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CBPP STATEMENT

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Statement of Robert Greenstein on the President's New Tax Proposals

In recent decades, economic growth has powerfully benefitted Wall Street, while leaving much of Main Street behind. The plan that President Obama unveiled today would take large, important steps to help redress part of the imbalance and make prosperity more broadly shared. The President's new tax proposals will surely elicit howls of protest from various special interests and on ideological grounds; adversaries will make predictable claims that the proposals would harm the economy and jobs. Yet while the proposals do present a major challenge to the status quo, they should *benefit* economic growth, not hinder it, while substantially helping tens of millions of middle- and lower-income working families and individuals.

The revenue-raising proposals — in particular, the reforms in capital gains taxation — would reduce economically inefficient tax sheltering and tax avoidance. They also would address "lock in" that keeps substantial investment capital from being invested in the most economically productive ways. In addition, the President's plan uses the revenue raised in ways that not only benefit large numbers of middle- and lower-income working families but also increase work, educational attainment, and retirement savings — thereby making the labor force larger and more productive and thus promoting long-term economic growth.

For too long, tax reform has been thought of as consisting solely of lowering tax rates and broadening the tax base. Such reforms, if well designed, can help the economy. But the President's new proposals constitute an important tax reform that would benefit both the economy and — unlike some other tax reform proposals — very large numbers of ordinary Americans.

Reforming Capital Gains Taxation

The tax code strongly favors income from capital gains — i.e., increases in the value of assets such as stocks — over income from wages and salaries. This imbalance fuels inefficient tax avoidance and unproductive asset-hoarding. It's also very regressive, since the top 1 percent of households hold about 42 percent of total wealth.

The preferences for capital gains include a top tax rate on capital gains from the sale of assets held more than one year that is much lower than the top tax rates on income from employment. In addition, capital gains taxes are due only when the gain is "realized" — usually when the asset is sold — while taxes on income from work and salaries (as well as on interest from savings accounts) must be paid in the year the income is received.

Moreover, if an individual holds on to an asset until he or she dies, the increase in the asset's value is *never* subject to capital gains tax. This encourages wealthy people to turn as much of their income as possible into capital gains and to hold on to the assets until death.

The President proposes two major changes in capital gains taxation: 1) applying the capital gains tax to large, "unrealized" capital gains that wealthy individuals leave behind when they die, similar to a proposal in the 2010 plan authored by Erskine Bowles and Alan Simpson; and 2) narrowing the differential between the top capital gains rate and the top tax rates on earned income by returning the capital gains rate to its level under President Reagan.

The proposal to tax unrealized capital gains upon an individual's death generally would *not affect* middle-income families or even most high-income families. That's because the first $100,000 of unrealized capital gains per individual — $200,000 per couple — would be exempt, as would $500,000 in capital gains on personal residences (which could cover more than one home). Additional protections would apply to family-owned small businesses.

As a result, only a very small percentage of people — essentially those who are quite wealthy — would owe any tax on unrealized capital gains when they die. Not only would the vast preponderance of middle-income families be untouched, but most upper-income people would be as well.

The Treasury estimates that *99 percent* of the revenue raised by these reforms (raising the capital gains rate and taxing some unrealized gains at death) would be paid by the *top 1 percent* of tax filers. Indeed, more than 80 percent of the added revenue would come from the wealthiest 0.1 percent of Americans.

Opponents are sure to cry that this will decimate the economy. In reality, the proposal would more likely help the economy than harm it, for two reasons: the capital gains and related revenue-raising reforms would reduce various inefficiencies that impair growth, and the revenue that is raised would be reinvested in ways that not only help middle- and lower-income working families but also boost economic growth by increasing the size and productivity of the labor force.

Economic Merits of the Proposed Tax Reforms

The current tax treatment of capital gains income fosters economic inefficiency in ways these reforms would address.

- Wealthy individuals have an incentive to hold assets until death to escape the capital gains tax, even if they have better investment opportunities. This inefficiency — known as "lock in" — discourages capital from flowing to where it is most productive. Leonard Burman, one of the nation's leading tax policy experts and co-director of the Urban-Brookings Tax Policy Center, has previously written that "taxing capital gains at death would go a long way toward removing the lock-in effect. Taxpayers could still defer capital gains liability by avoiding asset sales, but they could no longer avoid it entirely by holding assets to death."

  Burman has also noted that "taxing capital gains at death would enhance efficiency by deterring expensive tax-avoidance schemes." Wealthy filers go through all sorts of financial gymnastics to turn income into capital gains and then to hold such gains until the tax liability is extinguished at their death.

- The proposal to raise the top capital gains rate has economic merit as well. The President proposes raising the rate from 20 percent to 24.2 percent for married filers with incomes over about $500,000 (and single filers with incomes over about $430,000), bringing the total tax rate on capital gains to 28 percent — the Reagan-era level — when the 3.8 percent surtax on high-income households' investment income is included. Burman has explained that the large differential between the top rates on ordinary

income and capital gains is one of the biggest drivers of economically inefficient tax sheltering, as wealthy investors employ an array of tax-avoidance mechanisms to convert regular income into capital gains.

- Nor does the economic literature indicate that the economy needs today's low capital gains tax rates. University of Michigan tax economist Joel Slemrod, another leading tax policy expert, has found "there is no evidence that links aggregate economic performance to capital gains tax rates."
- It's also instructive that the Tax Policy Center has found no statistically significant correlation between capital gains rates and growth in real gross domestic product (GDP) during the last 50 years.

In short, the President's proposed capital gains rate increase would likely reduce investment in the *tax shelter industry*. But the evidence doesn't support claims that it would injure the economy.

The capital gains proposals would address certain other inequities in the tax code as well. For example, middle-income people with 401(k)s, IRAs, or other retirement accounts must begin withdrawing funds from their accounts (which virtually always include some capital gains earnings) no later than age 70½ and pay taxes on the withdrawals. This rule is designed to ensure that the tax-advantaged funds in the accounts don't escape income tax altogether. But wealthy individuals with vast stock portfolios need *not* withdraw any of their assets and pay taxes on them and can escape taxes on their capital gains by holding the assets until they die.

Financial Crisis Responsibility Fee

The new proposal also includes a measure designed to discourage the financial services industry from taking excessive risks — and to help recoup costs of bailing out the industry — by levying a financial crisis responsibility fee on very large, "too-big-to-fail" financial firms. This addresses a problem that former Ways and Means Committee Chairman Dave Camp recognized in designing his tax reform plan, which included a broadly similar tax on large financial firms.

Helping Workers and Families Work and Build Skills and Savings

Not only do the revenue proposals represent sound policy in their own right, but the President's plan would use the new revenues to finance policies that support work and help working families build skills and savings. The plan includes proposals to expand the child and dependent care tax credit and establish a tax credit for secondary earners in two-earner families. The President has signaled he'll also release shortly a related budget proposal for new investments to boost child care access and quality. These proposals should enable and encourage more parents to go to work or to work more hours, thereby strengthening the economy by expanding the work force, while also helping many middle- and lower-income working families make ends meet.

In addition, the proposals would simplify, consolidate, and better target tax subsidies for higher education, and the revenue that the plan would raise also would finance the President's recently unveiled proposal to make two years of community college free of charge. These measures should result in more students attending and completing college — another positive for the economy.

In releasing the proposal today, the White House reiterated its support for extending the pro-work and anti-poverty effects of the Earned Income Tax Credit (EITC) to low-income workers who aren't raising children and for making permanent key provisions of the EITC and the Child Tax Credit slated to expire after 2017. In a rare sign of possible bipartisan convergence, the Obama proposal to expand the EITC for

childless workers and a proposal last year from House Ways and Means Chair Paul Ryan are almost identical.

The EITC has been shown to raise labor force participation rates among single parents, and many researchers believe a more adequate EITC for childless workers could have similar effects on those individuals, who include many young adults. The proposal to make key EITC and Child Tax Credit improvements permanent is also vital; if they expire, 16 million people in low-income working families — including 8 million children — will be pushed into, or deeper into, poverty in 2018.

Finally, the new Obama proposal includes measures to expand opportunities for retirement savings for many workers, which should boost their savings. That, too, could be positive for the economy.

Together, these investments represent sound policies that would help more workers join and remain in the labor force. They would enable more parents to afford both child care and college education for their children. The economy should benefit from higher labor force participation, higher productivity from a better educated workforce, and more retirement saving. These policies would also help to ease the enormous and growing income and wealth disparities and ensure that the benefits of the economic recovery are somewhat more widely shared.

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