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Economic and Revenue Effects of Permanent and Temporary Capital Gains Tax Cuts

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Summary

Recent proposals have been made to enact either a temporary or a permanent capital gains tax cut. The former would probably gain revenue in the first 2 years but lose that revenue and more, most likely within the following 3 years. H.R. 3090, passed by the House, would lower the top tax rate from 20% to 18% for assets held at least a year. The Senate Finance Committee version of H.R. 3090, does not reduce capital gains taxes. 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 tax cut is unlikely to provide any stimulus. Permanently lower capital gains taxes can contribute to economic efficiency in some ways and detract from it in others. Capital gains tax cuts would favor high income individuals, with about 80% of the benefit going to the top 2% of taxpayers. This report will be updated to reflect legislative developments.

Introduction

Recent proposals have been made to enact a capital gains tax cut, and some arguments have been made that such tax cuts are needed to stimulate the economy. Proposals include both temporary cuts in capital gains taxes rates for 2 years as well as permanently lower rates. Interest in a tax stimulus package has increased following the terrorist attack of September 11, and a capital gains tax cut is one of a number of tax cuts being discussed. H.R. 3090, passed by the House on October 24, in a 216-214 vote, would lower the top tax rate to 18% for assets held a year. The Senate Finance Committee version of H.R. 3090, which was approved by the Committee on November 8, does not contain a capital gains tax cut.

Under tax law prior to 2001, individuals were taxed on ordinary incomes at rates of 15%, 28%, 31%, 36% and 39.6%. A new 10% bracket will be added for 2002, and the top rates (28% and higher) began to drop in 2001; eventually the 28% bracket will become 25%. Capitals gains on assets held for a year or more, however, are (and will continue to be absent legislative changes), taxed at special rates. The capital gains tax rate for

individuals in the 28% or higher normal tax rate bracket is 20%. Assets acquired after 2000 and held for 5 years will then be subject to a tax rate of 18%. Individuals in the 15% rate bracket are taxed at 10%, or 8% for assets held for 5 years (regardless of when acquired). Proposals have been made to reduce the 20% rate to 15%, and the 10% rate to 7.5%. One proposal would make this change permanent; another would provide a temporary rate cut for 2 years. H.R. 3090, reported out of the Ways and Means Committee on October 12, would lower the 20% and 20% rates to 18% and 8%.

The vast majority of capital gains tax revenue is collected from individuals in the 28% regular income bracket or above. This report focuses on the likely revenue effects and effects on the economy of such tax changes, focusing on the proposed 15% rate, although other issues are addressed as well.[1]

Revenue Effects

Permanent Tax Cuts

There is a significant difference between the revenue effects of a permanent and a temporary capital gains tax cut. Past capital gains tax cuts (such as the reduction in rates from 28% to 20% in 1997) have been estimated to gain revenue in the first 2 calendar years (which may extend over 3 fiscal years) and lose revenue thereafter. This initial effect occurs because of realizations responses–increases in realizations induced by the reduction in the tax rate. These responses occur because of an unlocking effect. Individuals who might wish to sell their assets and invest in some preferred alternative (either because they expect the rate of return to be higher or because the alternative asset has a more desirable risk-return trade-off) are locked in by the capital gains tax. To shift to the new asset causes taxes to be paid earlier (or, in cases where assets were intended to be held indefinitely, causes taxes to be paid at all). Lowering the rate allows an unlocking, which tends to be more pronounced initially. These induced realizations, and the tax collected on them, offset the static revenue loss. However, as the tax rate falls, the induced response offset declines, for two reasons. First, the responsiveness is estimated to be smaller at lower rates than at higher ones. Second, the induced realizations are taxed at lower rates.

To illuminate these points, in 1999, H.R. 2488, the Financial Freedom Act, passed the House with a similar provision, to cut the capital gains tax rate to 15%. The provision, which became effective in mid-year, was projected by the Joint Committee on Taxation to lose revenue of $0.7 billion in FY2000 and $3.8 billion in FY2001. The revenue loss then rose to $5.8 billion per annum, and cumulated to $51 billion over a 10-year period. This revenue pattern can be contrasted with the effects of a larger tax cut in 1997 (from 28% to 20%), which was estimated to gain revenue in the first 3 fiscal years, and was estimated at that time to cost $21 billion over 10 years. While some increase in projected gains had occurred, the difference between the initial year patterns, and the cumulative total indicates that a capital gains tax cut will be expected to cost considerably more for

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[1] For a description, history and overview of capital gains taxes see U.S. Library of Congress, Congressional Research Service, *Capital Gains Taxes: An Overview*, by Jane G. Gravelle, CRS Report 96-769 E (Washington: August 30, 1999).

a given amount of stimulus because of the lower starting point. This provision is estimated to cost $10 billion over the next 10 years.

Temporary Tax Cut

A temporary tax cut has additional nuances. First, the temporary tax cut may gain revenue in the initial years. The unlocking response will be somewhat larger for certain types of assets because the slightly lower tax has made the tradeoff for currently taxing income more favorable (that is, there is a larger incentive to realize gain today than with a permanent tax cut because the tradeoff is between different rates as well as between rates of return and tax deferral). This effect is somewhat offset because of complications with the 18% rate, as described below.

Secondly, the lower rate can create an incentive for individuals to sell even if they would not otherwise desire to do so in the absence of tax considerations. This effect occurs when the asset is expected to be sold relatively soon in any case (otherwise, without a higher expected rate of return or other inducement, the benefit of the lower rate is swamped by the loss of tax deferral). A similar event occurred when the 1986 tax reform act was passed and a higher 28% capital gains tax rate effective the next year became known in advance. There was a significant rise in capital gains realizations. Capital gains realizations rose from 4.22% of GDP in 1985 to 7.60% in 1986, and then fell to 3.2% in 1987, and continued to fall. While it is hard to control for the different forces affecting capital gains, it is clear that there was a significant response.

While the prospect of higher rates caused a jump in realizations, this type of magnitude is not likely to be repeated for this proposed tax cut. This effect occurs not only because the differences between old and new rates are much smaller today than they were in 1986, but also because of the 18% rate. Any asset acquired after 2000 and held for 5 years becomes eligible for an 18% tax rate. Suppose the lower rate is adopted effective Jan 1, 2002. The arbitrage will be most successful if the asset sales are delayed until the end of the second year. Any assets held in 2003 will be potentially eligible for the 18% tax rate if they were acquired after 2000, that is, any assets held for less than 3 years (assuming sale on the last day of 2003). If any of these assets are sold, however, they will have to restart the 5-year holding period. For that reason, we calculate that all of the advantages for these assets would be for cases where there was an existing plan to sell before 5 years. Thus any shifting of taxes would occur in most cases within 5 years: in less than 4 years for assets already held for a year, within 3 years for assets already held for 2 years, and within 2 years for assets already held for 3 years. If plans were to hold the asset for longer than those times, realizing gains now would restart the clock on the 5-year holding period, and require such a longer time to wait to qualify that the deferral period would offset the advantage of the lower 15% tax bracket.

It is possible to have longer periods for assets that were acquired before 2000 which are not eligible for the 20% rate (as was the case for assets in 1986). But these individuals also did not take advantage of a previous arbitrage opportunity (selling assets at the beginning of 2001 to take advantage of the 18% rate cut), which makes it less likely that they would do so in this case.

Effects on the Economy

Permanent Tax Cuts

A fiscal policy can stimulate the economy in the short run only if it increases aggregate spending. There are reasons to expect that capital gains tax cuts would have the smallest stimulative effect on the economy of virtually any fiscal stimulus option. While a fiscal stimulus delivered through direct spending has a relatively straightforward effect, a fiscal stimulus delivered via a personal tax cut tends to have a more muted effect on the economy, because only part of it will be spent. The smaller the share spent, the smaller the stimulus, although for most types of tax cuts, the presumption is that most of the tax reduction will be spent.

There are two reasons that a capital gains tax cut is less likely to be spent. First, there are both theoretical reasons and empirical evidence for the view that individuals with higher wealth would save a larger portion of a tax cut.[2] Capital gains taxes are perhaps the most heavily concentrated among higher income and higher wealth individuals than virtually any other tax. For 1999, those with earnings over $200,000, who constitute the top 1.8% of income, account for 78.6% of capital gains taxes.[3] While the average capital gains tax paid for all returns was $476, the average for the highest income class was $20,536 and the average for all returns in the bottom half was less than $10. The capital gains tax is 4.5% of total federal income, payroll and excise taxes; however, it is 14% of total taxes in the highest income bracket, and less than one half of 1% for the bottom 70% of the population. For the income tax alone, capital gains taxes are 8.1% of total income taxes, but 16.2% of income taxes in the top income class. In the bottom 70% of the distribution, the capital gains tax is less than 1% of income taxes.

Secondly, a capital gains tax cut may increase savings through incentive effects (although most empirical evidence does not support a large savings response).

Both of these effects suggest that a larger fraction of a capital gains tax cut will likely be saved than would be the case with other types of tax cuts, and thus the capital gains tax cut is less likely to stimulate the economy.

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[2] While simple life cycle models do not necessarily support the notion that marginal propensities to spend a permanent tax cut would vary across individuals with different permanent income levels, realistic modifications of the model do. First, lower income, young individuals may be liquidity constrained, so that they are prevented from spending as much as they want because they cannot borrow against future income. A tax cut would be wholly spent in that case. Second, higher income individuals are more likely to have higher lifetime savings rates (and thus would save more of any marginal income) because they are more likely to leave significant bequests. A recent study that finds evidence of higher marginal propensities to save among wealthy individuals is Jonathan McCarthy, "Imperfect Insurance and Differing Propensities to Consume Across Individuals," *Journal of Monetary Economics*, Vol. 36, No. 2 (November 1995).

[3] These data are derived from Joint Committee on Taxation estimates. See U.S. Library of Congress, Congressional Research Service, *Capital Gains: Distributional Effects*, by Jane G. Gravelle, CRS Report RL30317 for further details.

Note that there has always been a tension between short run and long run fiscal policy. Measures that increase consumption are expansionary in the short run, but may detract from growth in the long run because deficit finance causes aggregate savings to fall (unless the economy is at such a low rate of employment that the stimulus induces sufficient output to offset the loss in savings). That is, government spending and tax reductions financed by deficits tend to crowd out investment in the long run. There are exceptions, however. Government investment spending, such as spending on infrastructure, may provide a short run stimulus without detracting much from long term growth (and can even enhance long-term growth if the productivity of the government investment is greater than the productivity of private investments). However, it is often difficult to enact such spending in a timely fashion. Subsidies directly to private investment spending (such as investment credits) may mitigate effects on growth because they may directly stimulate investment. Unfortunately, the evidence supporting a positive short-run response of investment to a stimulus is very weak, and such a tax cut may be largely saved in the short run (by reducing debt) or paid out in dividends. (This effect may occur because firms are reluctant to add to the capital stock during a period of excess capacity as is typical in a recession.) Whether a subsidy that directly targets investment would be more likely to induce short-run spending than a subsidy that is directed at saving is uncertain, however.

Some macroeconomists have modeled a capital gains tax cut as a direct revenue stimulus, perhaps because macro-models do not have a direct lever to use to introduce a capital gains tax cut. This approach does not reflect, however, the appropriate transmission mechanism of a capital gains tax cut, which must first induce saving, and only after a lag might induce investment.

Some modelers have also assumed an increase in stock market prices, by capitalizing the tax into asset values. While one might expect some upward pressure on stock market prices, its magnitude is uncertain because a capital gains tax cut also induces selling, which causes downward pressure on prices. Any effect on stock prices is temporary, however, because economic pressures cause asset prices to adjust back to reflect asset values, with the period of transition dependent on the cost of adjustment. This analysis reflects the standard view of investment modeling which focuses on the ratio of market value of assets to their costs (Tobin's q).[4]

Finally, note that many economists doubt the efficacy of any fiscal policy in countering a recession because it is very difficult to enact such a stimulus in a timely fashion and fiscal stimulus can be easily dissipated in an open economy with flexible exchange rates and international capital flows (through a fall in net exports). Monetary policy may be more effective in such an environment.

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[4] This part of economic analysis is technically complicated and there is a difference between average q and marginal q. However, a fundamental outcome of this analysis is that a tax rate change, such as a change in the individual or corporate rate, will not affect the long run valuation of the stock market. For a technical analysis, see David Romer, *Advanced Macroeconomics*, Chapter 9 (New York, McGraw-Hill, 2001).

Temporary Tax Cut

A temporary tax cut differs from a permanent one. As noted above, it may raise revenue initially and then lose a larger amount of revenue in a very short time horizon. Essentially, it is the equivalent of borrowing from high income individuals at a higher than market interest rate, and redeeming the bonds relatively quickly.

For these reasons, any explicit tax reduction will be delayed until the future when assets are sold with a higher basis, so that for those who believe that some portion of any cash flow derived from a tax cut is spent, this incentive will not occur until 3 to 5 years in the future (or perhaps more). There will be a present-value tax benefit, but it will be of negligible size, temporary in nature, and unlikely to have much effect on aggregate consumption because any income effects should be spread over a long period of time.

Because of the temporary nature of the tax cut, there is no permanent stimulus to invest in stocks. A person investing immediately and planning to hold an asset for at least one year (to qualify for the long term rate) but no more than 2 years, would receive some benefit, but that is likely to be a limited category of investments. Since there will be an incentive to sell assets, but not an incentive to invest, the more likely short-run effect is to depress the stock market, although such effects would probably be modest because of the modest size of the tax revision.

Other Issues

Three other issues not discussed in this report have played a role in the capital gains tax debate, and they primarily apply to permanent tax cuts. The first is that capital gains tax cuts may increase economic efficiency by reducing the lock-in effect of the tax, and also by reducing the tax burden on corporate equity investment. However, capital gains are favored relative to dividends, because of the lower tax rate on gains, the deferral of the tax, and the possibility of passing on gains untaxed at death, and magnify that distortion. Capital gains tax cuts are often criticized by some because they are particularly beneficial to the wealthy as noted above. Finally, arguments are made that lower capital gains taxes encourage entrepreneurship, although it is difficult to find empirical evidence to support this claim and most capital gains tax cuts go to owners of established large corporations and real estate.[5]

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[5] For a further discussion, see U.S. Library of Congress, Congressional Research Service, *Capital Gains Taxes, Innovation and Growth*, by Jane G. Gravelle, CRS Report RL30040 (Washington: July 14, 1999).