RAISING FEDERAL REVENUES BY LOWERING CAPITAL GAINS RATES

A major feature of last year's tax reform bill is its elimination of special tax treatment for capital gains. This "reform" ostensibly is to raise revenue for the federal government; in fact, however, revenue is far more likely to fall. If Congress thus is now looking around for ways to raise revenues, or at least prevent them from falling, a sure way would be to restore the special tax treatment for capital gains. Indeed, nine members of the House Ways and Means Committee are calling for a cut in capital gains taxes to a maximum of 15 percent. These Congressmen estimate that such a cut would raise up to $8 billion in additional revenues for fiscal 1988 and up to $11 billion additional for fiscal 1989.

Previous experience confirms that higher capital gains taxes actually yield lower revenues. The Tax Reform Act of 1969, for example, sought to cut back the special tax treatment for capital gains by doubling the maximum rate on long-term capital gains. The result: a decrease from $5.3 billion in 1969 to $3.2 billion in 1970 of the revenues raised by the capital gains tax. Five years later, capital gains tax revenues were still below their 1969 level.

Drying Up Funds. The reason why capital gains are so sensitive to tax rates is because taxpayers have the option of deciding when to realize such gains. If rates are too high, investors simply will hold on to stocks or other assets rather than sell them and realize taxable gains. Or they will wait until they have capital losses that offset such gains. Economists call this the "lock-in" effect. It is this which lowered total gains realized by taxpayers from $35.6 billion in 1968 to just $20.8 billion in 1970.

The negative economic effects of higher capital gains taxes, moreover, go beyond their effect on tax revenues. The higher capital gains taxes imposed in 1969 inhibited the efficient use of capital and virtually dried up funds available for risky new ventures and new technologies. By 1978, these facts led a number of economists, such as Harvard's Martin Feldstein, to predict that a cut in the capital gains tax would raise government revenue. Congress was persuaded by this logic and in that year passed the Steiger Amendment, which reduced the maximum tax rate on capital gains from about 50 percent to 28 percent. Although President Jimmy Carter denounced this measure as a sure revenue-loser and a giveaway to the rich, he reluctantly signed the bill into law.

The effects were exactly the opposite of Carter's prediction. Total capital gains jumped from $45.3 billion in 1977 to $73.4 billion in 1979, increasing revenue from capital gains taxes from $8.1 billion to $11.7 billion. The bulk of these new revenues were paid by the rich. Total capital gains realized by those with incomes over $100,000 per year increased by over 250 percent between 1978 and 1982, compared to a 10 percent increase for those with incomes below $100,000. A 1985 Treasury Department report concluded that the 1978 capital gains tax cut had increased government revenues and spurred an explosion of new enterprises and risk capital. Indeed, America's high-tech revolution might never have been launched without the 1978 cut in capital gains taxes.

Obfuscating the Issue. Economists recently have been studying the results of increases and reductions in capital gains taxes. Almost all conclude that the tax rate which maximizes capital gains revenues is below the present 28 percent rate mandated by last year's tax law. Thus the new higher capital gains tax is likely to lose federal revenue, rather than raise it. It is impossible to tell how much revenue the drafters of the 1986 tax package actually expected from the higher capital gains tax. Neither the Treasury Department nor the Joint Committee on Taxation provided estimates, preferring to obfuscate the issue by including the revenue effects of capital gains taxes in the total. This surely was done because no one would believe that boosting the top tax rate on capital gains from 20 percent to 28 percent (a 40 percent hike) would in fact raise revenue. Had the backers of the tax bill been honest, however, and indicated that revenue might be lost, they could have endangered passage of the legislation.

Harvard economist Lawrence Lindsey now has calculated such figures. According to one study cited by him, the current 28 percent maximum capital gains tax exceeds the revenue-maximizing rate by as much as 72 percent. Lindsey's own estimate indicates that an 18 percent rate would maximize revenue. Thus he concludes that the federal government will lose between $27 billion and $105 billion in revenue over the next five years from higher capital gains taxes. For fiscal 1988 and fiscal 1989, he estimates the loss at between $11 billion and $42 billion. The higher capital gains taxes can also be expected to reduce venture capital available to new firms, crippling America's ability to innovate and develop the new products and technologies needed to compete in the international marketplace.

Keeping the U.S. Competitive. Thus Congress would do well to pay careful attention to the proposal by the nine Ways and Means Committee members that calls for cutting the capital gains tax rates. Enacting this or similar measures could add billions of dollars to the federal treasury this year alone and give an important boost to high-tech and other industries and businesses seeking the venture capital to keep the U.S. ahead of its international competitors, most of whom impose no capital gains taxes at all.

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For further information:

"Nine Ways and Means Republicans Suggest Fifteen Percent Capital Gains Rate," Tax Notes, June 22, 1987, pp. 1239-1240.

Lawrence Lindsey, Capital Gains Taxes under the Tax Reform Act of 1986: Revenue Estimates under Various Assumptions (Cambridge, Massachusetts: National Bureau of Economic Research, 1987).

Bruce Bartlett, "The Federal Tax Debate: Capital Gains," Heritage Foundation Backgrounder No. 399, December 27, 1984.