

THE ECONOMIC EFFECTS OF THE INCOME TAXATION OF CAPITAL GAINS

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Mr. Chairman, members of the Committee, I am pleased to have this opportunity to discuss President Bush's proposal to reduce the tax on capital gains.

Easing the tax bite on capital gains is, I believe, one of a number of steps that should be taken, at the earliest possible moment, to reduce the tax bias against saving and private capital formation. The tax on capital gains is one of the major provisions in the federal income tax that contributes to increasing the cost of saving and of capital formation. Those provisions distort market signals about the best ways for us to use our incomes and our production capability. The resulting losses of our economic well-being are not offset by any gains in terms of fairness of the tax laws or ease of compliance and administration.

The adverse effects of these tax-induced cost increases on the economy's efficiency and growth should be the principal concern in evaluating the President's proposal. These costs of the present tax treatment of capital gains should, I submit, outweigh considerations of the federal tax revenue consequences of reducing the tax bite on capital gains, irrespective of whether reducing the capital gains tax would raise or lower tax revenues.

The Bush proposal for reducing the tax on certain capital gains would be a significant step toward alleviating the income tax bias against saving and investment. The proposal has a number of serious limitations, and it should not be seen as a sufficient measure for dealing with the numerous income tax penalties on saving and investing. Nonetheless, I believe that the

Committee should assign a high priority to its enactment, sending a signal to all of us that public policy makers are aware of the anti-saving bias in our tax laws and are determined to reduce, if not totally eliminate, it.

The Income Tax Bias Against Saving and Investment

Saving is the use of current income to purchase a source of future income. The purchase of capital assets is one form of saving, and capital gains are one form in which future income is obtained. A neutral tax system would not impose a heavier tax burden on income that is saved than on income that is consumed. Unhappily, the federal income tax system weighs far more heavily on saving than on consumption; the principal culprit is the income tax imposed on corporations and on individuals, including the tax imposed on capital gains.

The income tax bias against saving and in favor of consumption has been explained in various ways to the Committee over the years, and presumably no lengthy exposition of that bias is needed on this occasion. I find it useful to treat this subject by showing that the income tax raises the cost of saving relative to the cost of consumption and that the greater the amount of taxes imposed under the tax structure on the returns to saving, the greater is the increase in the cost of saving compared with the cost of consumption.

A simple example helps to explain the income tax bias against saving. Suppose an individual earns an additional \$1,000. In the absence of taxes, that \$1,000 could be used to buy an additional \$1,000 of consumption goods and services or it could be saved — used to purchase assets or claims to assets that will provide the individual with additional income. Suppose the individual would be just indifferent between using it for current consumption or saving the additional \$1,000 if by investing it he could get an annual yield of 10 percent, i.e., an additional \$100 of income this year and every subsequent year. The cost to him of obtaining that additional future income is the \$1,000 of foregone current consumption; each dollar of additional income costs him \$10 of foregone current consumption. By the same token, the cost to him of \$1,000 of current consumption is the foregone additional future income — \$100 a year every year.

Now suppose a 28 percent income tax is introduced. The individual's \$1,000 of additional current income is immediately reduced by the tax to \$720. He can now buy \$720 of additional consumption goods and services, or he can save the \$720 and, assuming the yield on his saving is still 10 percent, he'll get an additional \$72 of income every year, *pretax*. But 28 percent of that \$72 of additional income will also be taxed, leaving him with \$51.84 after tax. By giving up \$720 of current consumption, the individual can obtain only \$51.84 of additional future income; each dollar of that after-tax additional income costs him \$13.89 of foregone current consumption compared with \$10 before the tax was imposed. The 28 percent income tax raised the cost of saving relative to the cost of consumption by 38.9 percent.

This is a significant increase in the relative cost of saving as a result of what may appear to be a moderately low tax rate. This is, however, only part of the income tax penalty on saving. The income tax in the example is a single-layer income tax; in fact, there are two layers of federal income taxes that apply to much of the returns for saving. The income produced by saving invested in corporate equities is subject to the corporate income tax; in addition, the income remaining after the corporate tax is subject to the individual income tax in the hands of the equity owner. If the income remaining after the corporate income tax is distributed to the individual as a dividend, that dividend is subject to the individual income tax. If the after-tax corporate earnings are retained and are reflected in an increase in the market value of the stock, this appreciation in value is subject to the capital gains tax when the individual sells his equity interest.

The effect on the relative cost of saving, even with the relatively low rates of tax now in effect, is dramatic. As a rough approximation, the combined effect of the corporate income tax and of the individual income tax, imposed either on dividends or on capital gains, is to raise the cost of saving relative to consumption by about 110 percent.

The Economic Consequences of the Anti-Saving Tax Bias

Because people respond to changes in relative costs and rewards, they tend to use more of their current income for consumption and to save less of it than they would if the tax system provided neutral treatment of saving and consumption. This lower rate of saving necessarily means a lower rate of capital formation, hence a smaller stock of capital resources than would prevail in a neutral tax climate. Indeed, the stock of capital is sufficiently lower and the pretax return it produces sufficiently higher that the after-tax income available to the saver-investor is the same as it would have been in a no-tax world. In our example, the pretax return has to go up to a bit over 21 percent if the individual is to obtain a net-of-tax return of \$72 on his \$720 of saving. This implies that the reduction in the stock of capital compared to what it otherwise would be is quite substantial.

The reduction in saving and in the stock of capital resulting from the tax bias against saving reduces the level and rate of gain of labor's productivity compared to what it otherwise would be. The true cost of the tax penalty imposed on saving includes the foregone job opportunities and lost labor income, not merely the loss of the returns for saving.

Moreover, average total costs of production are higher than they would otherwise be. If public policy makers are really concerned about the competitive position of American businesses in the world market place, they should carefully scrutinize the present federal tax system to identify opportunities to change it to reduce the tax bias against saving and capital formation.

Finally, the tax penalties on saving tend to shift the composition of production activity away from capital-intensive to labor-intensive operations. To be sure, the heavy payroll taxes imposed on wages and salaries exert an opposite pressure, although very likely not so severely. In any event, good tax policy should seek to minimize these selective excise effects, not to balance them off against each other.

It is sometimes argued that however severe the income tax bias against saving, the economic consequences are far less adverse than I've suggested because saving is not responsive to the tax-induced increase in its cost. I think this argument is without substance. Consumption and saving fully exhaust one's disposable income. If the amount of one's saving does not change in response to a change in the cost of saving, neither does the amount of consumption change. Suppose the cost of saving falls, that is, one must forego a smaller amount of current consumption to obtain a given amount of future income. Notice that this necessarily means that the cost of consumption has gone up. If one does not increase one's saving in response to the reduction in its cost, neither does one reduce one's consumption in response to an increase in its cost.

Indeed, some who argue that the tax-induced cost of saving is not important claim that people save less when the cost of saving falls and save more when the cost increases. This is the same as asserting that when the cost of consumption goes up, people consume *more*, and when the cost of consumption goes down, people consume less. The absurdity of the argument should be obvious. It is equally absurd to maintain that the tax bias against saving has little or no adverse effect on saving, on the stock of capital, on productivity, employment, and labor income and on the efficiency with which we use our productive resources.

Requirements for Tax Neutrality

If the income tax is to bear no more heavily on saving than on consumption uses of income, the rewards for saving should not be depressed to any greater degree than those for consumption. One way to achieve this tax neutrality would be to tax the income that is saved but not the returns to saving. In the example, the \$1,000 of additional income would be taxed but the returns on the remaining \$720 that is saved would not be taxed. The individual, then, would obtain \$72 a year in additional income as the reward for foregoing \$720 of current consumption. As in the case of the no-tax world, the cost per dollar of future income would be \$10 of current consumption. Another way of eliminating the anti-saving distortion would be to defer the tax on the income that is saved and instead assess the tax on the gross returns when they are withdrawn. In the example, the initial \$1,000 would be taxed if used for consumption, leaving \$720 for that purpose. It would not be taxed if saved, but the \$100 of gross return would be taxed, leaving the individual with \$72 per year as the return on his \$1,000 of saving. In this case, too, the individual would forego \$720 of current consumption to obtain \$72 more income

every year. Each dollar of that additional income would cost him \$10 of foregone consumption, just as in the no-tax world.

The latter treatment is provided in the case of qualified pension plans, 401(K) and 403(B) plans and, to a limited extent, by some IRAs. A more thorough approach would be to reform the tax system along the lines of a consumption-based income tax, such as the one that is described clearly and in detail by David Bradford and the U.S. Treasury Tax Policy Staff in *Blueprints For Basic Tax Reform* (Arlington, Va: Tax Analysts, 1984).

In any case, there is no room in an income tax that seeks to provide neutral treatment of saving and consumption for a corporate income tax or for a tax on capital gains. The capital gains tax helps create the general bias against saving because it is an added tax on the rewards to one form of saving. In short, to help avoid an inefficient anti-saving tax distortion, the capital gains tax rate should be zero.

Additional Injustices And Inefficiencies Caused By Taxing Capital Gains

The taxation of capital gains at the full rate of ordinary income presents a variety of problems. These efficiency and equity concerns probably explain why capital gains have been taxed at a reduced rate during most of the income tax system's history.

An Inflation Tax

Because the tax code measures capital gains in nominal dollars with no adjustment for inflation, a large share of what is taxed as capital gains -- often the overwhelming majority -- does not represent real gains but merely inflation. Suppose, for example, that a person bought \$1,000 of stocks in 1965, that the stock rose at the same rate as the Standard & Poors 500 index, and that the person sold the stocks in 1988 for their value then of \$3,015. Also assume that the person is in the 28 percent tax bracket, a rate reached by many middle-class taxpayers. Because the nominal capital gain is \$2,015, the person would owe a capital gains tax of \$564. In real dollars, however, the person did not enjoy a capital gain but suffered a capital loss: \$1,000 in 1965 was worth \$3,755 in 1988 (based on the Consumer Price Index), \$740 more than the \$3,015 actually realized on the sale of the stocks. The person in this example had in fact suffered a capital loss of \$740 in dollars of constant purchasing power (1988 dollars). It is a harsh tax penalty and a strong deterrent to saving to extract heavy capital gains taxes from people who have suffered losses or meager gains on their investments.

More generally, the capital gains tax overstates the real gain whenever the inflation rate is greater than zero and thus raises the effective tax rate above the statutory rate. This camouflaged increase in tax rates is obviously unfair to savers. In addition, it puts them at special risk should inflation heat up: higher than expected inflation tends to mean that investors

will have higher than expected real tax liabilities. The elevated tax rates and added risk understandably increase the cost of saving, and people will respond by saving less, with the adverse economic consequences delineated above.

Many observers thought that one of the functions of the old 60 percent capital gains exclusion was to make a correction, admittedly a very rough one, for this phantom income. Even if capital gains are to continue to be taxed as ordinary income, the goals of justice and economic growth and efficiency make a powerful case that only real capital gains should be taxed; certainly we should not compound the tax bias against saving exerted by taxing capital gains by taxing illusory gains as well.

Anti-Equity Bias

The income tax system's pro-consumption, anti-saving bias inhibits all investments, no matter how they are financed. The corporation income tax adds a second layer of bias against corporate equity investments, as pointed out above. When the investor obtains these after-tax returns, whether as dividends or capital gains, they are again taxed, this time by the individual income tax. Interest on corporate debt, in contrast, is deductible at the corporate level; it therefore encounters only one layer of the income tax bias, instead of two. This difference in tax treatment, accordingly, exerts a greater bias against equity finance than against debt finance. Good tax law would be neutral in its influence on the form of financing business.

The government-induced tilt against corporate equity financing, moreover, also exerts a bias against the corporate form of business organization. Good tax law would not influence the choice concerning the form of organization; the present law does.

A reduced capital gains tax rate would help fight the bias against both the corporate form of organization and equity finance. Reducing the tax on capital gains realized by corporations would also contribute to this objective. Unfortunately, the President's plan affords no reduction in the tax on corporate capital gains. Such gains would still be subject to the 34 percent rate that is more than one-fifth greater than the 28 percent rate that prevailed prior to the Tax Reform Act of 1986 (TRA-86).

Another constructive move would be to reduce the present double taxation of dividends. In the Committee's recent hearings on leveraged buyouts, I urged a reduction in the capital gains tax rate and a partial dividend deduction on net new common stock issues as first steps toward alleviating the tax law bias against equity. I also sought to point out that the wrong way to deal with the anti-equity bias would be to curtail the deductibility of interest. Limiting interest deductibility would violate the fundamental tax principle that a legitimate business expense should not be included in income. Worse, by intensifying the existing tax bias against saving

and investment, it would further depress capital formation in the United States, costing us productivity and jobs.

The Lock-In Effect

The capital gains tax discourages investors from altering the composition of their asset portfolios in response to new opportunities or changes in their tastes and needs. Although capital gains tax liability accrues along with the accrual of gains, the actual payment of the tax occurs only when the gain is realized upon disposition of the asset. The tax acts therefore like an excise on transactions in capital assets.

Individuals who want to realize the gains that have accrued on one or more of their capital assets in order to acquire other assets, rather than to finance consumption outlays, find that the capital gains tax raises the threshold of earnings the new assets must provide. The after-tax earnings on the new assets must be sufficiently larger than those on the assets the investor now holds such that the present value of the additional earnings at least equals the capital gains tax to be paid on the gains realized on the sale of the old assets.

This lock-in effect clearly is an artificial constraint on capital asset transactions. As such, it impedes every saver-investor from achieving as efficient a portfolio of assets as he would otherwise hold at every moment in time. By reducing the mobility of saving, the capital gains tax impairs the efficient functioning of the capital market. Market valuations of capital assets are distorted by the tax; relative market values do not accurately reflect the relative productivity with which businesses use their production resources. In brief, the tax induces less than optimum allocation of saving among all the competing capital uses thereof.

In the wake of TRA-86, the lock-in effect is actually a bigger constraint for most savers than it was under prior law. TRA-86 increased the top corporate capital gains rate from 28 to 34 percent; it hiked the top individual capital gains rate from 20 to 33 percent (higher for many elderly savers).

Revenue Effects of a Reduction in the Capital Gains Tax

Most of the public policy debate concerning proposals to reduce the capital gains tax have focused on the federal revenue consequences of doing so. I do not believe, as I stated earlier, that the estimated revenue consequences should be the principal consideration in deciding whether to move positively on the President's proposal. The benefits for the economy to be obtained by reducing the capital gains tax and thereby moderating the tax bias against saving should far outweigh revenue considerations. Nevertheless, given the public concern about the budget deficit, the revenue consequences of reducing the capital gains tax cannot be ignored.

Estimates of revenue effects have come up both positive and negative. For example, with respect to President Bush's proposal to reduce the tax to 15 percent, the Joint Committee on Taxation has estimated a revenue loss of \$24.2 billion in the 1989-94 period. Economists at the Treasury Department, on the other hand, have argued that capital gains tax reductions in 1978 and 1981 yielded increases in revenue and that a reduction to 15 percent, in light of the 1986 increase in the rate, would yield a \$9.3 billion revenue gain in the years 1989-1994.

The problem with both of these assessments is that they do not consider all of the revenue enhancing features that capital gains tax reduction would include. They narrowly focus on only one, the "transaction response" or unlocking effect. In fact there are three important responses to a reduction in the capital gains tax that could significantly contribute to an expansion of the tax base and tax revenues.

The first and most direct effect on tax revenues of reducing the capital gains tax rate is through a reversal of the "lock-in effect" discussed above, the second is by increasing the value of assets in general, and the third is by stimulating economic growth. The combination of these effects could easily generate a revenue increase for the government.

An implication of reversing the lock-in effect is that gains will be realized more frequently. In the first few years after a rate reduction a surge of capital gains realizations can be expected as assets that were being held simply because of the tax deterrent to realization are sold off. Reduction in the capital gains tax rate will also reduce the incentive of older savers to forego realizations in favor of transferring gain-laden assets by testamentary disposition, thereby affording a step-up in basis of the assets for the heirs. This will tend to increase realizations on a continuing basis, not merely temporarily.

Whether the increase in gain realizations would be sufficient to generate as much tax revenue at the proposed lower rates as the revenue produced by the present higher rates on the realizations that will occur under present law has been at the heart of the debate among Treasury, CBO, and JTC economists. Looking only at this realization effect, one may well be skeptical that the proposed 46.4 percent rate reduction — from a top of 28 percent to the proposed top rate of 15 percent — would be a revenue gainer. Just to draw even, realized gains would have to increase by 86.67 percent. Such an increase is not inconceivable, but it is not highly likely. If the only effect of the proposed rate reduction were to unlock accrued gains and increase gain realizations, I suspect the rate reduction would be a revenue loser.

The lock-in effect could also be reduced by eliminating or shortening the holding period. Historically the differential tax treatment of capital gains has applied only to so-called long-term capital gains, those realized on assets held longer than some stipulated period, six months during many of the years in which lower rates applied to long-term gains, and a year or longer during some other years. This is an arbitrary distinction that, in many cases, distorts the timing of asset

sales, inducing investors to hold gain-laden assets longer than underlying economic considerations would justify.

The Administration's proposal, unhappily, would exacerbate this problem. After a phase-in period, only assets held for three or more years would be eligible for the reduced rate. This aspect of the proposal should be reconsidered. It is not beneficial to the economy and reduces the revenue-enhancing qualities of the administration's proposal.

Reducing the capital gains tax would also expand the tax base because the lower capital gains tax rate will increase the market value of existing eligible capital assets. Since the market value of a capital asset is determined by the risk-adjusted present value of the after-tax income produced by the asset, a lower tax rate will be reflected in greater capital gains. This effect will occur in both the short run and the long run, resulting in a permanent increase in the tax base relative to what it would be at the higher tax rate.

The third effect, economic expansion, is the most general and potentially the most significant in broadening the tax base. As already discussed, reducing the tax rate on capital gains would benefit the economy most significantly by reducing the tax bias against saving and therefore reducing the cost of capital for the economy as a whole. From the perspective of economic prosperity and growth, this is probably the single most beneficial effect of, and most important reason for, reducing the capital gains tax rate. The lower cost of capital would translate into a greater amount of capital and a higher capital-labor ratio, hence a higher level of labor productivity, a greater demand for labor services, and a larger number of jobs being created at higher rates of pay throughout the economy. In terms of increasing the tax base this is probably the most significant benefit that the government will realize from reducing the capital gains tax. Most of this new income will be taxed, not at the lower capital gains rate, but at the higher regular corporate and individual income tax rates.

It is likely that the combination of these effects will result, ultimately, in generating greater revenues for the government. If these greater revenues are applied to deficit reduction and are not simply used to expand the size of government, the revenue enhancing aspects of a capital gains tax reduction could contribute to the overall betterment of the economy.

Conclusions

The high and growing level of concern throughout the Nation about the adequacy of our national saving highlights President Bush's proposal to reduce the tax on capital gains. It is the significance of the proposed tax reduction for reducing the tax bias against private saving that gives urgency to the proposal and to similar proposals that have been made by various members of the Congress. Along with its implications for moderating existing tax distortions of market prices and alleviating the resulting resource misallocations, the capital gains tax reduction's

potential for enhancing the Nation's saving and capital formation warrant assigning top priority to the proposal. Additional measures are also needed in pursuit of these basic economic objectives. The President's proposal, therefore, should be seen as an initial step. As such, it is all the more urgent that it be enacted.