The Heritage Foundation Issue Bulletin

No. 28 | The Heritage Foundation • 214 Massachusetts Avenue • N.E. • Washington, D.C. • (202) 546-4400

July 10, 1978

A REVIEW OF THE CAPITAL GAINS TAX PROPOSALS

BACKGROUND

Prior to 1969, an individual could exclude from his taxable income half his net long-term capital gains and the remaining half would be taxed at the regular rate. However, even when the individual's regular rate was over 50 percent, he did not have to pay more than 25 percent on his capital gains.

The Tax Reform Act of 1969 limited the 25 percent top rate to the first $50,000 of each individual's capital gains and it raised the maximum rate for corporations to 30 percent. Furthermore, the Congress passed a 10 percent "minimum tax" on 10 preference items (e.g., the half of capital gains exempted from the regular tax). The 1969 Act also permitted the minimum tax to be paid only when preference income exceeded $30,000, in addition to the taxpayer's regular income.

After the Tax Reform Act of 1976 was passed, the minimum tax rate rose from 10 percent to 15 percent and replaced the old exemptions with a new one equal to $10,000 of preference income or half of regular taxes, whichever is the larger amount.

Under the present law, the combination of the regular income tax, the minimum tax and other requirements of the tax code means that taxpayers can now pay as much as 49.1 percent on their capital gains, which is almost twice the pre-1969 maximum.

MINIMUM TAX

At present, taxpayers are required to pay a minimum tax on income that is shielded from current taxation because the tax code excludes from income one-half of capital gains, allows deductions for depletion of minerals in excess of the amounts that would be allowed on the basis of cost, and permits accelerated

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

depreciation on real estate. The law applies a 15 percent minimum levy on all preference income that exceeds the greater of $10,000 or one-half of an individual's regular tax liability.

President Carter's proposal would keep the $10,000 reduction, but eliminate the rule allowing one-half of a taxpayer's regular income tax liability to be subtracted from the minimum tax.

ANALYSIS

According to the President, this change "will make the minimum tax more progressive and (a) more sharply focused deterrent to the use of tax shelters." Furthermore, proponents believe that this change will make the tax system fairer by raising the effective tax on those with substantial preference income.

Opponents argue that the progressiveness of this tax is the most compelling case against it. They believe that at this time, when the U.S. is lagging in capital formation, it is vitally important that the upwardly mobile taxpayer be given every incentive to save, and not be subject to heavy-handed taxation. The effect of progressive taxation on capital formation and fixed investment is devastating. The following statistics illustrate this problem.

NONRESIDENTIAL FIXED INVESTMENT
AS PERCENT OF REAL NATIONAL OUTPUT

1960 - 1973*

Country	Percent
United States	13.6
Japan	29.0
West Germany	20.0
France	18.2
Canada	17.4
Italy	14.4
United Kingdom	15.2
11 OECD Countries (1960-1972)	19.4

*OECD Concepts of Investment and National Product 1973 Estimated

Source: Department of the Treasury News Release April 1, 1975

Capital is the life blood of American enterprise. Unless funds are set aside for plants and equipment, jobs will suffer. No amount of public jobs will solve the unemployment problem when the base for private jobs is drying up.

"Gross capital formation as a percentage of Gross National Product has been substantially below the level over the long period 1869-1928 -- then 20.1 percent compared with 15.2 percent for 1966-1975 (15.8 for 1946-1975). A decline of nearly one-fourth is significant. Far more deserving of concern has been the change in net capital formation. The 1966-1975 rate of 6.8 percent of Net National Product was less than 60 percent of the 1869-1928 rate."[1]

Even more significant than the decline in capital formation is our weak growth rate in productivity. "The growth rate in plant and equipment per worker dropped from 2.6 percent in 1965-1970 to 1.6 percent in 1970-1975. The annual increase in worker productivity fell by more than half -- from 2.4 to 1.0 percent."[2]

When the productivity growth rate of the U.S. is compared with the rest of the West, the concern of businessmen and tax specialists alike is better appreciated.

PRODUCTIVITY GROWTH, 1960 - 1973
(Average Annual Rate)

	Manufacturing Output Per Man Hour
United States	3.3
Japan	10.5
West Germany	5.8
France	6.0
Canada	4.3
Italy	6.4
United Kingdom	4.0
11 OECD Nations	6.1

Quoted from The Need for Adoption of a Capital Cost Recovery System, presented by Charles W. Rau of Allis-Chalmers Corp. to the Cast Metals Federation, Washington, D.C., February 22, 1977, Slide #4.

---

1. C. Lowell Harriss, "Capital Shortage Issues Bearing on Future Tax Policy," The Tax Executive, Vol. XXIX, No. 4 (July 1977), p. 293 (published by The Tax Executives Institute, Inc.)

2. Ibid., p. 296.

Finally, the business community is extremely pessimistic that, even under the existing tax code, the needed capital for expansion in the future can be produced. The Business Roundtable conservatively estimates that there will be a gap of $50 billion a year in future capital formation.

ESTIMATED BUSINESS CAPITAL SHORTFALL
(Per Year -- 1977 - 1980)

Needed:	$312 Billion a Year
Expected:	
Depreciation:	$120 Billion
Retained Earnings:	36 Billion
New Debt:	96 Billion
New Equity Shares:	10 Billion (Best Year to Date: 11.4 Billion in 1971)
	$262 Billion raised at the most
Leaving a Gap of:	50 Billion per year

Source: Rau, Slide #2

In conclusion, the President's plan to keep the $10,000 reduction but eliminate the rule allowing one-half of a taxpayer's regular income tax liability to be subtracted from the minimum tax, will increase taxes for certain individuals by $0.3 billion in 1979, and will add another obstacle on the road to increased capital formation.[3]

CAPITAL GAINS

President Carter has previously recommended abolition, or at least curtailment, of preferential treatment of capital gains. He has somewhat stepped back from this proposal. At present, taxpayers are required only to include 50 percent of their income from capital gains in their tax base.

Another provision of the tax code sets a 25 percent tax ceiling on the first $50,000 of capital gains. This 25 percent ceiling, known as the "alternative tax," is what the Carter proposal seeks to eliminate. Therefore, rather than reducing

---

3. Fact Sheet 14, "Minimun Tax," The President's 1978 Tax Program, Department of the Treasury, Washington, D.C., January 21, 1978.

the capital gains, as many businessmen advocate, his proposal maintains the present rates. Moreover, the Carter proposal eliminates the alternative tax which presently helps taxpayers in the 50 percent tax bracket, thus enabling them to receive an extra tax break on the first $50,000 of capital gains.

ANALYSIS

Proponents argue that the elimination of this "alternative tax" will end an unjustified benefit for taxpayers whose marginal tax tax rate exceeds 50 percent. This makes treatment of capital gains more equitable. They also believe that the "alternative tax" introduces additional complexity into the system and its repeal will simplify the tax laws.

On the other hand, opponents argue that special treatment of capital gains is not a bail-out for the rich, but rather a much needed relief for the middle class. Half of those reporting capital gains in 1975 (the latest year for which figures are available) had an adjusted gross income of $15,000 or less, and half of the total capital gains tax came from families reporting adjusted gross incomes of $30,000 or less.[4]

Many think that the rate of taxation of capital gains should be changed by providing for reduced taxes proportionate to the length of time a capital asset is held. This would allow for new investment and would recognize that much of capital gains results from inflation. "According to the Business Roundtable, over 80 percent of the capital gain on common stocks, as measured by Standard and Poor's Index of Common Stocks, from 1960 through 1973, was merely inflation gain."[5]

The business community realizes that preferential treatment of capital gains forms an integral part of economic growth and jobs creation. Many observers of the stock market predict that a more favorable view towards capital gains by government would improve the employment situation in the country. "A reduction in the capital gains tax would unlock billions of dollars, much of which would be reinvested in new or small businesses thereby creating jobs for hundreds of thousands of people," says Edward R. Greeff, a senior partner in Adams and Peck, a member firm of the New York Stock Exchange. "I've been in Wall Street since 1933," he says.[6]

---

4. Shirley Scheibla, "Capital Gains Tax," Barron's, October 3, 1977, p. 26.

5. Ibid., p. 7.

6. Edward Cowan, "Into the Arena With Tax Reform," The New York Times, September 25, 1977, p. F1.

CONGRESSIONAL ACTION

A number of congressmen have expressed concern about the lack of capital formation in the U.S. economy, and have introduced bills to remedy this situation. Among them is Representative William A. Steiger (R-Wis.). First elected in 1966, he has a dozen years of seniority in the House and is the 5th ranking Republican member of the Ways and Means Committee.

On April 13, 1978, Representative Steiger introduced H.R. 12111 the "Investment Incentive Act of 1978." This bill would roll back the maximum capital gains tax rate to the pre-1969 level of 25 percent. This would eliminate capital gains from the preference items subject to the minimum tax, and impose the 25 percent maximum for all gains rather than just those less than $50,000. The bill also calls for a rollback of the corporate rate to 25 percent from 30 percent.

This legislation has 127 cosponsors in the House, 92 Republicans and 35 Democrats. On the Senate side a companion bill (S.3065) was introduced by Clifford Hansen (R-Wyo.). The bill has 61 cosponsors, 26 Democrats and 35 Republicans.

The House bill is still deadlocked in the House Ways and Means Committee and probably will not come to the floor until late July or early August.

The Senate Finance Committee held hearings on June 28 and 29. but no definite date has been determined for Senate floor action.

Representative James R. Jones (D-Ok.) proposed a compromise between the President's tax program and the Steiger proposal. The Jones amendment would exempt capital gains from the minimum tax and set a ceiling on all gains (including those below $50,000) of 35 percent. Jones also recommended reducing the capital gains tax for corporations to 28 percent from 30 percent.

As part of a general tax bill, Representative Jones also recommends:

A. A cut of all individual income tax rates by 6 percent across-the-board. The personal tax exemption would be increased to $1,000 from $750 and the present $35 per person tax credit would be eliminated.

B. A rejection of all of President Carter's proposed tax reforms except for the proposed repeal of deductions for state and local gasoline taxes and personal property taxes.

C. A reduction in corporate taxes from 48 percent to 46 percent and an increase from $50,000 to $75,000 the amount of corporate income taxed at reduced rates.

The Jones tax proposals have not been introduced as a separate bill as the Steiger bill has and, therefore, no hearings have been called on these recommendations.

Another proposal has been made with respect to capital gains by Representative Barber B. Conable, Jr. (R-N.Y.), ranking Minority Member on the House Ways and Means Committee. The bill (H.R. 12263), like the Steiger and Jones amendments, will not be considered for business by the Committee until at least mid-July. Conable is also a cosponsor of the Steiger Bill (as is Jones of Oklahoma). The Conable bill does not contradict H.R. 12111, (in fact, it builds upon it) and many observers feel that it will have a better chance of passing if the Steiger bill succeeds.

The provisions of the bill do the following:

1. Permit the "rollover" of investments with a 18 month period, or defer all taxes on capital gains until an investor stops investing. Provide for the "rollover" of equity investments or deferral of the tax on capital gains derived from the sale of common or preferred stock or until an individual disinvests or passes on his investment through a gift or through his estate at death.

   At disinvestment the total net Capital Gains would be taxed as earned income averaged over the years the investment is held, or the total estate would be taxed at gift or estate tax rates when given or bequeathed.

2. Provide for the deduction of all short or long-term capital losses against ordinary income.

3. Provide for the deduction of all interest paid on money borrowed to invest in equities or bonds -- except tax-free municipal or state bonds -- against ordinary income.

The Conable bill is based largely on suggestions made in the testimony of William F. Ballhaus, President of Beckman Instruments, Inc. of Fullerton, California and President of the California Chamber of Commerce, who on March 10, 1978 appeared before the House Ways and Means Committee.

He testified that neither West Germany nor Japan has a tax on capital gains. Furthermore, "taking 1967 as the base year in an index of hourly compensation, by 1976 Japanese workers have realized a 500 percent increase in pay and West German workers a 400 percent increase." U.S. workers in the same period have realized only an 80 percent increase, and much of that has been eaten up by inflation.

He went on to say that in 1971 his company had its first downturn in sales in thirty years. This prodded Beckman Instruments to initiate the largest research, development, and investment program it had ever taken. The returns on this investment have been quite favorable. Since 1971 the company has grown at a compound rate of over 14 percent per year in sales, and the shareholders have received a 4 percent annual increase in their dividends. The profits have grown by 28 percent net each year to a factor of 4.89; however, the primary beneficiary of this increase has been the government because taxes paid have increased 39 percent to a factor of 8.45.

ANALYSIS

The Administration's response to the flood of these capital gains bills has been primarily defensive. The President compaigned on the issue of tax reform (many voters view tax reform as tax reduction) and now he is faced with several proposals calling for tax reduction that are supported by most Republicans and many Democrats. In light of the passage of Proposition 13 in California, and the apparently growing lower taxes, anti-big spending sentiment of Americans, many observers believe that President Carter, by threatening to veto any reduction in the capital gains tax, is seriously misreading the mood of the country. Furthermore, his veto of any of the three bills (and at this time it looks like the Steiger bill has the best chance of passage in Congress -- 127 cosponsors in the House, 61 in the Senate -- could not only damage Carter's credibility as a tax reducer but could prove embarrassing to Democrats running for reelection in the Fall. "This raises a prospect but dimly grasped so far at the White House! Democratic congressmen campaigning under the banner of vetoed tax reduction, with federal income-tax rates scheduled to rise in January. Carter and his party would become counter-revolutionists fighting the tax revolt, bearing the burden of those who resist popular movements."[7]

David A. Williams
Policy Analyst
Economics/Taxation

---

7. Evans and Novak, "Will They Talk Carter Into a Tax Counterrevolt?," The Washington Post, June 23, 1978, p. A-23.