Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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CAPITAL GAINS TAX CUT WOULD BE POOR STIMULUS

by Chye-Ching Huang and Robert Greenstein

In recent weeks, several policymakers have proposed temporary or permanent cuts in the capital gains rate as an "economic stimulus" measure. This would be ineffective at best: the Congressional Research Service (CRS) has stated 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."[1] A temporary capital gains tax cut could even *harm* the economy by driving stock prices lower, as investors would likely rush to unload stocks to take advantage of the lower rate.

The purpose of economic stimulus is to encourage an immediate increase in aggregate demand by boosting consumer spending. But a capital gains tax cut is unlikely to release new resources that consumers would quickly spend.

- **Even those who believe cutting capital gains taxes would encourage business investment acknowledge that it is poor short-term stimulus.** During the 2001 recession, for example, then-House and Ways Chairman Bill Thomas, a proponent of cutting capital gains taxes, acknowledged that it would not promote short-term economic recovery.[2]

- **Any windfall that taxpayers receive from a capital gains tax cut is unlikely to be spent quickly.** The main beneficiaries of capital gains tax cuts would be high-income taxpayers, who own the vast majority of assets. For example, the Urban-Brookings Tax Policy Center has estimated that 98 percent of the benefit of temporarily cutting the capital gains rate in half would flow to the top 20 percent of households; 75 percent of the benefit would flow just to the *top 1 percent* of households.[3]

  The fact that capital gains tax cuts go mostly to high-income households makes them very poor stimulus, since high-income households are much more likely than low-income households to

[1] Jane G. Gravelle, "Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts," Congressional Research Service, September 17, 2003.

[2] Quoted in Joel Friedman, Iris Lav, and Peter Orszag, "Would a Capital Gains Tax Cut Stimulate the Economy?" Center on Budget and Policy Priorities, September 20, 2001, http://www.cbpp.org/9-20-01tax.htm.

[3] See Tax Policy Center Table T08-0246, October 14, 2008: http://www.taxpolicycenter.org/numbers/displayatab.cfm?Docid=2011&DocTypeID=2.

save rather than spend a significant portion of any new resources they receive. To boost consumer spending, stimulus resources should be directed at those who will spend these funds quickly.

- **A temporary capital gains cut could harm the economy.** A temporary capital gains tax cut would induce 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, thereby damaging consumer confidence. As the CRS report cited above stated: "since there will be an incentive to sell assets, but not an incentive to invest, the more likely short-run effect [of temporary capital gains tax cuts] is to depress the stock market." That, in turn, could rattle consumer confidence, already at historically low levels, and also spook financial markets more generally.

  A temporary capital gains cut may be somewhat less likely to spark a large stock sell-off when the economy is weak and the stock market is already down, because investors will have fewer stocks that have appreciated in value (and thus less opportunity to take advantage of the lower rate). But if the rate cut does not lead to a large increase in capital gains realizations, it cannot possibly have much of a stimulative effect on the economy, even under the most strained argument made on its behalf. This is because the only new resources that a capital gains cut can possibly make available for consumption are the tax benefits received by investors who sell stocks at a profit.[4]

  In short, if a temporary capital gains cut *does* prompt a large increase in capital gains realizations, it would likely depress stock prices and could further weaken a slow economy; if it does *not* prompt a large increase in realizations, it will have only a minor effect on consumption. Either way, it would prove ineffective — or even counter-productive — as stimulus.

Instead of providing high-income taxpayers with a tax cut that will not significantly boost consumption, Congress should focus on effective stimulus measures that would put resources in the hands of people who will spend them.

[4] By itself, the transfer of stock from sellers to buyers would generate no new resources for consumption. Sellers would have more cash on hand because of the proceeds from these sales, but buyers would have less.