fairly low. The budget deal authorizes gross tax reductions over 5 years of $135 billion (net reductions of only $85 billion because of $50 billion of tax increases). But two big-ticket items, a child credit and tax breaks for college students, may claim the majority of the cuts. The remainder must be divided among capital gains relief, estate tax relief, expanded individual retirement accounts, and other pro-efficiency reforms.

The current tax system imposes multiple taxes on saving and investment, creating a strong anti-saving, anti-investment tax bias. The core objective of capital gains tax reform should be to eliminate the portion of the bias attributable to the capital gains tax. (See Michael Schuyler and Roy Cordato, "The Case For Restoring A Capital Gains Differential," IRET Economic Report No. 49, July 1989.) Because of the revenue constraint, however, the tax writing committees cannot adopt the best reform of the capital gains tax: its abolition.

By retarding saving and capital formation — the economy's main sources of improved productivity — the capital gains holds back growth in production, real wages (which depend on productivity), international competitiveness, and living standards. Many observers think the capital gains tax has an especially adverse effect on entrepreneurial activity. Because the tax is triggered when investors sell assets, it also tends to "lock in" old investments, impairing efficient market valuations of alternative investments and distorting portfolio decisions.

If the capital gains tax is not eliminated, there should at least be a major reduction in its rate. The

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lower the rate, the smaller the bias against saving and investment. A worthy goal would be to cut the top rate in half, from 28% to 14%. Far from being a tax break, this would merely ease one of the layers of multiple taxation on the returns to saving.

With an accurate revenue estimate, the revenue cost of this rate reduction should be quite small. The lower tax on each dollar of capital gains would be mostly offset by more frequent capital gains realizations due to a decreased "lock-in" effect, by higher asset prices due to the lower tax rate on gains, and by more revenues from other taxes because the lower capital gains tax rate would lead to a stronger economy. Unfortunately, Congress's official revenue estimators have in the past only considered the first of these effects, ignoring two out of three positive revenue feedbacks. For several years their estimates further exaggerated the revenue cost of capital gains relief because they incorporated erroneous Congressional Budget Office (CBO) estimates that the big hike in the capital gains tax rate following the 1986 tax act did not slow capital gains realizations. By 1993, CBO's overestimate of realizations was more than 100%! If Congress's estimators deliver reasonably accurate estimates this time, the job of the tax writing committees will be much easier.

The sooner the capital gains tax is cut, the more quickly the economy can reap the benefits. Thus, a cut that takes effect quickly is more desirable than one that slowly phases in over many years. House Ways & Means Chairman Bill Archer and Senate Finance Committee Chairman William Roth (R-Del) have announced that the effective date for a reduced rate will be May 7. But it is not yet clear whether the full cut will occur then or be spread out over several years.

Capital gains tax relief should not be confined to individuals. The capital gains tax is imposed on individuals or corporations depending on who realizes the gains. In 1993, for example, $152 billion of capital gains were realized by individuals and $79 billion by corporations (*SOI Bulletin*, Spring 1996). If Congress excludes corporate capital gains from relief, the tax's harmful biases will be unabated on a substantial share of capital gains. Given that income taxed to corporations is again subject to tax on individuals, there is all the more reason why capital gains tax relief should include corporate-level capital gains.

For capital gains relief to be significant, it also needs to apply to all capital assets. Highly targeted capital gains measures have the allure that their revenue cost is low, but their downside is that they fail to reduce the tax's distortions in most cases and may create new distortions of their own. For example, the Administration's budget proposed to lower the capital gains tax — but only on sales of homes — the assets already receiving the best capital gains tax treatment. That would do nothing to lessen the capital gains tax's negative effects on investment in plant, equipment, structures, and new businesses.

Policy makers may also consider targeting capital gains tax relief if they believe they have special insights into which investments are best. For such government targeting to be better than no government targeting, however, policy makers must be better judges of value and productivity than private investors. In fact, government planning has a lamentable record of failure throughout the world. Better to let private investors decide which investments make sense.

In the past the capital gains tax rate has generally been conditioned on how long assets are held, with the tax rate sometimes decreasing as the holding period increases. That, too, is misguided. The private sector does not need advice from Washington on the proper time horizon. If investors routinely sell their assets too quickly, they will predictably lose money by doing so, and the profit motive will quickly tell them to hold their assets longer — without a government-dictated, tax-based carrot and stick.

A valuable reform would be to permit greater use of rollovers, whereby tax is not triggered if a capital asset is sold and the proceeds reinvested in another asset. Current law provides rollover treatment for gains on the sale of principal residences and exchanges of like-kind investment property. Rollovers do not abolish the capital gains tax but defer it; the full tax (computed from the original cost basis) is due if the proceeds are not reinvested. Rollovers would make possible greater flexibility in adjusting the investment mix to changing needs and opportunities; it would virtually eliminate the "lock-in" effect. Revenue considerations may require limiting the amount of gains to which rollover treatment would apply.

Several bills introduced in this session of Congress would provide rollover treatment for exchanges of qualified small business stock. One example is the Return Capital To The American People Act, introduced in the Senate as S. 501 by Senator Mack (R-FL) and in the House as H.R. 1033 by Congresswoman Dunn (R-WA). Broader application of rollovers is desirable, but even such extremely limited extensions would be an improvement over current law.

A major concern is that a highly visible rate cut may be eroded by adverse, but less visible, changes in the tax treatment of capital gains. Such hidden take backs would undo some of the intended tax relief and are apt to worsen tax complexity. The Administration's budget recommends numerous take backs. (Some of these are discussed in Michael Schuyler, "Tax Increases By Any Other Name," IRET Economic Policy Bulletin No. 70, March 1997.)

Indexing capital gains for inflation would be a positive step. But it is complicated, and the current low rate of inflation reduces its near-term importance. If the revenue constraint forces a choice between indexing and other desirable features of capital gains tax relief, it might be sensible to leave indexing for later or delay its effective date.

This year's budget deal has relatively few items to improve the economy's efficiency. Capital gains tax relief may be one of those few. Given the benefits to everyone from economic growth, it is vital that the capital gains measure which emerges from Congress be a good one.

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