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THE FEDERAL TAX DEBATE : CAPITAL GAINS

INTRODUCTION

The taxation of capital gains is among the most controversial issues in public finance. It is likely to become more so as the Treasury Department's recent tax reform proposal is scrutinized. Under the Treasury plan, capital gains would be taxed at ordinary income rates, raising the maximum marginal tax rate on long-term capital gains from the current 20 percent to 35 percent. Such gains would be indexed to inflation so that taxes would be paid only on gains that exceeded the inflation rate.

This proposal has been greeted warmly by liberal tax reformers and with alarm by venture capitalists who, rightly, see the change as benefiting old capital at the expense of new capital.[1] Venture capitalists will probably argue strongly for maintaining the current tax system, which excludes from taxation 60 percent of all long-term gains and taxes the balance at ordinary income rates.

What the U.S. economy needs, however, is neither the current capital gains tax policy nor the Treasury proposal. Needed is a true reform that abolishes the capital gains tax completely. This would ignite risk taking and encourage the expansion of venture capital funds, leading to more businesses and jobs.

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1 See Peter Behr, "Tax Plan Scares Venture Capitalists," The Washington Post, November 29, 1984, pp. B1-B2.

This is the first of a series of studies analyzing federal taxes. Among the topics examined by subsequent studies will be corporate and value-added taxes.

REDUCTION IN RATES

The Tax Reform Act of 1969 sharply increased the maximum tax rate on capital gains in response to liberal arguments that preferential treatment for capital gains allowed many wealthy individuals to escape paying what was called their "fair share" of taxes. In the 1976 presidential campaign, Jimmy Carter repeatedly said that capital gains ought to be treated no differently than ordinary income. His Treasury Department proposed ending special treatment of capital gains in 1978.[2]

During hearings on this reform proposal, Congress concluded that Carter was absolutely wrong. What was needed, decided the lawmakers, was not less but more preferential treatment for capital gains. It was argued, for example, that the 1969 capital gains tax hike had hurt high-tech companies severely.[3] In addition, it was demonstrated that such a high capital gains tax so inhibited risk investment that the government's revenue from the capital gains tax was below what a lower tax rate would yield.

As a result of its investigations, Congress cut the maximum capital gains tax in 1978 from about 49 percent to 28 percent; the maximum federal income tax rate on ordinary income at the time was 70 percent. When the maximum tax rate on ordinary income was cut to 50 percent in 1981, the maximum capital gains rate fell to 20 percent. The evidence strongly suggests that this capital gains tax cut led to the positive effects that its proponents had predicted.

THE ECONOMICS OF CAPITAL GAINS TAXES

When Congress was considering the reduction in capital gains tax rates in 1978, the move was strongly opposed by the Carter Administration and liberal journalists.[4] Criticism centered on the fact that most capital gains are realized by those with upper incomes. In 1981, for example, 45 percent of all long-term capital gains (in excess of short-term capital losses) accrued to taxpayers with incomes above $100,000.[5] Hence, any cut in the capital gains tax rate was seen as simply a giveaway to the rich.

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2 On numerous occasions Carter said that one of his principal goals was to treat all income the same for tax purposes. See U.S. Congress, House, Committee on House Administration, The Presidential Campaign 1976 (Washington, D.C.: U.S. Government Printing Office, 1978), pp. 152, 158.

3 U.S. Congress, House, Committee on Ways and Means, The President's 1978 Tax Reduction and Reform Proposals, 95th Congress, 2nd session (Washington, D.C.: U.S. Government Printing Office, 1978), part 3, pp. 1307-1338. See also, Robert J. Samuelson, "Making Life Difficult for Congress," National Journal, March 18, 1978, p. 437.

4 Robert J. Samuelson, "Pounding the Carter Tax Proposal From All Sides," National Journal, May 13, 1978, pp. 757-759; Editorial, "How to Unsoak the Rich," New York Times, May 19, 1978.

5 Internal Revenue Service, Statistics of Income--1981, Individual Income Tax Returns (Washington, D.C.: U.S. Government Printing Office, 1983), p. 41.

It is true that wealthy individuals benefit from a lower tax rate on capital gains in the sense that if they had realized the same amount of capital gains and been taxed at ordinary income tax rates, their tax liability would be higher. Brookings Institution scholar Joseph Pechman has estimated, however, that in this case individuals with incomes above $1 million would pay 16.4 percent more in federal income tax in 1985.[6] But, of course, most of these capital gains would not be realized at the higher tax rate, as investors would simply hold on to their assets rather than sell them.

It would appear that raising capital gains taxes does not necessarily lead to an increase in federal tax revenues. A reduction is more likely.

The Mobility of Capital

This important characteristic of capital gains taxes is known as the "lock-in" effect. Capital gains are taxed only when realized. As long as an asset is not sold, no taxable income results even if it has increased in value substantially. Thus a high tax rate on capital gains encourages investors to hold on to assets that have appreciated in value rather than sell them and pay the tax. The higher the tax rate on capital gains, the more pronounced this effect is going to be.[7]

This has important economic implications. Capital needs to be "mobile" to be efficiently used. But if capital is locked in to particular investments because of the capital gains tax, the nation suffers from plants that are not built, jobs that are not created, and goods that are not produced.

Capital was less mobile in the 1970s because wealthy people were less willing to buy or sell corporate stock for fear of realizing gains that would be taxed at excessive rates. They preferred instead to invest in paintings, estates, and similar assets, which produced nontaxable "psychic" income, thereby locking their wealth into illiquid nonfinancial and nonincome-

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6 Joseph A. Pechman, Federal Tax Policy, 4th edition (Washington, D.C.: The Brookings Institution, 1983), p. 360.

7 For a theoretical discussion, see Charles C. Holt and John P. Shelton, "The Lock-In Effect of the Capital Gains Tax," National Tax Journal December 1962, pp. 337-352; Jonathan A. Brown, "The Locked-in Problem," in U.S. Congress, Joint Economic Committee, Federal Tax Policy for Economic Growth and Stability, 84th Congress, 1st session (Washington, D.C.: U.S. Government Printing Office, 1955), pp. 367-381. For some empirical data, see Martin Feldstein and Joel Slemrod, "The Lock-in Effect of the Capital Gains Tax: Some Time-Series Evidence," Tax Notes, August 7, 1978, pp. 134-135; Shlomo Yitzhaki, "An Empirical Test of the Lock-in Effect of the Capital Gains Tax," Review of Economics and Statistics, November 1979, pp. 626-629.

producing forms. By 1978, 39 percent of all household wealth was tied up in tangible assets, compared with 29 percent in the mid-1960s.[8] According to the Federal Reserve Board, corporate equities as a share of household financial assets fell from 35.3 percent in 1968 to just 15.6 percent in 1978.[9]

Inflation and Capital Gains Taxes

Inflation made the capital gains tax all the more oppressive. Investors knew that much, if not all, of any gain they might report would be the result solely of inflation, not of any real gain.[10] According to a 1979 study by former Reagan Advisor Martin Feldstein and Joel Slemrod, individuals paid $500 million in excess federal tax in 1973 because paper capital gains were not adjusted for inflation. Their research shows that in that year individuals realized some $4.5 billion in nominal capital gains on corporate stock. When adjusted for inflation, this $4.5 billion "gain" actually turned into a $1 billion capital loss. Yet taxes were still paid on these "gains."[11]

Feldstein has also analyzed the lock-in effect of the capital gains tax on the selling and switching of common stock and the realization of gains, thereby denying funds to new and growing companies. He concludes that the capital gains tax at pre-1978 rates discouraged significant amounts of stock selling; so much so, he predicted, that a reduction in the capital gains tax rate would increase federal revenue.[12]

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8 Balance Sheets for the U.S. Economy, 1945-83 (Washington, D.C.: Federal Reserve Board, Division of Research and Statistics, Flow of Funds Section, April 1984), series 702.

9 Ibid.

10 For data on the impact of inflation on financial and tangible assets, see Jack Hibbert, Measuring the Effects of Inflation on Income, Saving and Wealth (Paris: Organization for Economic Cooperation and Development, 1983).

11 Martin Feldstein and Joel Slemrod, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," National Tax Journal, June 1979, pp. 107-118.

12 See Martin Feldstein and Shlomo Yitzhaki, "The Effects of the Capital Gains Tax on the Selling and Switching of Common Stock," Journal of Public Economics, February 1978, pp. 17-36; Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," Quarterly Journal of Economics, June 1980, pp. 777-791. See also Joseph Minarik, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains: Comment," Quarterly Journal of Economics, February 1984, pp. 93-110; Martin Feldstein, Joel Slemrod and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains: Reply," Quarterly Journal of Economics, February 1984, pp. 111-120.

Impact on Federal Revenues

The question of whether the capital gains tax cut would increase federal revenue has dominated most of the discussion on the topic. The Treasury Department's consultant on this issue, Professor Gerald Auten of Bowling Green State University, concludes that, through 1981 at least, the tax cut increased capital gains tax revenue by about $2.5 billion over what would have been raised by the pre-1978 tax law.[13] The most recently available data from the IRS indicate that realizations of capital gains have increased substantially since 1978, especially among the wealthy--far outstripping inflation during the period.

Table 1

LONG-TERM GAINS NET OF LONG-TERM LOSSES
(in billions)

Adjusted Gross Income Class	1978	1981	Percent Change
0-$25,000	$9.7	$13.2	36.1
$25,000-$50,000	9.0	10.2	13.3
$50,000-$100,000	6.6	11.2	69.7
$100,000-$500,000	8.6	19.0	120.9
Over $500,000	3.7	14.9	302.7
Total	$37.7	$68.6	82.0 (average)

Source: Internal Revenue Service, Statistics of Income, Individual Income Tax Returns, 1978 and 1981.

Even if capital gains tax revenues themselves do not rise, total tax revenues undoubtedly will be higher because of higher profits and larger payrolls resulting from the increased investment caused by the tax cut.

Raising tax revenues, however, was not, nor should it be the justification for the tax cut. Its real purpose is to stimulate investment, especially risk investment.[14] On this score, the tax

13 Gerald E. Auten, "Capital Gains: An Evaluation of the 1978 and 1981 Tax Cuts," in Charls E. Walker and Mark A. Bloomfield, eds., New Directions in Federal Tax Policy for the 1980s (Cambridge, Massachusetts: Ballinger, 1983), p. 136.

14 The capital gains tax has long been known to have a particular impact on entrepreneurial activity. See Thomas H. Sanders, Effects of Taxation on Executives (Boston: Division of Resarch, Graduate School of Business Administration, Harvard University, 1951), pp. 210-214.

cut is a huge success. Economist George Gilder explains that new commitments to venture capital funds increased from just $39 million in 1977 to $11.5 billion by the end of 1983. Venture capital is the principal fuel for American entrepreneurial advances in computers, biotechnology, and many other high-tech industries since 1978.[15]

Effect of Rate Reductions on Business Formation

The capital gains tax cuts of 1978 and 1981 very importantly improved the ability of firms to raise funds through equity offerings. The average daily volume of transactions on the New York Stock Exchange, for example, increased from 28.6 million shares in 1978 to over 85 million shares in 1983. University of Minnesota economist Joel Slemrod attributes much of this to the capital gains tax cut.[16] In addition, new issues of corporate common stock have increased three-fold since the 1978 tax cut, spurting after both the 1978 and 1981 tax reductions (see Figure 1).

The increase in new issues and volume and the increase in potential after-tax returns have contributed to a sharp rise in the market value of corporate equities. As Table 2 shows, the market value of corporate equities in inflation-adjusted dollars fell 24 percent in the five years prior to the capital gains tax cut and has risen 46 percent in the five years since.

Another important indication of the capital gains tax success is that proprietors' equity in noncorporate business--generally small businesses--has increased 185 percent in real terms since 1979, compared to a decline of 16.7 percent between 1975 and 1979 (see Table 3). This suggests that many more small businesses have been formed successfully as a result of the tax cut. And according to studies by David Birch at MIT, small firms with fewer than twenty employees are responsible for two-thirds of net new jobs in the U.S.[17]

Equity and Tax Neutrality

Many liberals ignore this evidence and continue to argue that capital gains ought not, as a matter of equity, be taxed

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15 George Gilder, The Spirit of Enterprise (New York: Simon & Schuster, 1984), p. 44.

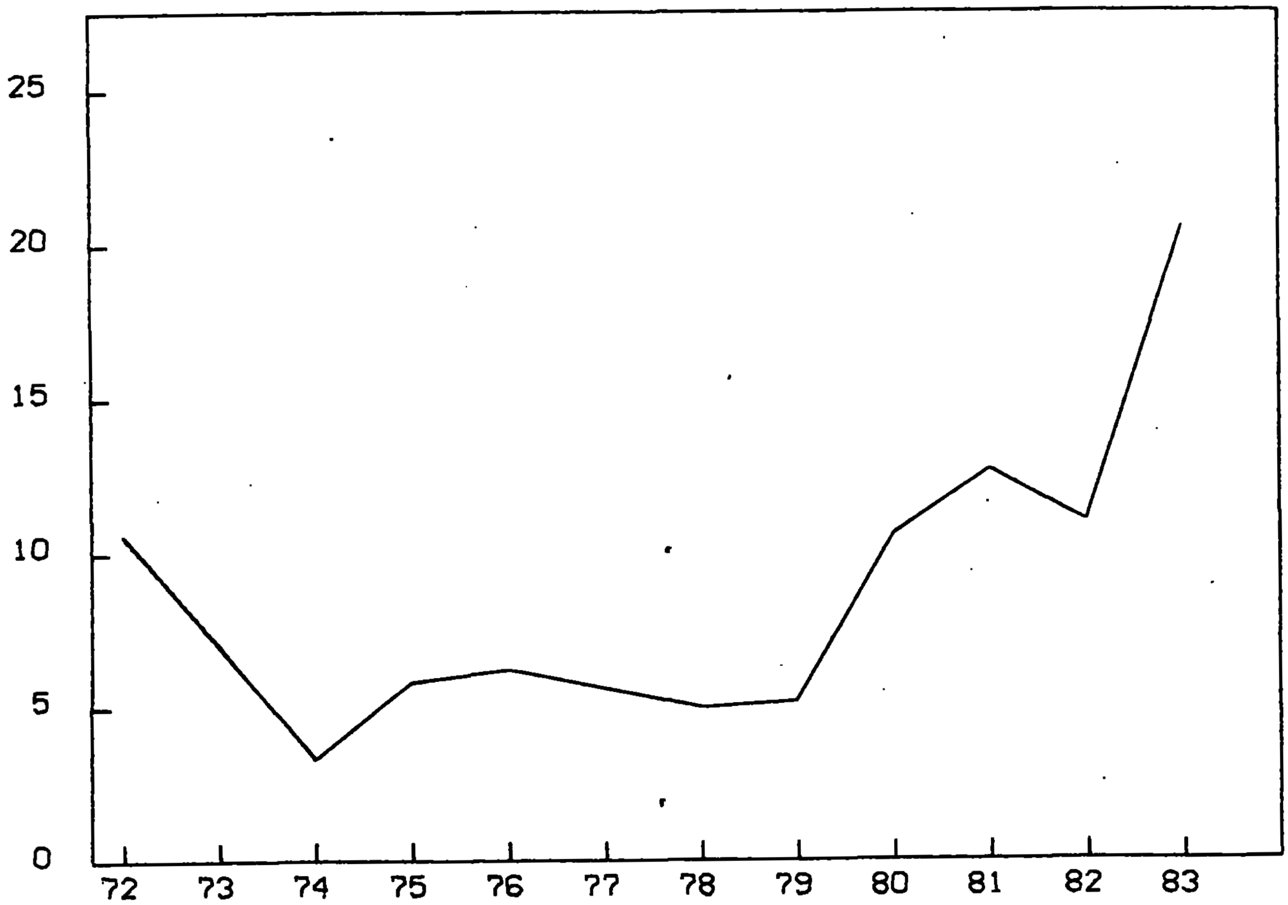
16 New York Stock Exchange Fact Book 1984, p. 73; Joel Slemrod, "Stock Transactions Volume and the 1978 Capital Gains Tax Reduction," Public Finance Quarterly (January 1982), pp. 3-16; see also Michael K. Evans, The Truth About Supply-Side Economics (New York: Basic Books, 1983), pp. 163-185.

17 David L. Birch, "Who Creates Jobs?" The Public Interest, Fall 1981, pp. 3-14.

Figure 1

NEW ISSUES OF CORPORATE COMMON STOCK

(billions of 1972 dollars)



Source: Economic Report of the President, 1984, p.322.

Table 2

MARKET VALUE OF CORPORATE EQUITIES
(in billions)

Year	Current Dollars	1972 Dollars
1983	2,151.5	999.1
1982	1,810.5	873.0
1981	1,568.5	801.9
1980	1,635.6	916.7
1979	1,230.7	753.1
1978	1,028.3	683.6
1977	995.4	710.7
1976	1,051.9	794.8
1975	892.5	709.5
1974	676.9	588.2
1973	948.1	896.6
	PERCENTAGE CHANGE	
1978-1983	+109.0	+46.0
1973-1978	+8.5	-24.0

Source: Federal Reserve, Flow of Funds Accounts.

Table 3

PROPRIETORS' EQUITY IN NONCORPORATE BUSINESS
(in billions)

Year	Current Dollars	1972 Dollars
1984*	60.3	27.1
1983	44.0	20.4
1982	16.1	7.8
1981	18.9	9.7
1980	28.0	15.7
1979	15.5	9.5
1978	16.4	10.9
1977	19.2	13.7
1976	17.2	13.0
1975	14.4	11.4
	PERCENTAGE CHANGE	
1979-1984*	+289.0	+185.0
1975-1979	+7.9	-16.7

Source: Federal Reserve, Flow of Funds Accounts.

* Based on figures for first two quarters of 1984.

differently than ordinary income.[18] Tax reform proposals, such as the Bradley-Gephardt bill, eliminate special treatment for capital gains.

The equity argument is spurious. In fact, the only fair tax rate on capital gains is zero, because capital gains are not income in an economic sense. Taxing capital gains, even at a low rate, while also taxing the income from capital, necessarily imposes a double tax on capital, which is indefensible on equity grounds and seriously detrimental to the economy. This seems to be appreciated in a number of countries known for their concern for equity. While Britain, for instance, now deals with capital gains much as the U.S. does, Belgium, Italy, Japan, the Netherlands, West Germany, Australia, and other nations in effect do not tax long-term capital gains.[19]

Legal Issues

The Supreme Court has had difficulties with the question of whether a capital gain constitutes income within the meaning of the 16th Amendment, which established the federal income tax. In Eisner v. Macomber (1920), the Court limited the definition of income for tax purposes in an important way. This case involved the payment of a stock dividend from a corporate surplus, and the Court held that such a dividend did not constitute income to the taxpayer, merely the transfer of capital; it became income only when the stock was sold.

Capital thus is not subject to tax, because the 16th Amendment only gives government the power "to lay and collect taxes on income," and capital is not income. There is, therefore, no express authority to tax capital.[20] This is why no tax is paid on unrealized capital gains. Proposals are periodically made for taxing unrealized capital gains, although practical difficulties make this almost impossible.[21] For example, in the absence of a market transaction, how would the value of an asset be determined? And without a stream of income of some sort, with what would the taxpayer pay the tax?

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18 See, for example, Alan S. Blinder, "Capital Gains: Tax Them Like Income," The Washington Post, July 22, 1982.

19 Comparison of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments in Ten Countries (New York: Securities Industry Association and Arthur Anderson & Co., 1980).

20 Ronald Foulis, "What is Capital Gain and How Should It Be Taxed?" American Bar Association Journal (April 1978), p. 510. Presumably, this raises questions about the constitutionality of the estate and gift tax as well.

21 James Wetzler, "Capital Gains and Losses," in Joseph A. Pechman, ed., Comprehensive Income Taxation (Washington, D.C.: Brookings Institution, 1977), pp. 115-162; Revision the Individual Income Tax (Washington, D.C.: Congressional Budget Office, July 1983), p. 78.

ELIMINATING THE CAPITAL GAINS TAX

The very issue of whether capital gains are actually income rarely has been raised in recent years, but Harvard's Martin Feldstein, drawing on the work produced in the 1930s at Yale by Irving Fisher, argues that income from capital ought to be free of taxation. He points out that existing taxes on capital violate the principle of horizontal equity, which holds that individuals who would be equally well off in the absence of a tax should be equally well off if there is a tax.[22]

To put the matter simply: gains from the sale of long-term assets do not arise out of current production and are not current income. They merely represent the conversion of an asset from one form into another. Hoover Institution economist Roger Freeman has noted that Congress already recognizes this principle with regard to the sale of homes. Under current law, any capital gain arising from the sale of a primary residence, provided it is reinvested in another primary residence of equal or greater value within 24 months, is free of tax. "It can be argued," says Freeman, "that there is no reason to treat a 'rollover' in other types of investment differently--except the political reason that millions sell their houses for more than they paid for them (or plan or hope to) but only one taxpayer in 14 enjoys other types of capital gains."[23]

In sum, although capital gains--realized or not--represent added wealth, they do not represent income. To tax capital gains, therefore, means taxing capital. Not only is this contrary to the 16th Amendment, which vests in the federal government only the power to tax incomes, but it has extremely adverse economic effects. It discourages the formation and mobility of capital, thereby reducing the standard of living of all Americans.

Writes Lawrence Seltzer of Wayne State University:

> Capital gains and losses, it is contended, are not valid elements of true income, as the term is widely used. The traditional concept of income includes only more or less regular and recurring receipts, or, in any event, only those that are more or less expected. An occasional, sporadic gain or loss, especially if unsought and unexpected, does not function like income in guiding conduct or in determining the allocation of economic

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22 Martin S. Feldstein, "Taxing Consumption," The New Republic, February 28, 1978, pp. 14-17; see also Martin Feldstein, "On the Theory of Tax Reform," Journal of Public Economics (1976), pp. 77-104; idem, "The Welfare Cost of Capital Income Taxation," Journal of Political Economy, April 1978, part 2, pp. S29-S51; Michael A. Schuyler, Consumption Taxes: Promises & Problems (Washington, D.C.: Institute for Research on the Economics of Taxation, 1984), p. 28.

resources. For this reason, many economists, for their general analytic purposes, though not specifically for those of taxation, confine the concept of income to more or less expected or recurring receipts. Similarly, the accountant usually excludes capital gains and losses from his measure of current income.

Further, it is urged that capital gains do not constitute disposable income for the country as a whole. In many instances they do not represent additions to the total wealth of the country but merely changes in the value of titles to some of this wealth. A reduction in corporate income tax rates, for example, may well raise the market prices of common stocks by several times the amount of the annual tax reduction without adding commensurately, if at all, to the nation's wealth. In other instances, capital gains may reflect real additions to the country's wealth, as when new mines or oil resources are discovered, but these additions cannot currently be consumed. They represent only the capitalized values of expected future incomes. They are capital, not income, is contended; and taxes on them, therefore, tend to reduce capital accumulation.

Further, to tax capital gains as income, it is argued, puts a double tax on the recipient: first, on the capital value of future incomes; then, on the incomes themselves as they are received. A man who reinvests a capital gain of $50,000 will be subject to income tax on the future incomes he obtains from the gain; and these incomes constitute his real gain. To tax him also on the principal value of the gain itself is to tax him twice.[24]

CONCLUSION

The case against the capital gains tax is strong on economic and equity grounds. There are legitimate reasons for going beyond advocating a lower rate or indexing capital gains for income tax purposes, as Treasury Secretary Regan proposes. There are strong reasons for opposing the Treasury recommendation that the partial exclusion of long-term gains from tax be ended. Capital gains should be completely free of tax.

Indeed, the vast bulk of capital gains are already effectively free of the capital gains tax. Capital gains on the sale of

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23 Roger A. Freeman, Tax Loopholes (Washington, D.C.: American Enterprise Institute, 1973), p. 43.

24 Lawrence H. Seltzer, "Capital Gains and the Income Tax," American Economic Reivew (May 1950), p. 372.

homes by individuals are almost never taxed, and most capital gains on corporate equities are realized by financial institutions trading on behalf of pension funds, which again are not subject to the capital gains tax. And because they are more difficult for the IRS to locate than other sources of income, capital gains taxes are often evaded.[25]

Rather than tinkering with the issue as proposed by the Treasury Department, the Administration should move directly toward tax neutrality by abolishing the capital gains tax. Its repeal could trigger events dwarfing those that followed the capital gains tax cuts of 1978 and 1981. Investment would soar, risk and innovation would be rewarded, and the entire nation would benefit in goods and earnings from this mobilization of U.S. economic potential.

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25 See Eugene Steuerle, "Is Income from Capital Subject to Individual Income Taxation," Public Finance Quarterly, July 1982, pp. 283-303. It should be remembered that under current law even if the capital gains tax were abolished wealthy individuals with capital gains would still be subject to the minimum tax.