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WOULD A CAPITAL GAINS TAX CUT STIMULATE THE ECONOMY?

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Some Congressional leaders are promoting a proposal to reduce the maximum tax rate on long-term capital gains from 20 percent to 15 percent. This reduction in the capital gains rate is being championed as a way to stimulate the economy. A reduction in the capital gains tax rate, however, is highly unlikely to provide a stimulus. In fact, it offers one of the least appropriate responses to the nation's current economic challenges.

Advocates of a capital gains tax cut have not traditionally claimed it has a stimulus effect. In the past, they have argued that it would provide long-term, rather than short-term, benefits for the economy. Even these long-run benefit arguments are weak. The Congressional Budget Office and other respected analysts have found that a capital gains tax cut would have very little impact on economic growth.

- The country's current economic challenges center on short-run difficulties. Most economists believe the underlying fundamentals of the economy remain strong — a point underscored by the chairman of the President's Council of Economic Advisers, Glenn Hubbard, in a recent *Wall Street Journal* op-ed² — and that the principal problem we face is the prospect of a short-run downturn.
- A capital gains tax cut is typically promoted as producing economic benefits in the *long run*, not the short run. Even those who believe that a capital gains tax cut would encourage business investment have previously acknowledged that “the impact is slow, because it takes a long time to move the capital stock.”³ According to the standard claims of capital gains tax cut proponents, the proposal is inconsistent with the short-term nature of the economic difficulties the country now confronts. Indeed, Allan Sloan reported in the *Washington Post* on September 18 that even Rep. Bill Thomas, the Chairman of the House Ways and Means Committee who has been promoting a capital gains tax cut in recent days, has acknowledged that “he doesn't consider it a short-term recovery tool.”⁴

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² R. Glenn Hubbard, “America's Economy Will Rebound from Attacks,” *The Wall Street Journal*, September 17, 2001.

³ “Capital Gains Taxes and the Economy: A Retrospective Look,” prepared for American Council for Capital Formation by Standard and Poor's DRI, June 25, 1999.

⁴ Allan Sloan, “The Buck Stopped Here in Deference to Humanity,” *The Washington Post*, September 18, 2001.

- The best evidence from respected neutral analysts such as the Congressional Budget Office indicates that a capital gains tax cut would produce little economic benefit, even in the long run. CBO found that a capital gains tax cut would increase the size of the economy, as measured by the Gross Domestic Product, by about only *a couple hundredths of one percent after ten years*, an imperceptible change. In the short run, the benefits would be even more minuscule and could be negative, since the proposal's long-term revenue losses would exert upward pressure on long-term interest rates.

A capital gains tax cut would do little to spur the economy over the next few quarters. Both former Treasury Secretary Robert Rubin and respected financier Warren Buffet stated in a television interview with 60 Minutes on September 16 that a capital gains tax cut would make no contribution to improving the nation's current economic situation. A new Congressional Research Service report issued September 17 also reaches a similar conclusion, stating that "a capital gains tax cut appears the least likely of any permanent tax cut to stimulate the economy in the short run; a temporary capital gains cut is unlikely to provide any stimulus."⁵ (Some policymakers have floated the idea of a *temporary*, rather than a permanent, cut in the capital gains tax rate.)

Most troubling is that a capital gains rate cut could be counterproductive, as revenue losses from the tax cut could exert upward pressure on long-term interest rates. A capital gains rate reduction would likely accelerate the collection of tax revenues in the next couple of years, as investors sell more assets to take advantage of the lower capital gains tax rates. These short-term revenue gains, however, would give way to revenue losses in subsequent years — even if the rate cut were only temporary. Lower revenues later in the decade would add to the long-term fiscal burden created by the recently enacted tax cut.

Federal Reserve Chairman Alan Greenspan acknowledged during a Senate hearing this summer that the long-term cost of the tax cut has placed upward pressure on long-term interest rates. This is preventing the Fed's rate-reduction policy from being as successful as it otherwise would be in stimulating the economy. Further long-term revenue losses, such as those associated with a capital gains tax cut, would only exacerbate the problems with long-term interest rates. Higher long-term interest rates could discourage economic activity today, weakening efforts to encourage business investment and bolster consumer confidence.

In general, a *temporary* cut in the capital gains tax rate could be even more problematic than a permanent reduction. A temporary reduction would induce more investors to hurry and sell their stocks now while the lower tax rate applies. The resultant sell-off could cause a larger decline in stock prices and thereby damage consumer confidence. Given the fragile nature of consumer confidence and its importance to the economy, endangering that confidence by providing an incentive to sell stocks in the months ahead hardly seems beneficial.

It makes little sense for the government to pursue policies that encourage investors to sell stocks at a time when the economic outlook is clouded and the markets are weak. There already

⁵ Jane G. Gravelle, "Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts," Congressional Research Service, September 17, 2001.

Greenspan Agrees Tax Cut Puts Upward Pressure on Long-Term Interest Rates

Following is an exchange between Federal Reserve Chairman Alan Greenspan and Senator Charles Schumer at a hearing held by the Senate Banking, Housing, and Urban Affairs Committee on July 24, 2001.

Senator Schumer: One other thing you mentioned that one of the reasons — I think this was to Senator Reed — that you thought that [long-term] rates hadn't come down enough was that the rate of decline of Treasury debt had been not as great as we thought. Is that due to the economy, the slowing of the economy? Is that due to the tax cut?

Chairman Greenspan: I think it's basically [due] to a series of things: one, the tax cut; two, expenditure increases which were higher than expected; and three, the economy.

Senator Schumer: Right, so the tax cut did have a negative effect on this?

Chairman Greenspan: Oh yes, no question.

is concern that funds will flow out of the stock market into safer investments, such as Treasury bonds, money market funds, and even gold, in the aftermath of the recent attacks.

Capital Gains Tax Cut Would Yield Few Long-Term Benefits

Proponents of capital gains tax cuts typically claim that such cuts would raise investment and risk-taking in the long run. Credible analysis has not substantiated these claims. A study undertaken by the Congressional Budget Office in 1998, in which it reviewed a permanent reduction in the capital gains tax proposed by then-Speaker Newt Gingrich, concluded that the proposal would increase private saving and the size of the economy by only minuscule amounts.⁶ Where studies have shown large, positive effects, CBO found these studies achieved these results only by relying on faulty and inappropriate assumptions.

The CBO study concluded that reducing the top tax rate on long-term capital gains from 20 percent to 15 percent — precisely the proposal now being recycled — would have only a very small effect on private saving and long-term economic growth. CBO found such a rate reduction “would make a relatively small change to a tax that applies to relatively little capital income.” CBO estimated that private saving would rise by 0.3 percent, adding about 0.06 percent to the capital stock after ten years. The increase in GDP would amount to about \$2 billion to \$3 billion after ten years — or less than two one-hundredths of one percent of GDP — an amount that is little more than rounding error in the measurement of GDP in an economy that is over \$10 trillion this year. CBO found the impact to be minuscule for essentially two reasons:

⁶ Congressional Budget Office, “An Analysis of the Potential Macroeconomic Effects of the Economic Growth Act of 1998,” CBO Memorandum, August 1998.

- First, the tax rate on capital gains already is lower than the tax rate on other income, so a further reduction would have less of an impact. Not only are the statutory rates lower — with the current 38.6 percent top rate on regular income nearly twice as high as the 20 percent top rate on long-term capital gains — but investors can further lower the impact of capital gains taxes by deferring the sale of assets. In fact, about half of all capital gains tax is avoided by investors altogether, as they hold onto assets until they die. Heirs do not have to pay tax on the gains accrued during the lifetime of the original owner.
- Second, a reduction in the capital gains rate applies to a limited amount of assets, mitigating its overall effect on investment and saving decisions. To benefit from a capital gains tax cut, the return on an investment must come in the form of a capital gain, not as interest or dividends. Further, the gain must be taxable. Capital gains in tax-exempt pension funds or individual retirement accounts would be unaffected by such a tax cut. Given these factors, CBO estimated that only about one-quarter of investments would be affected by a capital gains rate reduction.

Supporters of a capital gains tax cut often assert that it would foster innovation and risk-taking and thereby spur economic growth. CBO found, however, that “no study has measured the relationship between capital gains tax and innovative enterprise....Without empirical evidence, the response of innovative enterprise to a capital gains tax cut remains speculative.” Moreover, the Congressional Research Service found that only a small fraction of venture capital funds are subject to capital gains tax — with the remainder provided by tax-exempt pension funds, foundations, and foreign investors, whose investment decisions are essentially unaffected by a reduction in the capital gains tax rate.⁷ Indeed, the vast majority of capital gains taxes are related to the sale of real estate and stock in well-established corporations, not venture capital. CRS concluded that “there is no apparent relationship between venture capital investments and the capital gains tax.”

Furthermore, small firms are more dependent on sources of investments such as personal savings, family, and friends that may be more sensitive to the nature of the business opportunity than to the specific capital gains rate. The CRS study concluded that “a general capital gains tax cut is a poorly targeted and ineffective incentive to investment in small innovative firms.”

Looking at the numerous changes in the capital gains tax rate over the past four decades, Urban Institute senior fellow Leonard Burman found there was essentially no relationship between changes in the capital gains tax rate and economic growth. (Burman’s research and findings are included in a book he authored on capital gains that the Brookings Institution published in 1999.⁸) Brookings Institution senior fellow Henry Aaron reached a similar

⁷ Jane G. Gravelle, “Capital Gains Taxes, Innovation, and Growth,” Congressional Research Service, January 28, 1999.

⁸ Leonard Burman, *The Labryinth of Capital Gains Tax Policy: A Guide for the Perplexed*, Brookings Institution, 1999.

conclusion, finding that “evidence does not support the contention that the capital gains cut would have any perceptible positive effect on growth.”⁹

A Capital Gains Rate Reduction Would Lose Revenue in the Long Run

A capital gain occurs when an asset — such as a small business, a stock, or other property — increases in value. Although an asset may appreciate each year, it is not until it has been sold and the gain has thereby been “realized” that a tax is levied on the increase in the asset’s value. Because no capital gains taxes are incurred until an asset is sold, investors have control over when they will pay capital gains taxes. For instance, investors frequently defer the sale of an asset that has increased in value to time it with the sale of an asset that has declined in value, using the loss to offset some or all of the gain and thereby reducing capital gains tax liability.¹⁰

For individuals, capital gains generally are taxed at a lower rate than other income. For assets held more than one year, taxpayers in the 15 percent bracket and lower brackets face a 10 percent capital gains rate, while taxpayers in the 27 percent bracket and higher brackets face a 20 percent capital gains rate.¹¹ The current top regular income tax rate of 38.6 percent is nearly twice as high as the top capital gains tax rate. The proposed capital gains rate reduction would lower the top capital gains rate from 20 percent to 15 percent.¹² Because the proposal applies only to taxable capital gains, many assets would be unaffected. For example, assets held in pension funds and individual retirement accounts do not face capital gains tax. Similarly, for most families, any gain on the sale of their personal residence is exempt from the capital gains tax, since the first \$500,000 of the gain for married couples is exempt from the tax. (The exemption is \$250,000 for singles.)

In theory, a reduction in the capital gains tax rate would encourage investors to sell appreciated assets they otherwise would not sell until some later date. That is, investors who had previously been unwilling to sell appreciated assets because they did not want to pay the capital gains tax (which is known as the “lock-in effect”) would, at lower tax rates, be willing to sell these assets and realize gains sooner rather than later. A key issue for revenue in the short run is how large of an increase in realizations a rate reduction would generate. If realizations are

⁹ Henry Aaron, “The Capital Gains Tax Cut Mystery,” Tax Notes, March 9, 1992.

¹⁰ In the absence of realized capital gains that can be offset with capital losses, taxpayers are limited to a deduction for capital losses of \$3,000 in a year. Losses above this limit can be carried forward to future years.

¹¹ Rates lower than these can apply to assets held for at least five years. Assets acquired after December 31, 2000 that would otherwise be subject to the 10 percent rate will be taxed at 8 percent if they have been held for more than five years before being sold. For assets otherwise subject to the 20 percent rate, a 18 percent rate will apply if the asset has been held for more than five years and was acquired after December 31, 2000. This 18 percent rate thus can be applied to some assets sold beginning in 2006. Assets held for less than one year (short-term capital gains) are taxed at the same rate as regular income.

¹² Presumably, the 10 percent rate would be reduced to 7.5 percent, which has been the case with similar proposals in the past, but no specifics are currently available.

unchanged, a lower capital gains tax rate would simply result in a loss of revenues. If the increase in realizations is large enough, it could offset the effects of the lower tax rate and even increase revenues in the short term.

In the past, the Joint Committee on Taxation has estimated that capital gains rate reductions of the magnitude assumed in the current proposal would boost realizations sufficiently to increase revenues in the first year or two that the proposal is in effect. After this initial surge, however, the additional realizations would subside, and revenues would decline. Another factor reducing revenues over time is that investors would shift more funds into assets that generate capital gains to take advantage of the lower tax rates. By moving more funds out of assets that generate more highly taxed ordinary income — such as interest and dividends — and into capital gain assets, investors would pay less in taxes overall, further reducing revenues to the Treasury over the long term. Although no official Joint Tax Committee estimates of the proposal are available, these effects would be expected to result in revenue losses totaling more than \$50 billion over the next ten years. (In 1999, the Joint Tax Committee estimated a similar proposal to cost \$52 billion between 2000 and 2009.¹³)

Concerns That Capital Gains Tax Cuts Could Do More Harm Than Good in the Short Run

Proponents of capital gains tax cuts typically highlight the potential long-term benefits (which, as explained above, are not large), while acknowledging that the impact is not immediate. For instance, while arguing that a capital gains tax cut would encourage business investment, a paper prepared for and issued by the American Council for Capital Formation admits that “the impact is slow, because it takes a long time to move the capital stock.”¹⁴ Similarly, the *Washington Post* reported House Ways and Means Committee Chairman Bill Thomas as saying that “he doesn’t consider it a short-term recovery tool.”¹⁵ In other words, even according to advocates of a capital gains tax cut, the proposal is aimed at the long run and has little to do with boosting the economy in the short term. In fact, a capital gains tax cut could actually be *counterproductive* in the short run for two reasons:

- First, the reduction in revenue in the long term from a capital gains tax cut carries an immediate economic cost: Further erosion of long-term fiscal discipline could increase upward pressure on long-term interest rates, which could be a net negative for the economy. Fed Chairman Greenspan stated before a Senate Banking Committee hearing in late July that long-term interest rates are higher

¹³ Joint Committee on Taxation, “Estimated Budget Effects of H.R. 2488, the Financial Freedom Act of 1999, as passed by the House of Representatives,” JCX-53-99, July 22, 1999. One would expect the costs to be higher today, as the budget window has shifted forward to 2002 through 2011 and baseline estimates of capital gains realizations have risen.

¹⁴ “Capital Gains Taxes and the Economy: A Retrospective Look,” prepared for American Council for Capital Formation by Standard and Poor’s DRI, June 25, 1999.

¹⁵ Allan Sloan, “The Buck Stopped Here in Deference to Humanity,” *The Washington Post*, September 18, 2001.

now than they otherwise would be due in part to the enactment of the large tax cut this spring, which, together with spending pressures, will squeeze down the federal budget surplus (see box on page 3). Greenspan apparently was reflecting the bond market's apprehension about maintaining the pace of debt reduction in the face of these costly tax cuts.

Higher long-term interest rates undercut the Fed's policy of reducing short-term interest rates to get the economy moving. Long-term interest rates are more important than short-term interest rates for many crucial areas of economic activity. For example, long-term rates are typically more relevant for decisions such as whether a household should take out a mortgage to buy a new home or whether a firm should issue new debt to finance an expansion of its activities. Reductions in short-term interest rates thus will be less effective in stimulating the economy if they are not accompanied by reductions in long-term interest rates. If the reductions in short-term rates are accompanied by *increases* in long-term rates, the overall economic effect could be negative.

A reduction in the capital gains tax rate would compound the problems associated with high long-term interest rates. After a short-term burst of revenue, a reduction in the capital gains tax rate would result in revenue losses. These losses would occur on top of the large cost of the recently enacted tax cut bill, which, if the bill is extended, will total more than \$4 trillion in the second ten years the legislation is in effect.¹⁶

- Second, the capital gains proposal could create an incentive to sell increased amounts of stock in the near term, which could precipitate a further decline in stock prices. The incentive to sell stock would be even stronger with a temporary capital gains rate cut (see box on page 8). A falling stock market could rattle consumer confidence, leading to lower levels of spending throughout the economy — a chain of events that could leave the economy worse off. The chairman of the President's Council of Economic Advisers, Glenn Hubbard, recently noted the link between consumer confidence and the stock market, stating that further declines in the market could hurt consumer confidence and the economy.¹⁷

By putting upward pressure on long-term interest rates and potentially causing a sell-off of shares, which could further weaken consumer confidence, a capital gains tax cut could be harmful in the short run.

¹⁶ Joel Friedman, Richard Kogan, and Robert Greenstein, "New Tax-Cut Law Ultimately Costs as Much as Bush Plan: Gimmicks Used to Camouflage \$4.1 Trillion Cost in Second Decade," Center on Budget and Policy Priorities, revised June 27, 2001.

¹⁷ Ross Finley, "White House's Hubbard Looks for 'Fairly Robust' Growth," Associated Press, September 10, 2001.

A Temporary Capital Gains Tax Cut Would Be Particularly Inappropriate

A temporary capital gains tax cut could potentially be beneficial for the economy in the short run if it increased consumer spending substantially. For a capital gains rate reduction to boost consumer spending, however, investors selling appreciated assets in response to the tax cut would have to spend some of the proceeds. There is no way of knowing how much of their realized gain investors actually would spend, particularly at a time when they are concerned about the uncertain state of the economy. The available evidence suggests that at most, only *a few cents* on the dollar would be spent.

A temporary capital gains rate cut would create an incentive for investors to sell appreciated assets so they can take advantage of the lower tax rates. The principal beneficiaries of this tax cut would unquestionably be those with high incomes, as they own the vast majority of assets and pay the vast bulk of the capital gains tax. Normally this high-income group would be less inclined to consume and more inclined to save any new funds than would people with more moderate incomes. The uncertainty in the economy and weakness in the stock market could make them even more inclined to sock away rather than spend the gains from this tax cut.

In remarks at a recent Federal Reserve Bank symposium, Fed Chairman Alan Greenspan highlighted the difficulty of predicting how much investors will spend after realizing a capital gain, but indicated that well under 10 cents on the dollar likely would be spent.* This is well short of what would be needed to generate meaningful short-term economic stimulus in the absence of a massive sell-off of shares.

Furthermore, if a temporary cut in the capital gains rate were somehow to achieve the desired change in investor behavior — that is, getting investors to sell assets and spend the proceeds to stimulate the economy — its success would depend upon money being withdrawn from the stock market. A market sell-off would weaken consumer confidence, which would be a net negative for the economy. An economic strategy that hinges on consumers spending the proceeds from a massive sell-off of stocks is not only risky but potentially counterproductive.

Proponents of capital gains tax cuts typically focus on the potential benefits for business investment, not consumer spending. They argue that a capital gains tax cut boosts the returns to starting new firms and taking business risks. But even by the logic of such proponents, a *temporary* reduction in the tax rate makes little sense: How many people will be willing to start new firms or invest in risky projects and expect to realize the gains over the next year or two? Business investment could actually fall in the short run in response to a temporary capital gains tax cut. The risks associated with this tax cut — a possible drop in consumer confidence in reaction to a sell-off in the stock market induced by the temporary rate cut, and higher long-term rates in reaction to the loss of revenues — could deter business investment.

Finally, advocates of the capital gains rate cut are unlikely to be satisfied with a temporary measure; if a temporary capital gains tax cut were enacted in the name of stimulating the economy, one can be certain its advocates would push subsequently for its permanent extension. But, as explained in this analysis, a permanent capital gains tax cut would add to long-term revenue losses and fiscal problems, while offering only minuscule long-term economic benefits.

*Alan Greenspan, "Opening Remarks at a Symposium Sponsored by the Federal Reserve Bank of Kansas City," August 31, 2001. The symposium was held in Jackson Hole, Wyoming.

A Capital Gains Tax Cut Would be Regressive

Finally, a capital gains tax cut would be regressive, providing large tax subsidies to the very top earners who garnered a highly disproportionate share of the recently enacted tax cut. High-income taxpayers, who have the largest portfolio of assets and pay the most in capital gains taxes, would reap windfall benefits from the proposed capital gains tax cut. Based on estimates by the Congressional Research Service, it is likely that 80 percent of the benefits from this proposal would accrue to the two percent of the population with the highest incomes — those with incomes exceeding \$200,000.

Using Joint Committee on Taxation data for 1999, CRS estimated that the 1.8 percent of taxpayers with incomes over \$200,000 (in 1999 dollars) pay 78.6 percent of capital gains taxes.¹⁸ The highest-income 8 percent of taxpayers — those with incomes over \$100,000 — pay more than 90 percent of capital gains taxes. Recent data by the Citizens for Tax Justice show a similar distribution of capital gains taxes, with the top one percent of taxpayers paying 72.5 percent of these taxes and the top 10 percent paying 94.6 percent.

To be sure, the number of middle-income taxpayers who incur some capital gains tax liability exceeds the number of high-income taxpayers who do so. A majority of the individuals who pay capital gains tax thus are middle-income taxpayers. But the capital gains taxes that middle-income individuals pay are typically very small compared to the capital gains taxes those with higher incomes pay. Middle-income taxpayers can incur modest amounts of capital gains tax, for instance, as a result of small distributions from a mutual fund. Indeed, CRS found that while the average capital gains tax was \$476 for all returns in 1999, the average was \$20,536 for those with incomes over \$200,000 and less than \$10 for all returns in the bottom half of the income distribution. That millions of middle-income taxpayers may receive a small benefit from a reduction in the capital gains tax rate does not alter the finding that the benefits of such a tax cut would be overwhelmingly concentrated on those with very high incomes.

	Percentage Distribution of:	
	Taxpayers	Capital gains taxes
Under \$10,000	16.1	0.0
\$10,000 to \$20,000	19.0	0.0
\$20,000 to \$30,000	14.6	0.2
\$30,000 to \$40,000	11.5	0.5
\$40,000 to \$50,000	9.4	0.7
\$50,000 to \$75,000	14.3	2.8
\$75,000 to \$100,000	7.2	4.4
\$100,000 to \$200,000	6.1	12.7
Over \$200,000	<u>1.8</u>	<u>78.6</u>
Total	100.0	100.0

Source: Congressional Research Service

Capital gains proponents sometimes seek to denigrate data such as those in the CRS study. They argue that examining the incomes of taxpayers with capital gains in the year that

¹⁸ Jane G. Gravelle, "Capital Gains Taxes: Distributional Effects," Congressional Research Service, September 24, 1999.

these taxpayers realize the capital gains dramatically overstates the income levels of these taxpayers over time. The Congressional Budget Office considered this issue. CBO found that data on the incomes of investors in the years they realize capital gains generally convey an accurate picture of how the benefits of a reduction in the capital gains tax rate would be distributed across the income spectrum. (As a check on these annual income data, CBO also examined the incomes over a 10-year period of those with capital gains. Under the ten-year income measure as well, capital gains income was found to be very concentrated among those with high incomes, albeit somewhat less so than under an annual snapshot.¹⁹) CBO reported that high-income taxpayers tend both to have many more assets that can generate capital gains than do other taxpayers and to realize capital gains more frequently. Capital gains income also represents a larger share of these taxpayers' incomes.

Conclusion

The calls for cutting the capital gains rate to stimulate the economy are coming primarily from those who have long supported a reduction in capital gains taxes — or even total elimination of these taxes — for reasons unrelated to fiscal stimulus. Traditionally, proponents of capital gains rate cuts have trumpeted what they claim are the *long-term* benefits of such rate reductions. The faltering economy has created an opportunity for them to repackage this tax cut as a *short-term* economic curative. But rather than providing a cure for what ails the U.S. economy, a capital gains tax cut would yield a bonanza for the highest-income taxpayers while doing little for the economy in either the short or the long run. Such a proposal is not only likely to be ineffective, but has the potential to weaken efforts by the Federal Reserve to stimulate the economy because it could place upward pressure on long-term interest rates or spook consumer confidence by fueling a sell-off in the stock market.

¹⁹ Congressional Budget Office, "Perspectives on the Ownership of Capital Assets and the Realization of Capital Gains," CBO Papers, May 1997.