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CAPITAL GAINS TAXATION: THE EVIDENCE CALLS FOR A REDUCTION IN RATES

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INTRODUCTION

How to tax capital gains remains one of the most controversial issues confronting economic policy makers. Though a number of countries, like the Republic of Korea, do not tax capital gains at all, the United States approach has been a roller coaster. In the mid-1970s, for example, capital gains were taxed as high as 35 percent; this top rate was cut to 28 percent in 1978 and cut further to 20 percent by the 1981 Reagan tax reduction. Then the pendulum swung abruptly, and surprisingly, back in the comprehensive overhaul of the tax code in 1986. As a result, capital gains today are taxed at the same rate as ordinary income. This rightly alarms many economists because a high capital gains tax discourages investment, savings, and entrepreneurial risk-taking. Without these, the U.S. will become economically less competitive in the world.

Bipartisan Support. The Bush Administration, too, is alarmed by the economic disincentives spurred by today's high tax on capital gains. To remedy this, George Bush is proposing to reduce the maximum tax on certain capital gains from the current 33 percent to 15 percent. This call for a lower rate on capital gains is echoed in Congress, where nearly a dozen capital gains rate reduction bills have been introduced by Republicans and Democrats. These proposals have bipartisan support. Yet the prospect of capital gains rate reductions has generated intense opposition from a variety of sources – notably organized labor.

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.

Opponents of capital gains rate reductions attempt to build their case on three arguments:

1)Equity and Fairness – Capital gains preferences, critics say, favor the wealthy by providing a disproportionate share of the benefits to upper income taxpayers.

2)Cost – A capital gains tax rate reduction is said to increase the federal deficit because it will reduce tax revenues.

3)Effectiveness – A lower capital gains rate, critics argue, will have little affect on the decisions of individuals to invest or engage in entrepreneurial activity.

Each of these criticisms is challenged by supporters of capital gains tax reductions. They marshall an extensive collection of facts and research to demonstrate that the opponents' positions either are exaggerated or simply untrue. In particular, the two capital gains tax rate increases and the two tax decreases since 1969 provide solid evidence how individuals, businesses, and markets respond to such changes. What the last two decades reveal is that investors, businesses and venture capital markets are sensitive to changes in the capital gains tax rate. The data show that when rates are raised, venture funding slows or declines; conversely, when rates are cut, the venture capital market spurts.

Many opponents of the tax cut will concede that the cut will create economically useful incentives, but they worry about the ostensible loss of tax revenues. Studies reveal, however, that these concerns are unwarranted. Detailed econometric studies of the record since World War II indicate that capital gains tax rate cuts actually generate tax revenues by encouraging individuals to invest in taxable assets, unlock realized and taxable gains and redeploy capital efficiently – generating taxable income.

Evenly Spread Gains. The evidence also indicates that the fairness concerns are misplaced. When income is properly measured, the data reveal that capital gains realizations are spread rather evenly throughout different income levels and do not accrue only to the rich. Indeed, households earning less than $20,000 accounted for more than a quarter of all capital gains reported by taxpayers in 1985.

Lawmakers considering legislation to reduce taxes on capital gains should examine this evidence carefully. Critics of tax cut proposals will level charges that a cut would be bad for the economy and the budget, and unfair to moderate and low-income taxpayers. Yet the data refute them, suggesting strongly that a cut would boost the economy while spreading tax benefits to all major income groups.

WHY TAXING CAPITAL TROUBLES MANY ECONOMISTS

The debate over the wisdom of cutting taxes on capital gains begins with the very idea of whether the realized appreciation of any capital asset should

be taxed. Many economists contend that such gains should not be taxed at all because they reflect either inflation or the market's assessment that a company's (or asset's) future earnings will be higher.

Inflation Penalty. If the gain is in part due to inflation, then a capital gains tax serves to confiscate existing wealth accumulated from past income that already has been taxed at least once. Moreover, the tax, or penalty for inflation, is imposed only when the asset is converted from one form to another, thereby discouraging capital mobility and the efficient allocation of scarce resources.

This inflation penalty is not trivial. Under circumstances similar to those occurring in the 1970s and early 1980s, it could lead to very high implicit tax rates. For example, under current law, an investment providing a real return of 5 percent in an economy with 8 percent inflation would be subject to an effective tax rate of 57.5 percent on real earnings if sold after five years.[1] Economic columnist Warren Brookes noted that a 1970 investment in stock that was sold in 1988 would pay an effective tax rate of 339 percent on the net real gain because the rate of inflation over the period was almost as great as the appreciation in the stock market.[2]

Triple Taxation. When the gains reflect the market's reevaluation of the company's future profit potential, then the taxation of such gains, when realized, constitutes the triple taxation of income from capital: first when it is earned by the corporation and paid in corporate income tax; next when paid out as dividends and taxed at the shareholder's personal rate; and a third time when the gains are realized through the sale of the shares.

The tax code in the past has attempted to compensate for market reevaluation by providing special treatment for capital gains. For example: residential housing, which represents the single biggest investment for most households, is largely free of capital gains tax as long as the proceeds from the sale are reinvested in another residence, or if they represent a one time cashing out of the investment close to retirement. Similarly, professional investors in income-producing real estate are able to avoid capital gains taxes through a technique known as a "tax free exchange of property."[3] Investments in financial assets, however, have never been permitted this privilege, although the capital gains exclusion, which was an integral part of the tax code until 1987, reflected an inadequate attempt to do so.

Absent appropriate tax exclusions, the gauntlet of taxation faced by investors discriminates against capital income, discourages savings and investment, and harms U.S. international competitiveness by raising the cost of capital for Americans relative to that of foreign competitors, many of

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1 James M. Poterba, "Venture Capital and Capital Gains Taxation," National Bureau of Economic Research *Working Paper* No. 2832, January 1989, p. 17.

2 Warren Brookes, "Fairness, Envy and Capital Gains," *The Washington Times*, March 14, 1989.

3 This process allows certain investors to postpone the taxation of capital gains in real estate by immediately reinvesting the proceeds of the sale in another income-producing property.

whom fully exempt capital gains from income taxes. In fact, Belgium, Italy, Japan, The Netherlands, Hong Kong, Malaysia, Singapore, South Korea and Taiwan exempt all capital gains from income taxation, while long-term (six months) capital gains in Germany are exempt. Meanwhile, effective capital tax rates in the U.S. have been increasing. The January 1989 *Economic Report of the President* calculates that the effective tax rates on investment in equipment due to the Tax Reform Act of 1986 quadrupled from 10 percent to 39.6 percent.

THE IMPACT OF CAPITAL TAXATION ON INVESTMENT DECISIONS

Advocates of a reduced tax rate or an exclusion for capital gains contend that these changes would increase savings and investment by decreasing the cost of capital to a firm and increasing the return on investment to the investor. At present, the gauntlet of corporate income taxes, the taxation of capital gains, and personal income taxes creates a large gap between what business earns on an investment and what the individual shareholders ultimately receive. This gap often is referred to as the "tax wedge." Reduced tax rates would encourage individuals to acquire a financial asset by raising the after tax rate of return on the asset. Such rate reductions would make investments in new and growing firms relatively attractive because most benefits of such investments would be in the form of capital appreciation rather than income paid in taxable dividends.

For the firm, a lower capital gains rate would reduce the effective cost of capital and encourage the acquisition of productive assets. For the new and growing firm, with limited income but unlimited promise, a lower rate or capital gains exclusion would encourage investors to take risks by offering the opportunity for a potentially higher reward.

What the Data Reveal

Several studies and surveys on the affect of capital gains rates on the willingness of investors to acquire shares in new firms support the view that rate reductions have stimulated venture capital market growth. Although some analysts challenge this, arguing that a substantial portion of venture funding comes from non-taxed sources such as pension funds, the surveys and studies do not support this and instead indicate that the individual investor is an important participant in the venture capital market.

In a 1988 study by economists John Freear of the University of New Hampshire and William Wetzel of Babson College, questionnaires were sent to the chief executive officers of 1,073 technology-based ventures founded in

New England between 1975 and 1986.[4] The results from the 284 firms responding indicate:

1) **More new technology-based firms raise** equity-type capital from private individuals than from any other outside source, including venture capital firms.[5]

2) **Private individuals are the primary source** of outside equity-type capital for new technology-based firms when total funds raised each time the firm goes to the financial market is under $1 million.

3) **Private individuals tend to invest earlier** in the life of a new technology-based firm than do other outside sources of equity type capital, including venture-type[6] funds.[7]

Significantly, an analysis of the ebb and flow of venture capital over time indicates that there is a close correlation between the availability of such funds and changes in the capital gains tax rate. Table 1, which presents the trend in Initial Public Offerings (IPOs) as one measure of venture capital raised in organized securities markets, illustrates the sensitivity of new offerings by firms going public to the capital gains tax rate.[8]

Soaring Capital. As the table indicates, when rates increased between 1969 and 1978, initial public offerings declined significantly, from an annual average of nearly $2 billion between 1969 and 1972 to an average of just $225 million between 1975 and 1978. But following the major rate reductions in 1979 and again in 1982, the capital raised through IPOs soared, stalling at a plateau beginning in 1986-1987 when the rate was raised from 20 percent to 28 percent under the 1986 Tax Reform Act. Since then the amount raised has declined slightly and likely will continue this trend through 1989.

Table 2 illustrates the same connection between capital formation and capital gains tax rates using figures from the venture capital market[9]. As in the case of IPOs, the venture capital market has expanded when capital gains tax rates are cut, and has declined or stagnated when rates are increased.

4 John Freear and William E. Wetzel, "Equity Financing for New Technology-Based Firms," paper prepared for the Babson Entrepreneurship Research Conference, Calgary, Alberta, May 1988.

5 Equity-type investments are those that provide a share of the ownership to the investor and a right to participate in the profits.

6 "Venture-type" funds are professional investment companies that specialize in investing in promising new companies.

7 The authors' hypothesis that total equity type capital raised by these firms from private individuals exceeds the total capital raised from other outside sources, including venture capital funds, was not validated by the study. Indeed, the study found that the firms in the sample raised five times more capital from the funds than they did from individuals. Although many of these funds are tax-exempt, many of their investors are not, and the profits and gains of these funds are passed on to the investors who are taxed as individuals or corporations according to whether the earnings were ordinary income or capital gain.

8 IPOs refer to new capital issued through initial public stock offerings of corporation. This capital flows largely to relatively young rapidly growing companies.

9 Venture capital here refers to funds raised by companies that specialize in investing in the shares of new businesses.

Opponents of capital gains tax relief argue that such correlations merely are coincidence, not causation. They contend that the growth in the venture capital market really reflects the development and commercialization of new technologies, or the general improvement in equity markets that occurred during the same period.

Table 1
New Capital Raised Through Initial Public Stock Offerings (IPOs)

Year	Capital Gains Tax Rate	Number of IPOs	Dollars Raised (billions)
1969	27.50%	1,026	$2.61
1970	28.91	358	0.78
1971	29.82	391	1.66
1972	30.50	568	2.72
1973	30.91	100	0.33
1974	31.55	15	0.05
1975	31.81	15	0.27
1976	33.49	34	0.23
1977	33.77	40	0.15
1978	34.13	45	0.25
1979	25.97	81	0.51
1980	26.67	237	1.40
1981	24.81	448	3.22
1982	20.00	222	1.45
1983	20.00	884	12.62
1984	20.00	354	3.9
1985	20.00	362	8.6
1986	20.00	719	22.4
1987	28.00	541	24.2
1988	28.00	280	23.4

Source: *Going Public: The IPO Reporter* (Philadelphia, Pennsylvania) and the U.S. Treasury.

Yet such alternative explanations of the correlation are not, of course, necessarily independent of capital gains tax rates, because changes in the capital gains tax rates have a direct influence on these other factors by improving the incentives in the market and encouraging individuals to invest in shares. Lower capital gains tax rates increase the incentive to invest, and this increased demand for assets raises the price of financial assets, such as common stocks. Similarly, when investor interest is increased in securities offering capital gains potential, new and growing firms capable of providing such potential will be encouraged to bring their shares to market. Comparative observations by M.I.T. economist James Poterba in his recent

study for the National Bureau of Economic Research offer some support for this view. According to Poterba:

> In the decade between 1976 and 1986, the stock of commitments to the U.S. venture capital industry rose at a compound annual rate of 17.1%. Measured in constant dollars, the pool of venture capital funds in 1986 was 4.85 times as large as the pool one decade earlier. In Canada, by comparison, the annual growth rate of venture funds was only 5.7%, so that in 1986 the pool of funds was 1.75 times as large as in 1976. While international comparisons are difficult because of problems in controlling for institutional differences, the finding that venture capital investment grew more rapidly in the United States, the country that reduced its capital gains tax rate, is further supporting evidence for a potential link between capital gains taxation and venture capital.[10]

Elsewhere in his study, Poterba presents additional information to underscore this relationship.

> Since the Tax Reform Act of 1986, which raised individual capital gains tax rates from 20% to 28% (or in some cases 33%) venture funding has been stable. Total revenue commitments increased six percent between 1986 and 1987, and preliminary 1988 data suggest that this level has at least been maintained through 1988. The recent growth of venture capital investment in other nations, however, suggests that the post-1986 U.S. performance may reflect a negative effect of tax reform. In the U.K., the flow of venture capital commitments nearly doubled between 1986 and 1987. In Canada, venture funding rose even more dramatically, from $209 to $800 million. While the growth of venture capital in Canada and Britain may in part reflect the maturation of their venture capital industries, they provide a useful contrast to the recent U.S. experience.[11]

THE IMPACT OF CAPITAL GAINS TAXES ON TAX REVENUES

Although the evidence strongly indicates that lower capital gains rates encourage individuals to fund risky ventures, many policy makers still question whether the benefits are worth the potential losses in tax revenues due to a lower tax rate on capital gains. Skeptics also believe that a lower rate of taxation bestows disproportionately greater benefits on higher income individuals than on moderate income Americans.

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10 Poterba, *op. cit.*, pp. 4-5.

11 *Ibid.*, pp. 2-4.

Table 2
Supply of Venture Capital Financing, 1969-1987

Year	Net New Commitments to Venture Capital Firms (billions)	Maximum Personal Tax Rate on Capital Gains (percent)
1969	$ 505.7	27.50
1970	271.8	28.91
1971	251.8	29.82
1972	156.9	30.50
1973	133.2	30.91
1974	124.2	31.55
1975	19.8	31.81
1976	93.3	33.49
1977	68.2	33.77
1978	978.1	34.13
1979	449.2	25.97
1980	961.4	26.67
1981	1,627.8	24.81
1982	2,118.6	20.0
1983	5,097.7	20.0
1984	4,590.0	20.0
1985	3,502.3	20.0
1986	4,650.1	20.0
1987	4,900.0	28.0
1988	---	28.0

Source: Column 1, Venture Economics, *Venture Capital Yearbook 1988*, p. 17. Entries as presented in 1987 dollars, deflated using the GNP deflator. Column 2, U.S. Treasury.

Proponents of a lower capital gains rate counter that, contrary to the intuitively plausible proposition that rate cuts reduce revenues, experience demonstrates just the opposite: every instance of a capital gains rate cut has been followed immediately by a significant increase in capital gains realizations (net capital gains proceeds received from the sale of assets and reported to the Internal Revenue Service) and by higher taxes paid on those gains. By lowering the tax cost of selling assets, and thereby increasing the after-tax yield on such assets relative to other sources, lower capital gains tax rates can lead to greater capital gains realizations and increased total tax payments by the owners of those assets.

Stimulating Investment. Lower capital gains rates, experience shows, also increase the attractiveness of such assets relative to other sources of income or consumption. This encourages more purchases of such assets, which bids up their prices, leading to higher realizations of capital gain when the assets are sold – both because there are more investors now holding such assets and because the increased demand raises their price and profits. Again, this rise

in value and volume can mean higher tax payments even at a lower tax rate. And to the extent that such tax rate reductions stimulate more investment, business formations and entrepreneurial activity, then general income tax revenues also would rise.

What the Data Reveal

As Table 3 indicates, the rate cuts of both 1979 and 1982 were followed by large increases in reported capital gains and by increases in capital gains tax payments. Conversely, the tax rate increase enacted in 1969 was followed by declining realizations and lower capital gains tax revenues. Indeed, the $5.9 billion of capital gains revenues received in 1968 was not exceeded until 1976.

Some opponents of a cut in capital gains tax do admit that a rate reduction does boost immediate tax yields, but then they argue that the observed increase merely reflects a change in the timing of realizations that would ultimately occur at higher tax rates. Today's tax gains from a cut, they contend, simply would be at the expense of higher tax payments in the future under current rates.

Complex, Arcane Research. The primary focus of the debate over the capital gains tax is the predicted effect on tax revenues. As the debate has become more intense, the economic research on the subject has become more extensive and systematic, but unfortunately also more complex and arcane. Nonetheless, a review of the most recent studies suggests that the weight of evidence is shifting in favor of those analysts who argue that revenues will not decline if rates are cut.

A 1987 review of the academic literature by Harvard economist Lawrence B. Lindsey concludes that it is extremely unlikely that the capital gains tax increase in the Tax Reform Act of 1986 will produce any additional tax revenue.[12] Most likely, he says, it will produce less revenue than the much lower tax rates of the old law.

Seeking the Best Rate. According to Lindsey, all but one of the academic studies he reviewed predict 1987-1991 revenue losses in the range of $27 to $105 billion when compared with what would have occurred under prior law. Lindsey notes that these same academic studies imply that the capital gains tax rate that would yield the most revenue lies in the range of 9 percent to 21 percent. This finding has led most of the sponsors of a rate cut to settle on a 15 percent rate.

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12 Lawrence B. Lindsey, *Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions* (Cambridge, Mass.: National Bureau of Economic Research, 1987.

Table 3
Capital Gains Realizations and Tax Revenues
1954-1985

Year	Capital Gains Realizations (billions of $)	Tax Revenue (billions of $)	Marginal Tax Rate (percent)
1954	7.157	1.010	25.00
1955	9.881	1.465	25.00
1956	9.683	1.402	25.00
1957	8.110	1.115	25.00
1958	9.440	1.309	25.00
1959	13.137	1.920	25.00
1960	11.747	1.687	25.00
1961	16.001	2.481	25.00
1962	13.451	1.954	25.00
1963	14.579	2.143	25.00
1964	17.431	2.482	25.00
1965	21.484	3.003	25.00
1966	21.348	2.905	25.00
1967	27.535	4.112	25.00
1968	35.607	5.943	26.87
1969	31.439	5.275	27.50
1970	20.848	3.161	28.91
1971	28.341	4.350	29.82
1972	35.869	5.708	30.50
1973	35.757	5.366	30.91
1974	30.217	4.253	31.55
1975	30.903	4.534	31.81
1976	39.492	6.621	33.49
1977	45.337	8.104	33.77
1978	50.526	9.104	34.13
1979	73.443	11.669	25.97
1980	74.582	12.459	26.67
1981	80.938	12.684	24.81
1982	90.153	12.900	20.00
1983	119.118	18.468	20.00
1984	138.658	21.534	20.00
1985	168.570	24.495	20.00

Source: U.S. Treasury.

A 1988 study by the Congressional Budget Office (CBO) disputes this reasoning, however.[13] Although the study found changes in tax rates on capital gains produce a significant change in the behavior of investors, it would not be sufficient to generate higher revenues from lowering the tax rate on capital gains to 15 percent. But the authors of the study note the crucial caveat that their statistical estimates are sufficiently imprecise that a conclusion that lower rates will raise revenues cannot be ruled out.

The revenue impact debate currently centers on an updated study recently completed by the U.S. Treasury.[14] The original Treasury study, completed in 1985, concluded that:

> The available statistical evidence shows that the reduction in tax rates on capital gains in the 1978 Act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut, and in the long run either increased or only slightly decreased the annual Federal revenue from capital gains taxes.[15]

Source of Debate. The 1985 study came essentially to the same conclusion regarding the 1981 capital gains tax rate cuts, but the reluctance of tax critics to accept the broad conclusions of the 1985 study led the Treasury to update its findings. The 1988 report concludes:

> When we extend the original Treasury specifications through 1985, the results imply that the 1978 act produced large and continuing direct revenue gains. Extension of the sample and correction of the flaw in the Treasury report's measurement of inflationary GNP dramatically reduce the estimated losses from the 1981 changes. Finally, substitution of clearly superior regression specifications taken from the 1988 CBO study yields the conclusion that both acts were significantly revenue enhancing.[16]

These results immediately were challenged by the opponents, and that challenge was met just as quickly by the authors.[17] As Joseph Minarik, a critic of the Treasury studies, observes in his most recent critique, "The battle over capital gains taxation will probably last as long as we own our income tax."[18] And so the battle continues, but with the weight of evidence growing in favor

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13 "How Capital Gains Rates Affect Revenues: The Historical Evidence." The Congressional Budget Office, March 1988.

14 Michael R. Darby, Robert Gillingham, and John S. Greenlees,"The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence," U.S. Treasury, Research Paper No. 8801, May 1988.

15 "Report to Congress on the Capital Gains Tax Rate Reductions of 1978", U.S. Treasury Dept., September 1985.

16 Darby, *et al.*, *op. cit.*, pp. 2-3.

17 Joseph Minarik, "The New Treasury Capital Gains Study: What is in the Black Box?" *Tax Notes*, June 20, 1988; and Michael R. Darby, Robert Gillingham, and John S. Greenlees, "The Black Box Revealed: Reply to Minarik," *Tax Notes*, July 25, 1988.

18 Minarik, *op. cit.*, p. 1471.

of the proposition that a capital gains tax rate cut will not lose revenue, and may even gain some.

TAX REVENUES AND FAIRNESS: WHO WINS?

Closely related to the issue of revenues is that of fairness – who would receive the benefit of a rate reduction and how would this change their tax obligations. Few myths are as enduring as the belief that reductions in the capital gains tax rate shift the tax burden from the rich to the poor. Opponents of capital gains rate cuts assert that the rich would receive a disproportionate share of the capital gains realizations and most of the benefits. By their definitions, the critics note that the wealthiest two percent of the population receive more than a quarter of their annual income in the form of capital gains and that nearly 75 percent of all capital gains realizations are received by taxpayers with incomes over $100,000, while 45 percent of such gains go to those with incomes in excess of $500,000. One such critic notes that Bush's proposal would "save" the richest taxpayers at least $25,000 a year but save only $20 for most of those earning $60,000 or less.[19]

Supporters of the rate cut respond that such tax rate reductions actually would increase tax payments from the wealthy because it would induce them to shift their wealth from tax shelters to taxable investments and to "unlock" gains that were not realized because of high taxes. The evidence supports this view. Past rate cuts have led to substantial increases in capital gains realizations and tax payments, and that an increased share of these tax payments comes from upper-bracket taxpayers. Table 4 demonstrates this.

Table 4

Adjusted Gross Income	Taxes Paid on Capital Gains ($ thousands)		Percentage Increase
	1980	1984	1980-1984
$0-20,000	422,097	574,917	36
20,000-75,000	1,847,440	2,543,912	37
75,000-200,000	1,915,221	3,478,397	82
200,000-500,000	1,443,513	3,405,787	136
500,000+	2,363,446	9,598,114	306

Source: Estimated by the Office of Tax Policy, U.S. Chamber of Commerce using Statistics of Income, Internal Revenue Service

As the table indicates, the tax payments by the richest segment increased more than eight times that of the lowest income group. Critics may contend that the rise in revenues merely reflects the improving stock market over the period, and that the largest single source of capital gains realizations are from the sales of common stock. But such a contention simply is not supported by

19 Robert S. McIntyre, Statement before the Senate Finance Committee, March 14, 1989.

the facts. Over the period covered in the table, the New York Stock Exchange Composite Index rose by just 36 percent compared with the 306 percent increase in tax payments by the richest income group. Revenue increases of this magnitude reflect increased unlocking of gains, proportionately more investment in taxable assets, and greater mobility of capital.

Table 4 also demonstrates that the cut in taxes actually shifted the tax burden toward the richest groups, in contrast to the popular wisdom. Between 1980 and 1984, the share of capital gains taxes paid by taxpayers earning $20,000 or less declined from 5.3 percent to 2.9 percent, while the share from taxpayers reporting incomes of $500,000 or more rose from 29.6 to 48.6 percent of all taxes paid on capital gains.

While Table 4 and analysis demonstrate the extent to which capital gains rate reductions lead to proportionately greater tax payments by the higher income households, such aggregate data as presented in Table 4, actually overstate the extent to which capital gains realizations are experienced by the wealthier households. In fact, capital gains realizations tend to be spread rather evenly throughout the income distribution when the income distribution is defined to include only "recurring" income — that is, reported income less capital gains realizations.

Important Distinction. This distinction in the measurement of income is important. For many individuals, capital gains realizations are infrequent occurrences and reflect a unique one-time event that makes the taxpayer appear rich by pushing him into the higher income brackets. Realized capital gains tend often to be such non-recurring events as: the sale of a small business upon retirement; an elderly widow liquidating her husband's accumulated investments; the sale of stock to buy a house or pay for a child's college tuition; or the liquidation of an investment portfolio in anticipation of an economic downturn. When aggregated with other income, these give the appearance of being received almost exclusively by the very rich.

Table 5 shows the relationship of capital gains realizations to levels of income net of capital gains. With this correction, it can be seen that realized capital gains actually are distributed rather evenly throughout the income distribution. More than a quarter of realizations were experienced by households earning $20,000 or less, and households earning less than $75,000 received more than half of realized capital gains. Thus, in stark contrast to the claims of the critics, a capital gains rate reduction would provide significant benefits to all income levels, not just to the affluent.

THE PROPOSALS BEFORE CONGRESS

Nearly a dozen proposals to reduce the rate have been introduced in this Congress. The proposals differ widely in coverage, holding period, rate reduction, complexity and economic impact. To evaluate rival measures, lawmakers need to judge them against a set of base criteria. Among the most important of these:

1) Tax Rates

Since a key goal of a tax cut must be to stimulate the greatest volume of investment with the minimum revenue loss to the Treasury, preference should be given to those proposals that cut the tax rate as deeply as possible while still leaving it within Professor Lindsey's estimated revenue maximizing range of 9 to 21 percent. With 15 percent as the mid-point of this range, proposals which include rate cuts to 15 percent or less should be preferred. Bush's proposal, with rates ranging between 0 and 15 percent, and H.R. 461 and H.R. 499, with flat rates of 15 percent, lead the list. S. 171 with its implied top rate of 16.5 percent is close to this group of leading measures.

Table 5
Distribution of Capital Gains by Recurring Income: 1985

Income Group (thousands of $)	Capital Gains (billions of $))	Percent of All Gains
Under $10	$35.30	20.79
10-20	8.90	5.24
20-30	10.70	6.30
30-40	10.10	5.95
40-50	11.10	6.54
50-75	17.50	10.31
75-100	12.50	7.36
100-150	13.10	7.71
150-200	8.70	5.12
Over 200	41.90	24.68
Total	169.80	100.00

Source: Internal Revenue Service, 1985 Individual Tax Model File, Public Use Sample.

2) Holding Period

In principle there should be no required holding period before an asset becomes eligible for taxation as a capital gain instead of as ordinary income. Required holding periods serve no useful economic purpose and probably distort investment patterns in a counterproductive direction. In practice, however, the tax code has made a distinction between short-term and long-term capital gains, with the preferential rates being applied to the latter as a disincentive to speculation. Qualifying periods have varied from a low of three months to as long as a year. Currently the qualifying period is six months.

Alleged Failing. A popular, though unverified, notion holds that many of America's competitive problems stem from the "shortsightedness" of its business managers. The lengthy holding periods in several of the proposals represent a peculiar, though ineffective, way of curing this alleged failing. In fact, few other industrialized countries, including the "far-sighted" Japanese, make such a distinction.

The many capital gains proposals now under consideration contain required holding periods ranging from none in H.R. 461, one year for H.R. 499 and S.171, and four years for S.348. Inasmuch as all of these proposals seek to encourage entrepreneurial start-ups, the lengthy holding period could discourage such investments. Even a one-year required holding period might be too long. With the average postwar business cycle averaging five years, the four and five year holding periods required by several of the proposals could shift needed investment away from new firms in favor of mature companies.

3)Coverage

In an effort to target the tax incentive to preferred forms of economic activity, each of the legislative proposals would limit the preference to certain types of investments. For instance, S.171 covers only common stock, S.348 covers newly issued common stock in firms with less than $100 million paid in capital, while the Bush plan covers all common stocks as well as bonds, land and non-depreciable real property. S.551, H.R. 461 and H.R. 499 are the most inclusive in coverage, with the latter two proposals including virtually all assets. Excluded from many plans are "collectibles" and depreciable real estate such as office building and apartment complexes. Owner-occupied housing also is excluded, but existing preferences in the tax code serve effectively to shelter realized capital gains on houses.

As with the holding period, the exclusion of certain types of assets distorts investment decisions and leads to an inefficient allocation of capital resources. Bonds are held by investors for their potential capital gain as well as interest income. Precluding them from capital gains taxation could raise bond interest rates relative to the return on equities and penalize those firms dependent upon debt for capital. This interest rate burden would fall more heavily upon the mature and troubled industries with limited access to equity markets. It also could lead to immediate wealth losses for individuals and institutions (such as pension funds) with bonds in their portfolios.

Favoring New Ventures. S. 348 would extend the capital gains tax preference only to the newly issued shares of businesses with paid in capital of less than $100 million, to target assistance to new and growing small businesses. But although new ventures play a vital role in a dynamic economy, there is no particularly good economic reason to assist them at the expense of their larger competitors. Such discrimination could lead to serious distortions, misallocating capital throughout the economy and encouraging costly and unproductive corporate restructurings to take advantage of the tax rate reduction on special classes of shares.

Proposals such as S. 348 also would create complexities among new and existing shareholders of eligible companies and these complexities and uncertainties could offset in whole or in part the benefits of the more favorable capital gains treatment. Growing companies generally issue their shares in increments over their first several years of existence as the need for capital arises and as they become better established in the market. Because newly issued shares would under S. 348 be sold with the one time capital gains tax preference, existing shares — which now would sell without the

preference — would decline in value in secondary trading whenever a new offering is announced. This added uncertainty, combined with the required four year holding period and relatively high capital gains tax rate, suggest that S. 348 would provide very limited incentives to investors, and thus would do little to assist new firms in raising capital.

CONCLUSION

The evidence accumulated since World War II makes a powerful case in favor of a substantial reduction in the capital gains tax rate. Whether the issue is encouraging savings and investment, fairness, or revenues, the data and the studies demonstrate that concerns expressed by critics of a cut are either unwarranted or exaggerated.

Increasing Economic Well-Being. In response to this evidence, the White House and many members of Congress from both political parties have developed proposals and introduced legislation to rectify the mistakes made in the treatment of capital gains by the Tax Reform Act of 1986. While some of these proposals are better than others, collectively they represent a growing appreciation by public officials that low tax rates make important contributions to America's economic well-being. This trend should be encouraged and Congress and the White House should work together to craft legislation to apply a lower tax rate to a broad definition of financial and tangible assets.

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