The Capital Gains Tax Cut: Economic Panacea or Just Plain Snakeoil?
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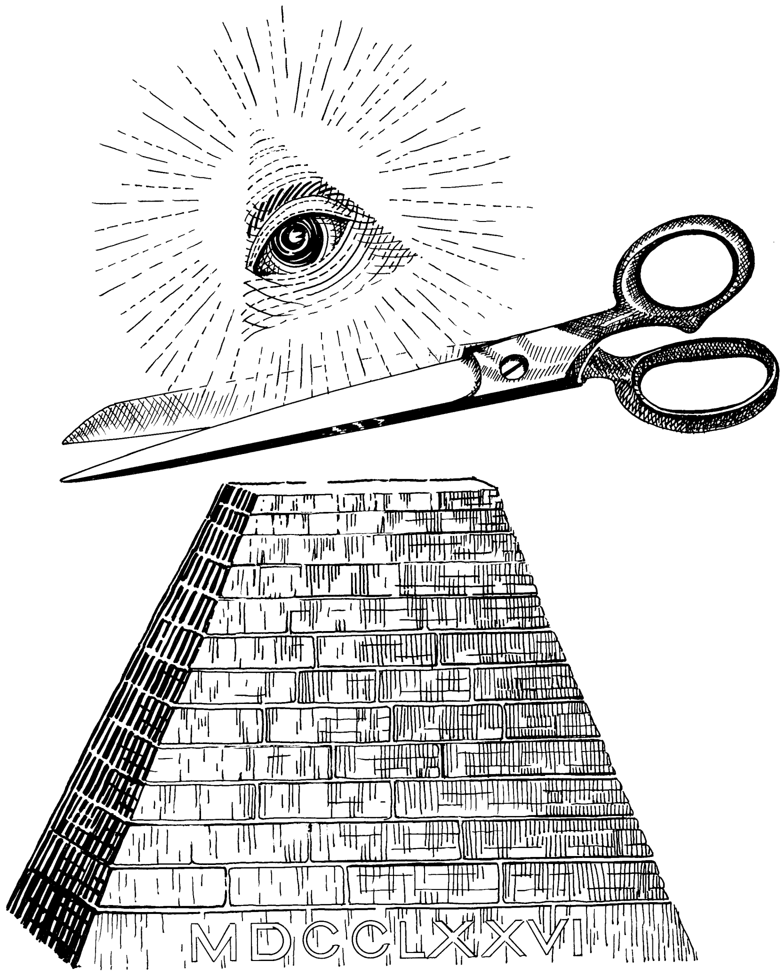

SHOULD TAX RATES on income from realized capital gains be set below rates on other income? In a way, the question is academic. They already are, in practice. Although the maximum statutory tax rate on capital gains is 30 percent, more than half of all capital gains are never taxed. Either they are held until the owner dies, after which they are exempt from tax to subsequent owners. Or they accrue to tax-exempt U.S. entities, such as pension funds, or to foreign owners not subject to U.S. tax. In addition, most capital gains are realized several years after they actually accrue, a delay that automatically and significantly reduces effective tax rates. And the longer the delay, the greater the reduction. In actual practice, the tax rate on capital gains is less than 10 percent.

Advocates of reduced statutory rates, however, clearly want more. To make their case, they offer four lines of argument. First, reducing the tax rate on realized capital gains will promote growth. Second, it will mitigate flaws in the tax system. Third, it will increase tax equity. Finally, it either is, or comes very close to being, a perfectly efficient tax cut: it generates benefits but no costs.

None of these arguments, alas, is valid. Each is either demonstrably false or ignores alternative—and better—policies.

Promoting Growth

To understand why a capital gains tax cut will not promote growth, it is important to keep in mind a key economic identity. Domestic investment is exactly equal to private saving less the government budget deficit less U.S. net investment abroad as measured by exports minus imports. That assertion is not a matter of opinion or economic analysis. It is an identity that must exist, given the way we count investment, saving, government spending and revenues, and international transactions. The idea is clear enough. Resources for investment can come from the domestic saving left over after paying for the government deficit and from whatever we invest abroad. (In recent years the United States has been borrowing from foreigners, not investing abroad.) There is nowhere else to get the resources.

Private Saving

If the reduced rate on capital gains is to boost private saving, it must do so by increasing the after-tax rate of return to saving. Economists have debated whether private saving really does increase when the rate of return rises. In theory, the effect could go either way. A higher rate of return lessens the *need* to save (someone saving, say, to make a down payment on a house five years hence can put aside a little less each year the higher the rate of return). But it also makes saving more *attractive* (bringing within reach, for example, the goal of saving enough to make a down payment on a larger house).

Most economists think that private saving will rise if the rate of return increases, but they are unsure how much. One widely used estimate is that of current Council of Economic Advisers chairman, Michael Boskin, who suggests that a 10 percent increase in the rate of return would boost saving about 4 percent.

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Say that the average annual rate of return to capital is 10 percent, that one-third of this return accrues in the form of capital gains, and that the effective rate of tax on these capital gains is the maximum statutory rate of 30 percent. If so, reducing the capital gains tax rate by one-half (about what President Bush is seeking for assets held three years or more) would increase the rate of return by 7 percent, which would boost private saving by just under 3 percent. If these crude assumptions are valid, then, given the current U.S. net private saving rate of under 5 percent of gross domestic product, the capital gains tax cut would boost saving by 0.15 percent of GDP. Given standard economic models, such an increase in saving would raise growth of national income no more than 0.02 percent of GDP.

In fact, this estimate grossly exaggerates the effect of a capital gains tax cut on private saving, since, as noted, the effective tax rate on capital gains is actually less than 30 percent. Thus, the effect on growth through private saving, at best, is vanishingly small—assuming that saving really does increase when the rate of return rises.

Investment Demand

Nothing in any proposal, Republican or Democratic, to lower capital gains tax rates would require that investments be made in the United States to qualify for reduced rates. Nothing in any proposal, therefore, would tend to shift one cent of investment by U.S. taxpayers to the United States from abroad.

For that reason—recall the domestic investment identity—the reduced capital gains tax rate can increase investment in the United States only by increasing U.S. saving or by increasing borrowing from abroad (thus enlarging the trade deficit). We have already seen that U.S. saving cannot be expected to show a detectable increase. The only remaining way to boost U.S.-based investment significantly would be to increase foreign investment here.

If anything, however, a capital gains tax cut would lower, not raise, such investment. *Any* increase in U.S. saving and U.S.-based investment by U.S. savers would tend to lower the after-tax rate of return on investment in the United States. The decrease in the rate of return would be negligible if U.S. saving did not increase much, and the drop in foreign investment in the United States would also be small. But one thing is clear: a drop in investment in the United States by foreigners, however small, is not an increase. And such a drop would partially offset any increase in U.S. saving and further reduce any positive effect on U.S. economic growth.

Shifting the Composition of Investment

Even if a capital gains tax cut would not increase the *quantity* of investment, it might improve the *quality* of investment. But it could do so only if markets now rank investments incorrectly, favoring relatively low-productivity projects over high-productivity ones.

Is it possible that investors fail to appreciate the virtues of really terrific projects—and need reduced capital gains tax rates to help them see the light? Or that capital markets systematically deny resources to highly promising projects?

No such case can be sustained for investments undertaken by established corporations. They have ready access, through retained earnings, bank loans, sale of debt, or new stock issues, to the capital they need for new investments. They can choose the projects managers think will produce the highest expected returns, with proper allowance for risk.

Nor can such a case be made for investments, such as real estate, that can be financed largely with borrowed funds. Because the inflation component of interest is immediately deductible, while the inflation component of asset appreciation is untaxed until the asset is sold (and not taxed at all if the gains are not sold during the life of the owner), such investments are already powerfully favored by the tax system.

Is the case, perhaps, stronger for reduced capital gains taxes on investments in new companies, which do not have ready access to capital markets, but which create new products and fuel employment growth? Not really. To begin with, the contribution new companies make to output or employment growth tells precisely nothing about whether too much or too little is invested in them. It is not even relevant to the debate. Whether investments in new companies are too large or too small depends on whether their expected rate of return is greater or less *on the margin* than that on other investments.

Second, almost 90 percent of venture capital invested in new companies comes from sources—such as pension funds and foreign investors—that are tax exempt and thus unaffected by a tax cut. The argument that reduced capital gains tax rates would attract new funds to venture capital investments hinges on the likelihood that reducing a tax whose effective rate is already well below 10 percent to perhaps 5 percent would cause savers to disgorge a great deal of capital.

That argument is utterly implausible. If the net return on an investment after tax under current law is, say, 100, the tax cut would boost the net return at most to about 105, an increase of roughly 5 percent. If the supply of capital from taxable entities were highly responsive, it might grow 20 percent, raising the total supply of venture capital about 2 percent. Since *total* venture capital is less than 1 percent of total U.S. capital, and *taxable* venture capital is only 12 percent of total venture capital, the increment to investment from cutting capital gains taxes is likely to be about 0.02 percent.

These calculations are crude, but they are in the ballpark. The growth effects of any cut in capital gains taxes cannot be more than trivial.

Fixing Problems in the Tax System

Yet another line of argument for reducing capital gains tax rates is that doing so would mitigate two flaws in the current tax system.

First, inflation causes distortions in measuring capital income. (Because of inflation, nominal capital gains exceed real capital gains and nominal capital losses fall short of real capital losses.) Would cutting the tax rate on capital gains help minimize the distortion? Sometimes yes, sometimes no. For example, a reduced rate would actually *aggravate* the distortions on capital losses,

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adding the insult of a reduced rate for calculating tax offsets to the injury of understating the loss. To measure income correctly, it is necessary to index the calculation of capital gains—and of other forms of capital income, notably interest and depreciation.

Second, because corporate income is subject to tax at both the corporate and personal levels, the tax system may contain biases against investments in corporations. Projects that depend on the capacity of corporations to amass capital may have difficulty competing with projects that could be financed equally well by partnerships or single proprietorships.

Whether the double taxation of corporate income produces such distortions is a matter of dispute. In any event, cutting the capital gains tax does not solve the problem presented by double taxation and may aggravate it. The difficulty is that a large share of capital gains arises from real estate investments, which typically rely heavily on borrowing. Current rules impose what amounts to negative rates of tax on interest income to the extent that interest is paid by taxable entities and is received by exempt entities, such as pension funds, insurance companies, or foreigners. Extending reduced rates to capital gains, the major additional avenue through which capital income on real estate investment flows, would exacerbate an existing distortion.

More fundamentally, if double taxation is a problem (and I think it is), the responsible approach is to try to fix it, not paper it over.

Equity

Would a capital gains tax cut increase tax fairness? No objective argument can be made to show that one distribution of incomes among income classes is more or less fair than another. Equity is clearly in the eye of the beholder.

But even subjective judgments should rest on fact. It is a fact that inequality among income classes has increased greatly since the late 1970s after nearly three decades of approximately unchanged income shares. From 1977 to 1988 after-tax real incomes of the bottom 80 percent of the U.S. population rose a total of 0.1 percent, while incomes of the top 1 percent rose 96 percent. Meanwhile, the total federal tax rate on the bottom 80 percent of the population was virtually unchanged, while that on the top 1 percent fell by one-quarter, from 35.5 percent to 26.9 percent.

The capital gains tax cut initially proposed by President Bush in the State of the Union message would give the top 1 percent of taxpayers more than 50 percent of the benefits, an annual average of $3,730 per tax return. It would give the bottom 80 percent 10 percent of the benefits, an annual average of $8 per return.

To find this kind of a tax policy fair, one would have to believe that income equality was excessive during the three decades following World War II, that the sharp increase in inequality of the past 15 years has almost, but not quite, corrected those egalitarian excesses, and that more inequality is necessary for social justice. If you believe that, the capital gains tax cut is just what you want.

A Perfectly Efficient Tax Cut?

Sometimes cutting a tax *rate* can actually generate enough additional revenue to offset the direct loss from the rate cut. Some supporters of reduced capital gains taxes make that claim for their proposal. Those who sell assets, it is argued, will enjoy a tax break. But lower rates will cause people to sell assets they otherwise would have retained. The tax revenue from the added sales will offset the revenue lost by lower rates.

Everyone agrees that cutting capital gains taxes will induce some increase in asset sales. The question is: how much and when? The mathematics is simple. If the proportionate rise in sales is less than the proportionate fall in tax rates, revenues will fall. If the tax rate is cut by half, sales will have to double to maintain revenue.

President Bush proposes to cut rates by 45 percent in 1992 for capital gains on assets held more than one year. In 1993 the rate cut would apply only to gains on assets held more than two years; in 1994 and later years, to gains on assets held more than three years. The rate reduction would be smaller in 1992 and all later years for assets held more than one year, but less than the required period. Current rates would apply to gains on sales of assets held less than one year.

The structure of the cut, it is important to note, discourages the quick sale of assets. But sales of assets can increase only if taxpayers sell their assets more quickly than they do under current law or if they sell assets that they would otherwise have held until death. The president's proposal could easily retard the sale of assets that would be held less than three years under current rules.

Both the congressional Joint Committee on Taxation and the administration assume that realizations will rise. That they will rise the first year or two after enactment seems beyond dispute. Estimating the longer-run effect is more dicey, because no graduated tax rate has existed in modern times.

To offset a rate cut of 45 percent, sales would have to rise 82 percent. According to calculations by Alan Auerbach, such an increase would require (with the proportion of gains realized each year held constant) that the fraction of gains held until death, currently about half, would have to fall to 14 percent. Nothing in the record of capital gains taxation suggests that such a drop is remotely plausible. Accordingly, one can be quite certain that the president's capital gains proposal will reduce revenues.

In fact, the Joint Committee on Taxation estimates that the combination of the tax rate cut and induced sales will cut revenues $27 billion over five years if the president's proposal is adopted.

If revenues fall from this source and no other tax is increased, the federal budget deficit will rise and national saving will fall correspondingly. The reduction in national saving would cut investment (unless the flow of borrowing from foreigners increases—again, recall the domestic investment identity), depress growth of national product, and reduce revenues further. If foreign borrowing were to increase enough to sustain investment, national product would not fall immediately, but the United States would acquire additional obligations to make future payments to foreign lenders.

Either way, the capital gains tax rate cut means increasing other taxes or suffering reduced future economic growth, or both.

A Presidential Shell Game

Six years ago Congress boldly reformed the personal income tax. The strategy, embraced by the Reagan administration and by Congress, was to broaden the tax base and lower rates. The two elements of the plan were balanced, so that the share of personal taxes paid by each income bracket remained about the same.

For top-bracket taxpayers, the drop in rates was remarkable—from 50 percent to 28 percent. One of the most important provisions that made it possible to cut top rates without lowering revenues appreciably was the repeal of the provision excluding 60 percent of long-term capital gains from taxation.

Now, barely six years later, President Bush wishes to scrap the capital gains part of the bargain but keep the lowered rates, thereby lavishing lower taxes on income groups that have benefited mightily from rising incomes and lower tax rates, while providing almost nothing to the majority of the population that has suffered from economic stagnation.

With this year's deficit exceeding $300 billion, any tax cut at all should be viewed with extraordinary skepticism. A tax cut *might* be defensible if it promoted growth. But at best the capital gains tax cut could increase growth only trivially. The danger is that it could depress growth by cutting revenues and diverting even more of the meager U.S. national saving to cover the increased federal budget deficit.

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