IRET
Institute For Research On
The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

STATEMENT OF NORMAN B. TURE
PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION (IRET)
CONCERNING TITLE I, H.R. 9
PRESENTED TO
THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 22, 1995

SUMMARY

The reduction in capital gains tax rates and the inflation adjustment of the bases of capital assets proposed in Title I of H.R. 9 would contribute significantly to moderating the bias against saving imposed by the existing federal tax system. In view of the projected preemption of virtually all of the nation's saving by federal entitlement spending, easing the anti-saving tax bias is of the utmost urgency and should command top tax policy priority.

While these tax changes will improve the tax climate for all savers and investors, they will be particularly important for highly innovative, entrepreneurial businesses among which small and new businesses take a leading role. Innovative and entrepreneurial business activities, major sources of economic progress, depend heavily on access to saving for their funding.

The existing tax treatment of capital gains increases the cost of saving compared to consumption uses of current income. This anti-saving impact is exacerbated by taxing nominal rather than inflation-adjusted gains. Moreover, taxing realized gains, particularly without inflation adjustment, immobilizes accumulated savings and impairs the capital market's critically important function of assigning them to their most productive uses.

The proposed deduction from adjusted gross income of 50 percent of net long-term capital gains and inflation adjustment of basis would significantly improve the tax treatment of capital gains. These revisions would materially reduce the income tax bias against all saving, not merely

that invested in property identified as capital assets. Both business and household saving are likely to increase substantially above levels that would otherwise occur, although the desirability of the proposed capital gains reform does not depend on how large the saving response will be.

Both of these proposed reforms would improve the efficiency of the financial markets by significantly reducing tax impediments to investors' changing the composition of their asset holdings in response to market signals. Realizing the benefits of innovation and technological advance often requires business restructuring. The application of the changes proposed in Title I of H.R. 9 to corporate taxpayers is extremely important in reducing the existing tax barriers to changes in business ownership that are often needed for such restructuring.

Changes in asset holding and in business ownership, essential adjustments to dynamic changes in economic conditions, often result in capital losses. The limitations imposed by existing law on the offset and deductibility of losses impede these adjustments. A highly constructive improvement in the tax treatment of gains and losses would be to ameliorate the harsh treatment of capital losses, particularly those realized by corporate taxpayers.

Reducing the capital gains tax will increase the differential between the tax burden on distributed and retained corporate earnings. Enactment of Title I will increase the desirability of providing some relief at the corporate level for dividend distributions.

More severely taxing saving than consumption uses of income is unfair and economically damaging. There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving; such punitive taxation is not made "fair" because its weight is greater on the rich or on businesses than on others. By reducing the undue tax burden on saving, Title I of H.R. 9 is a welcome initiative for addressing this unfairness.

IRET Institute For Research On The Economics Of Taxation

IRET is a non-profit 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote growth and efficient operation of the market economy.

STATEMENT OF NORMAN B. TURE
PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION
(IRET)

CONCERNING TITLE I, H.R. 9
PRESENTED TO
THE COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
FEBRUARY 22, 1995

Madam Chairwoman, members of the Committee, I appreciate the opportunity to discuss with you the significant improvement in the federal income tax that will be provided by enactment of Title I of H.R. 9. Both of the principal features of the proposed capital gains reform — the reduction in the marginal tax rates applicable to capital gains and the inflation adjustment of basis — are highly commendable. Their enactment would contribute to moderating the unwholesome income tax bias against saving and would afford promise of additional efforts to eliminate it completely.

Welcome as the Title I provisions are, additional revisions of the capital gains provisions are needed to provide a tax environment less obstructive of economic growth. Let me call the Committee's attention to one such revision at a later point in my statement.

The context of the Small Business Committee's concern with Title I.

Policy makers should keep clearly in mind that business is the vehicle for economic progress, with small businesses providing much of the motive power for that vehicle. Business organizes the activities that convey ideas from drawing boards into deliverable products and services. New products and services and new production processes, major impetuses for economic progress, don't just happen. Making them realities depends on entrepreneurial activity, on the willingness of entrepreneurs to take the risks inherent in launching new ventures. Entrepreneurial infusions keep business, hence the economy as a whole, from stagnating. And while the entrepreneurial spirit is expressed in businesses of all sizes and ages, new and small businesses are extraordinarily important channels through which that spirit is implemented.

This most assuredly is not to state that the merits of Title I should be assessed solely or even primarily in terms of possible benefits for small business. Public policies, certainly including tax policies, should be fashioned to apply as even-handedly as possible. Much of the enormous complexity of the existing tax law is the product of efforts to particularize the law's application to differing types of transactions, differences in taxpayer situations, distinctions among taxpayer attributes, very often to confine tax relief to particular taxpayers. We have had far too much of this approach to tax policy formulation.

Evaluation of the benefits of Title I, therefore, should not rest on whether any particular group of individual or business taxpayers will benefit more than some other group. Instead, that evaluation should focus on whether Title I will move the tax law toward closer conformity with the critically important criterion of tax neutrality. This criterion calls for minimizing the "excise" effect of taxes — altering the relationships among prices that would result from the operation of the market system free of government influence or intrusion.

The existing tax system falls far short of meeting this standard, particularly with respect to private saving. I believe that it is in this connection that the Committee should be concerned with Title I.

Creating new businesses and implementing innovations requires access to saving. A society that saves a lot will not necessarily be highly entrepreneurial and innovative, but a society that is actively entrepreneurial and innovative must be able to draw on saving that is adequate to finance such efforts. Improving the prospects for small business growth, therefore, depends to an important extent on moderating, if not eliminating completely, the existing tax law's bias against saving.

The Nation has recently been instructed about the imperatives for a larger, more efficient, more rapidly growing economy, one in which the volume of private saving and its share of total income will very substantially exceed those of recent years. The Bipartisan Commission on Entitlement and Tax Reform reported that by about the year 2025 projected entitlement spending under existing federal entitlement programs would exceed the entire amount of revenues projected to be provided under existing tax laws. Federal borrowing to finance the resulting deficit would take up all of the saving of American households and businesses, leaving no saving to capitalize new business or to finance business growth or for investment in private capital formation and other growth-generating private uses.

These projections, even if substantially discounted, highlight the urgency of improving the tax environment for private saving. Title I of H.R. 9 is an important step to that end.

The anti-saving tax bias

The anti-saving, anti-investment bias in the income tax results from the fact that both income that is saved and the income produced by investing that saving are subject to tax, often several times over, while income that is used for current consumption is taxed only once. The consequence is that the amount of current consumption that must be forgone to obtain any given amount of after-tax return on one's saving is greater than if either the income that is saved or the return it produces were excluded from the tax base. The forgone consumption is, of course, the real cost of obtaining that future income. In other words the income tax increases the cost of saving compared to the cost of current consumption. Moreover, the income-tax induced increase in the relative cost of saving is greater the higher is the tax rate to which the person is subject.[1]

The separate income taxation of income generated in corporate businesses, the income taxation of capital gains, and the transfer (estate and gift) taxes very substantially accentuate the anti-saving bias of the federal tax system.

Moreover, the anti-saving bias is exacerbated by the imposition of the tax on the nominal rather than on the inflation-adjusted returns on saving and investment. The expectation of inflation, *per se*, adversely affects saving and investment. Inflation expectations increase the rate at which the returns on saving must be discounted to determine their amount in real terms; unless the expected nominal returns increase at least as rapidly as the expected inflation rate, the value of the expected *real* returns will be depressed, thereby increasing the cost — the forgone current consumption — of any given amount of real future income.

Taxing nominal capital gains aggravates this effect of inflation in increasing the cost of saving. This effect is likely to be particularly severe in the case of gains realized on the sale of corporate stock the market value of which has not kept pace with inflation. It may well result in taxing real losses, not merely overtaxing real gains that are less than nominal gains.

Taxing realized capital gains also impedes transactions in capital assets. An investor will be reluctant to sell his or her capital assets in order to purchase other assets unless the present value of the expected net returns on the replacement assets exceeds that of the expected returns on the existing holding by enough to defray the tax on any gain realized on the sale of the latter. For any given amount of accrued gain, the higher is the capital gains tax rate, the more imposing is the tax barrier to such changes in the composition of a person's assets.

[1] The appendix to my statement provides a number of simple arithmetic examples that show how the individual and corporate income taxes and the taxation of capital gains raise the cost of saving relative to consumption uses of income.

This locking-in effect tends to impose a kind of toll gate charge on business mergers and acquisition. Effective entrepreneurship often involves moving out of a matured business into new ventures, often by selling the business to others for whom it affords greater opportunities. Taxing the gain realized upon disposition of the business raises the reservation price for the sale and tends, thereby, to deplete the resources that would otherwise be rolled over into new ventures.

The existing tax treatment of capital gains and losses also imposes a barrier to the commitment of saving to innovative, therefore high-risk enterprises. Insofar as such ventures succeed, some of the resulting increase in the saver-investor's equity is taxed away if the saver-investor seeks to sell his or her interest in the enterprise to less venturesome savers and to shift his or her investment to other innovative, high-risk ventures. On the other hand, if the venture is unsuccessful, the saver-investor's loss very often is not fully deductible when realized. The effect is to accentuate the risk of such uses of saving, hence to raise the cost of undertaking such enterprises.

Benefits from enactment of Title I

Both the proposed exclusion from adjusted gross income of 50 percent of net long-term capital gains and the adjustment for inflation of the basis of capital assets would be significant improvements over the existing law treatment of capital gains. Of these provisions, the 50 percent exclusion is likely to be more significant in improving the tax climate for saving and investment.

Section 1001. 50 percent capital gains deduction

The proposed deduction from adjusted gross income of half of net long-term capital gains has the effect of cutting the marginal tax rates in half for individual taxpayers in the 15 percent and 28 percent brackets and of affording smaller, but still significant percentage reductions in the capital gains tax rates for people in higher brackets. For corporations, the proposed deduction would cut the top effective marginal rate on capital gains to 17.5 percent from 35 percent. These rate reductions would mitigate the adverse effects, discussed above, of the existing tax treatment.

Reducing the tax bias against saving

The fundamental economic benefit that would be realized from enactment of Title I would be the reduction in the severe bias against saving imposed by the existing federal tax system, particularly the personal and corporate income taxes. Although even outright elimination of the capital gains tax would not fully rid the tax system of its anti-saving, anti-investment bias, the proposed 50 percent gain deduction would make an important contribution in moving the tax system in the direction of neutrality between saving and consumption uses of income. It would, in other words, significantly reduce the extra cost of saving relative to consumption.

This highly desirable effect on the cost of saving would not be confined, it must be stressed, to saving invested in capital assets, as defined in the Internal Revenue Code. In an efficiently operating capital market, changes in market valuations in response to tax changes impel reallocations of saving until risk-adjusted net-of-tax returns are substantially equalized among all assets. Reducing the marginal tax rate on capital gains will reduce the cost of saving invested not only in capital assets but in all other uses, as well. Similarly, this cost reduction will not be limited to the activities, businesses, or industries that are heavily invested with capital assets, as defined in the tax code.

One of the major benefits of the higher levels of saving that is likely to result from enactment of Title I is that the work force will enjoy a greater endowment of all sorts of capital, particularly more technically advanced capital. The consequence is greater labor productivity that will enhance the efficiency of virtually all business activity.

The extent to which any particular business or industry will benefit from these developments is not readily determinable, but neither is this an appropriate public policy concern. The distribution of these benefits should be determined by market operations, not by government dicta. Public policy should not attempt to target particular activities, businesses, industries, or taxpayers for government-granted benefits or incentives. Policy makers should realize that every such selective benefit or incentive raises the costs confronting those who are not the favored targets. These are the real costs of selective tax or spending measures, costs that are never considered in government cost-benefit analyses.

The desirability of the 50 percent deduction and consequent reduction in marginal tax rates on capital gains does *not* depend on how large the saving response to the overall lower cost of saving will be. The objective of this reform is to reduce the existing anti-saving tax bias, not to dictate to households or businesses what uses they make of their income claims and property rights. Reducing capital gains taxes is constructive tax policy whether the resulting increase in saving is great or small.

Having said this, I believe that reducing taxes on capital gains will indeed result in significantly more saving than would otherwise be undertaken. Sound economic analysis urges that tax changes that reduce the cost of saving relative to consumption uses of income will lead to higher levels of saving than would otherwise occur. Opponents of capital gains tax reform insist that saving behavior is little if any responsive to changes in the cost of saving. They obviously fail to note that in making that assertion they are also maintaining that consumption behavior is little if any responsive to changes in its cost. In other words, according to these folks, people and businesses pay no attention to taxes in deciding anything about their economic activities. The Committee should recognize in this viewpoint a license for imposing any amount of any kind of taxes without regard for the damage that will result.

Improving capital market efficiency

Reducing the marginal rate of tax on capital gains will also ease the lock-in effect described above. It will, therefore, reduce the existing tax impairment of the market's function in facilitating the exchange of property rights, hence the market's efficiency. This enhancement of market efficiency is a very important benefit to be obtained from the proposed reduction in marginal tax rates on capital gains, irrespective of the magnitude of the change in the amount of gains realized.

As mentioned above, the lock-in effect of existing capital gains treatment erects barriers to the efficient transfer of business ownership. The proposed 50 percent reduction in the corporate capital gains tax rate will materially reduce this barrier and facilitate changes in corporate ownership as well as free up individuals' property holdings.

One of the most informative indicators of the surging dynamism of the U.S. economy is the ongoing business restructuring, involving major changes in the ways in which companies do business. Very often, business restructuring efforts, aimed at taking advantage of opportunities for productivity enhancement, lead to changes in company ownership. One of the costs of those changes is the tax on the capital gains that may be realized in the process. Reducing that tax wedge will facilitate productivity-enhancing corporate restructuring. It is, therefore, extremely important to retain the inclusion of corporate capital gains within the purview of Title I.

Section 1002. Indexing the bases of capital assets for purposes of determining gain or loss

Adjusting the bases of assets for purposes of determining gain or loss upon the disposition of the assets would avert accentuating the income tax's anti-saving bias in an inflationary environment. Clearly, this proposed change in the tax treatment of capital gains and losses would be inconsequential in an economic setting in which savers were absolutely confident that no inflation would occur over the time period that is relevant for their saving-investment decisions. By the same token, it would afford greater benefits the higher is the expected rate of inflation. Even if the expected inflation rate is quite modest, however, adjusting asset bases for inflation will forestall the adverse effect of the risk of inflation on saving and investment, discussed earlier in this testimony.

Indexing the bases of capital assets for inflation will also contribute, clearly, to freeing up currently locked-in savings. It will, therefore, make an important contribution to enhancing the efficiency with which the capital market performs its functions.

This is not to say that the indexing proposal is free of problems. For one thing, in the case of financial assets such as corporate common stocks, the proposed basis adjustment would apply as a rule only to the initial investment. The proposed indexing would not apply to the additions to basis represented by the corporation's retaining and reinvesting some of its after-tax earnings. The proposed indexing, accordingly, would apply to a smaller and smaller share of the accumulating basis of the stock the longer the stock is held, leaving larger and larger amounts of nominal gains exposed ultimately to tax. I hope the Committee on Ways and Means will address this deficiency.

I also hope that the Committee on Ways and Means will extend indexing of basis for purpose of determining gain or loss on the disposition of equipment subject to a net lease. The differences in contractual arrangements for the acquisition and use of property in a trade or business should not enter into determination of the eligibility of property for the inflation adjustment of basis. Even under modest inflationary expectations, denying this basis adjustment to property subject to a net lease would expose lease arrangements to a significant market place disadvantage with no discernible gain concerning tax principles.

As this Committee knows, small businesses rely relatively heavily on leasing, rather than purchasing, various types of equipment, as well as business premises. Excluding property subject to a net lease from the indexing provisions of Title I would keep the costs of such property unduly high.

One of the major deficiencies of the existing tax treatment of capital gains and losses is their asymmetrical treatment. For individuals, the taxable capital gains realized in any year are fully subject to tax in that year, but net capital losses are not fully deductible in the year in which they are realized. Instead, net capital losses may offset no more than $3,000 of ordinary income in the year in which they are realized. Unused capital losses may be carried forward until fully used up, but they may not be carried back. Since a dollar in the future is less valuable than a dollar today, this accentuates the asymmetry in the tax treatment of losses compared with gains.

Even harsher is the treatment of capital losses sustained by corporations. Corporations may offset capital losses realized in any particular year against the capital gains realized in that year, but none of these losses may be offset against ordinary income. Unused losses may be carried back up to three years and carried forward up to five years.

I discussed briefly above the benefits that Title I will afford in reducing the capital gains tax barrier to the changes in property and business ownership that is the hallmark of a dynamic economic environment. These changes do not always result in capital gains for the parties to the transactions. The existing law limitations on the deductibility of capital losses, particularly in the case of corporations, significantly impede the transfers of property rights to their more productive uses and thereby blunt efficient response to the opportunities and challenges continuously arising in a dynamic business environment. It is to be hoped that the Ways and Means and Committee will address this deficiency of existing law.

Dividend tax relief

Desirable as I believe to be the capital gains tax reforms, their enactment will tend to bias corporate decisions in favor of retaining after-tax earnings rather than distributing them as dividends to shareholders. As noted earlier in this discussion, the fact that the tax on capital gains is deferred until the gains are realized somewhat abates the punitive effect of taxing income generated by corporate businesses both to corporations and their shareholders. There can be little doubt that this somewhat influences corporate distribution policies, although the magnitude of this influence is by no means certain.[2] Expanding the differential in effective tax burdens on retained vs. distributed earnings by reducing capital gains taxation urges integration of the income taxation of corporations and their individual owners. An initial step in this direction would be to provide some relief at the corporate level for dividend distributions.

"Fairness"

Finally, a word about the "fairness" issue. Congressional consideration of tax proposals aimed at reducing tax barriers to saving, capital formation, and entrepreneurship has far too often been blocked by redistributionist assertions that such proposals are unfair because they would benefit rich people and/or business. It is well past time for policy makers to recognize that the goodness or badness of a policy does not depend on the specific attributes of the people who are immediately affected by them. A tax change that reduces the existing tax penalty on saving compared with consumption uses of income is not unfair because it may well more substantially reduce the tax liabilities of people who pay a great deal of taxes and who will greatly increase their saving in response to the tax change than it will the taxes of people who pay little or no taxes.

There is no meaningful social, let alone economic policy goal that is served by punitively taxing saving; such punitive taxation is not made "fair" because its weight is greater on the rich or on business than on others. And when one considers that the principal beneficiaries of increases in saving, capital formation, entrepreneurship, and other growth generating activities are labor and consumers, redistributionist objections to easing the differentially heavier tax burdens on these various activities should be dismissed out of hand.

Addressing the unfairness in more heavily taxing income that is saved than income used for current consumption promises substantial dividends in higher standards of living for everyone. Title I of H.R. 9 is an effective beginning.

---

[2] In the last decade and a half, an important academic literature has been produced that strongly suggests that some of the serious problems of corporate governance noted during the 1980s are attributable to corporate executives' efforts to maximize their welfare at the expense of maximizing the net worth of corporate owners. Excessive retention of corporate earnings may have contributed to these problems.

APPENDIX

Basic Income Tax Bias Against Saving

Pretend, for a moment, a no-tax world in which someone earns an extra $1,000. The person can either use the $1,000 for additional consumption or to purchase a perpetuity — a bond with no maturity date — paying, say, 10 percent a year. The person's choice is to enjoy $1,000 of additional consumption now or to have an additional $100 of income every year. The cost of each dollar of the additional income — the forgone consumption — is $10.

Now assume an income tax of the same basic configuration as the existing income tax is levied at a rate of, say, 25 percent. On the additional $1,000 of current income there is a tax of $250, leaving the person with $750 after tax that can be used either to buy an additional $750 of current consumables or a $750 bond paying 10 percent a year. Of course, the $75 of interest on the bond is also subject to the income tax, so that the after-tax income on the saving is $56.25. The person's choice is $750 more of current consumption or $56.25 more income each year. The cost — the forgone consumption — per dollar of that additional interest income is $13.33. The income tax increased the cost of obtaining future income compared to the cost of current consumption by 33.33 percent.

As noted in the text, this tax-induced increase in the cost of saving compared to that of current consumption is greater the higher is the marginal tax rate to which the person is subject. Suppose the tax rate to be paid by the person in the example were 40 percent instead of 25 percent. In this case, the income tax would increase the cost per dollar of additional future income from $10 to $16.67 or by 66 2/3 percent.

Additional bias imposed by the corporate income tax

Suppose that instead of buying a bond, the person in the example were to invest the additional income in corporate stock, and suppose the earnings per share were also 10 percent of the investment. Suppose the corporate tax rate were 35 percent and that the corporation were to distribute all of its after-tax earnings. In this case, the 25 percent bracket taxpayer would net $36.56 each year, for which he or she would have to forgo $750 of current consumption; the combined corporate and individual taxes raise this person's cost per dollar of additional future income from $10 to $20.51, a little more than 100 percent. If the person were in the 40 percent bracket, each net-of-tax dollar of return on his or her investment would cost $25.64 of forgone consumption, more than 150 percent more than in the absence of taxes.

The capital gains tax bias against saving

Suppose that the corporation retains its after-tax earnings and reinvests them in assets producing the same rate of return as before. Also suppose the 25 percent tax bracket person in our example held the stock for, say, five years before selling it. By assumption, the value of the stock will have increased from $750 to $1,027.57. On the gain of $277.57 realized on the person's sale of the stock, he or she owes $69.39, leaving an after-tax gain of $208.18. The same result would be obtained if the person were to receive an after-tax annuity of $43.48 over the five year period. With this tax treatment, the cost per dollar of future income, in terms of forgone current consumption, is $17.25 [3] Although the deferral of tax until the capital gain is realized imposes less of a tax penalty on saving than in the former case, it nevertheless substantially raises the cost of obtaining future income, in this example by 72.5 percent, compared to the cost in a no-tax world.

Section 1001 of H.R. 9 would significantly reduce the cost of saving compared with present law. If the person in the example were required to include only half of the net long-term gain in taxable income, the capital gains tax due upon the sale of the stock at the end of five years would be $34.70, leaving a net gain of $242.87. The same result would be obtained had the person received an after-tax annuity over the five years. In this case, the cost per dollar of future income would be $15.25 or 52.5 percent more than in a no-tax world but significantly less than under the existing tax treatment.

[3] The cost of future income, in these terms, would be lower the longer the person deferred realization of the capital gain.