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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.

CAPITAL GAINS REFORM, TITLE I OF H.R. 9, THE JOB CREATION AND WAGE ENHANCEMENT ACT OF THE CONTRACT WITH AMERICA

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PRESENTED TO
THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 25, 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.

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 also contribute significantly to reducing tax impediments to investors' changing the composition of their asset holdings in response to market signals, hence would improve the efficiency of the market's performance. The Committee should recognize that 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.

Estimates of the revenue effects of Title I should take account of the resulting changes in the market value of existing capital assets and the increased saving and economic activity, and the tax revenues generated thereby that would occur, not merely the increase in gain realizations.

More severely taxing saving than consumption uses of income is unfair and economically damaging. Title I of H.R. 9 is a welcome initiative for addressing this unfairness.

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Mr. Chairman, 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 as well as long sought. For those of us who have over the past thirty-five years devoted their efforts to calling tax policy makers' attention to the severe anti-saving, anti-investment bias in the income tax and to the seriously adverse economic consequences of that bias, Title I is a constructive and encouraging initiative. Its enactment would, itself, contribute to moderating that unwholesome tax bias and would afford promise of additional efforts to eliminate it completely.

The urgency of reducing, if not entirely eliminating, the income tax's anti-saving bias was highlighted last year by the findings of the Bipartisan Commission on Entitlement and Tax Reform. As you know, the Commission found that projected spending under existing federal entitlement programs would exceed the entire amount of revenues projected to be provided under existing tax laws by about the year 2025. The resulting deficit would preempt all of the saving undertaken by American households and businesses, leaving no saving for investment in private capital formation and other growth-generating private uses. Moreover, in those budget circumstances, the American economy could not rely on foreign saving to finance the additions to the stock of capital needed to maintain, let alone advance, labor's productivity and the nation's real living standards.

Even if one discounts the Commission's projections to a substantial degree, an economic holocaust is looming. The economy is accelerating down a slippery slope that ends at the edge of a cliff. The longer the delay in addressing the growth in entitlement spending and in removing tax barriers to household and business saving, the more difficult it will be to apply the brakes before we go over the edge.

In view of the obvious disinclination to deal constructively with entitlement spending, particularly the Social Security and Medicare Systems, the need to reduce the tax bias against saving is all the more demanding of the Congress's attention. This Committee is to be commended for having begun the work of seeking out and remedying the provisions of the Internal Revenue Code that produce that bias. Title I of H.R. 9 is an important step in that effort.

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.

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.

The anti-saving bias is accentuated by the separate income taxation of corporate income. The appendix includes an illustration of the additional increase in the relative cost of saving imposed by the separate income taxation of income generated by corporate businesses.

The taxation of capital gains also contributes to raising the cost of saving relative to the cost of current consumption. If instead of distributing its after tax earnings, the corporation retains and reinvests them in assets yielding at least the same rate of return that was obtained before, the market value of the corporation's stock is likely to increase by the amount of the retained earnings per share. If the person decides subsequently to sell the shares, the excess of the sales proceeds over the person's investment — the realized capital gain — is subject to the individual income tax. Because the capital gains tax is deferred until the accumulated after-tax corporate earnings are realized by the sale of the shares, the present value of the capital gains tax is less than the present value of the taxes paid on distributed corporate earnings over the period the shares are held. Notwithstanding, the capital gains tax adds to the amount of current consumption that must be given up per dollar of after-tax returns on one's saving. An example in the appendix illustrates the effect of the capital gains tax on the cost of saving.

The anti-saving, anti-investment bias of the income tax system is further accentuated by the federal transfer (estate and gift) taxes, by State income taxes, by State and local property taxes and by numerous selective taxes on capital or the returns capital produces imposed by State and local governments.

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 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 transaction 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.

This locking-in effect of the tax on capital gains impedes the assignment of accumulated savings to their most productive uses. As a result, it impairs the essential function of the capital market — to facilitate the exchange of property rights. This tax-induced barrier to these exchanges distorts the market's function in assigning values to competing uses of saving. The effectiveness with which this function is performed has a critically important bearing on how efficiently our saving is assigned to competing businesses and their use of our saving in expanding production- and income-generating capacity. Misusing our saving — directing it into companies and capital uses that are less productive than alternatives — is just as wasteful and costly as misallocating any other production inputs. To the extent that taxing capital gains locks in holdings of capital assets, it impairs the capital market's functioning and contributes to less than optimum uses of our saving and capital formation.

<u>Benefits From Enactment Of Title I</u>

Both the proposed deduction 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.

<u>Section 1001.</u> <u>50 Percent Capital Gains Deduction</u>

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.

<u>Reducing the tax bias against saving</u>

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. As the discussion above shows, even outright elimination of the capital gains tax would not fully rid the tax system of its anti-saving, anti-investment bias. There should be no doubt in the Committee members' minds, however, that 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.

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 is little if any responsive to changes in its cost. They obviously fail to note that in making that assertion they are also maintaining that consumption 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.

Section 1002. Indexing The Bases Of Capital Assets For Purposes Of Determining Gain Or Loss

Adjusting the basis 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.

The Committee has heard testimony from the Treasury Department to the effect that in combination with the 50 percent deduction, adjusting the basis of capital assets for inflation "...provides too large an adjustment for inflation."[1] In making this assertion, Assistant Treasury Secretary Samuels erroneously identifies the proposed deduction of 50 percent of net long-term capital gains as aimed at offsetting inflation, suggesting that there would be no occasion for this

[1] Statement of Leslie B. Samuels, Assistant Secretary (Tax Policy) before the Committee on Ways and Means, January 10, 1995, page 16.

change in the absence of inflation. In fact, as discussed above, the 50 percent deduction aims at partially offsetting the incremental tax penalty on saving, irrespective of expected inflation. By the same token, the proposed indexing aims at offsetting the additional tax penalty imposed by taxing nominal rather than real gains. In combination these two provisions can, contrary to Secretary Samuels' assertion, provide too large an adjustment *only* if one believes that good tax policy calls for penalizing saving uses of current income relative to consumption uses and for taxing more gains than people actually realize.

The Treasury testimony also asserts that indexing the basis of capital assets without indexing the debt used to finance the acquisition of the assets would encourage tax arbitrage and enable taxpayers to reduce their effective tax rates to zero. Mr. Samuels' example is a person who purchases $100,000 of undeveloped land, financing the purchase with $20,000 of his or her own cash and borrowing $80,000. The person later sells the land for $130,000, "with the $30,000 gain representing an inflationary increase in the value of the property." The person repays the $80,000 mortgage debt and pockets the remaining $50,000, paying no tax because the basis of the asset was indexed. According to Samuels, "...only $6,000 ...of the taxpayer's total $30,000 gain...represents the inflationary gain on the taxpayer's $20,000 investment...."[2] Presumably, according to Samuels, the correct result in principle would be to tax the person on the remaining $24,000 of *nominal* gain.

Notice, however, that in terms of constant purchasing-power dollars, the $50,000 in cash the person has left after paying off the mortgage indebtedness is only $20,000, exactly the amount of the person's original *cash* investment. If the person were subject to tax on the $24,000 of gain allocated by Samuels to the mortgage component of the investment, as Samuels suggests, the person would net only $17,280. The tax would subject the person to a net loss of $6,720 on the original investment. In fact, the arbitraging that Samuels asserts would result from indexing the basis of the asset but not the debt protects the person from having to pay tax on a zero gain. The Treasury's complaint is without merit.

There is much to commend extending inflation adjustments to indebtedness and the interest flows thereupon. There is, however, no downside of the sort the Treasury has asserted to indexing capital assets alone.

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

[2] The person's investment, contrary to Samuels' assertion, is $100,000, not $20,000. The person has undertaken an indebtedness for the discharge of which the person is legally responsible.

nominal gains exposed ultimately to tax. I urge the Committee to address this deficiency, and I'll be happy to provide the Committee and its staff such assistance as it may request in doing so.

I also urge the Committee to extend indexing of basis for the purpose of determining gain or loss on the disposition of equipment subject to a net lease when the proposed neutral cost recovery system is not used. 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.

Dividend Tax Relief

Desirable as I believe to be the capital gains tax reforms the Committee is considering, the Committee should be aware that 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.[3] Expanding the differential in effective tax burdens on retained vs. distributed earnings by reducing capital gains taxation should urge the Committee to add to its agenda careful consideration of ways to integrate 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.

Revenue Effects

At one time or another, the case for reducing the marginal tax rates on capital gains and for inflation indexing of the bases of capital assets has rested on the claim that either or both of these reforms be tax revenue raisers. As the Committee might well infer from my discussion to this point, I believe the case for these reforms rests on the very substantial economic benefits that would be obtained, not on their revenue consequences. I believe that enactment of Sections 1001 and 1002 of Title I of H.R. 9 would very likely prove to be a revenue raiser, but I strongly endorse these reforms notwithstanding.

Much of the arguments among economists and other tax specialists about the revenue effects of these changes in the tax treatment of capital gains has hinged on estimates of the

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[3] 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.

magnitude of the unlocking effects of these changes. Most of the empirical analyses that have been directed to this question have relied on time series of changes in capital gain realizations to measure the response to changes in the tax treatment of these gains. But an enormous number of other variables also affect the amount of capital asset transactions and the amount of gains realized thereby every year. Making allowances for these myriad other factors in efforts to determine the influence of changes in the tax law in such year-over-year analyses is a daunting undertaking. The Committee should not base its decisions about capital gains reforms solely or even primarily on such revenue estimates.

The conceptually correct measure of the effect of the change in the law is the difference between the amount of gains actually realized in any particular time period and the amount that *would have been realized* in the absence of the change in the law. This, too, is difficult to estimate, but it at least aims at providing a relevant answer to the question.

For the most part, the revenue estimates have been driven only by estimating the increase in capital gain realizations resulting from reducing the capital gains tax; they have ignored the virtually instantaneous increase in the market value of existing capital assets that would result from reducing the tax. This valuation effect would augment the amount of gain realized on the sale of any given amount of capital assets. To be sure, this valuation effect is one shot; because it would result in higher bases of capital assets in the hands of those purchasing the unlocked assets, it would tend to reduce the amount of taxable gains realized thereafter. Nevertheless, this valuation effect will tend to increase revenues, on balance, and should not be ignored in estimating the revenue consequences of reducing the marginal tax rates on realized capital gains.

Also ignored in most of the revenue estimates are the broader, very likely most consequential economic effects resulting from reducing the marginal tax rates on capital gains — the resulting increase in saving. The consequent increase in the stock of capital would itself generate additional taxable income; additionally, the increase in capital would contribute to an increase in labor's productivity, hence to employment and wages, leading to additional tax revenues from income, payroll, and other federal taxes.

"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.

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 ($75 gross return on the $750 corporate investment, reduced by the 35 percent corporate income tax and the 25 percent individual income tax), for which he or she would have to forgo $750 of current consumption; the combined corporate and individual taxes raises 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 [4] 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.

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