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BALANCED BUDGET TALKING POINTS #2: WHO WILL BENEFIT FROM CUTS IN CAPITAL GAINS TAXES?

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The Balanced Budget Act of 1995 contains important changes in capital gains tax policy. Specifically, the bill lowers the effective tax rate by 50 percent for individual tax filers through a deduction for half of net taxable gain. Thus, an individual in the 28 percent tax bracket would see his effective tax rate on gains drop to 14 percent. For corporations, the bill decreases the capital gains tax rate from a maximum of 35 percent to 28 percent. Both changes are effective after December 31, 1994.[1]

Proponents of these tax policy changes argue that lower capital gains tax rates will stimulate economic growth, improve the fairness of the tax code, and increase federal revenue from the capital gains tax by encouraging individuals to "unlock" gains that they have been unwilling to realize at the currently high tax rate. Critics of these changes argue that lower effective tax rates on capital gains disproportionately benefit wealthy Americans, thus rendering the federal tax system more unfair. The critics also suggest that the "economic stimulus" produced by the reduction in rates will improve principally the fortunes of the owners of capital, not the incomes of other Americans.[2]

The work of most economists who have analyzed capital gains taxes and publicly available government data on who pays these taxes all indicate that the proponents are right and the critics are wrong. There are three major reasons why adopting capital gains tax changes as defined in the Balanced Budget Act of 1995 will benefit nearly every American.

First, the benefits of cutting capital gains taxes go mostly to lower and middle income taxpayers rather than to the wealthy. When critics claim that capital gains go mainly to the wealthy, they mislead the public by including the gain when citing a person's income. In this way, a retiree living on a $12,000 Social Security check who realizes a $30,000 capital gain one year on the sale of his house is classified as a "person with a $42,000 income who receives a capital gain."

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1 U.S. House of Representatives, Conference Report to Accompany H.R. 2491, *Balanced Budget Act of 1995*, Part 2, November 16, 1995, pp. 1317-1321.

2 Christopher Georges, "Figuring Winners, Losers in Budget Plan of GOP Hinges on Tricky Judgments," *The Wall Street Journal*, November 22, 1995, p. A12.

Contrary to what opponents suggest about who will benefit from these tax cuts, the typical household declaring a capital gain had income from sources *other than capital gains* of $58,729 in 1991.[3] The typical capital gain for this household was $973. About 11 percent of all taxpaying households declared a capital gain in 1991.

- ✗ About 19 percent of taxpaying households with capital gains in 1991 contained more than one child. These households had an average income of $87,448 and an average capital gain of $1,178.
- ✗ Another 27 percent of taxpaying households with capital gains contained taxpayers over the age of 65 or blind. These taxpayers had an average income of $43,637 and an average capital gain of $2,151. It is particularly important that households containing children and elderly taxpayers be able to liquidate appreciated assets and realize as much after-tax income as possible if they are to pay for increasingly expensive educational and medical services.

As Table 1 shows, half of all capital gains were earned by households with incomes from other sources under $100,000, which also accounted for 52 percent of all non-capital gain income.

TABLE 1
Percent of Capital Gains by Intervals of Non-Capital Gain Income

Income Intervals	% of All Non-Capital Gain Income	% of All Capital Gains
Under $20,000	2.28	21.40
$20,000 to $50,000	19.71	15.28
$50,000 to $100,000	29.59	14.72
$100,000 to $200,000	18.71	12.43
Above $200,000	29.71	36.17

Source: IRS Public Use File for 1991

Second, economists who have analyzed the economic effects of balancing the federal budget while simultaneously cutting taxes (including the capital gains tax) have all concluded that these policy changes result in widespread economic benefits through a stronger, more productive economy. One of the nation's most independent and celebrated models of the U.S. economy, the University of Michigan's Quarterly Model, found that balancing the budget with tax cuts produced immediate reductions in interest rates and inflation and higher long-term economic activity.[4] Each of this country's leading private economic consulting firms (DRI/McGraw-Hill, Wharton Econometric Forecasting Associates, and Laurence H. Meyer & Associates) recently predicted that balancing the budget with these tax cuts would lead to a much stronger economy with higher wages and more spendable household income.[5]

3 15,016,505 returns contained a capital gain declaration in 1991. These statistics on taxpayers who declared capital gains on their tax returns were developed from actual returns for 1991 selected by the Internal Revenue Service and made available on the Public Use File for Tax Year 1991 through the IRS's Statistics of Income Division. The Heritage Foundation owns a copy of this tape.

4 Associated Press, November 16, 1995.

5 Roger Brinner, "Economic Impacts of Balancing the Federal Budget," Testimony before the Joint House and Senate Policy Committees, November 9, 1995; Laurence H. Meyer & Associates, "Macroeconomic Aspects of the Republican Contract with America," *Special Analysis*, March 1995; Kurt Karl and Daniel Bachman, "A Dynamic Analysis of the House and Senate Budget Resolutions," Wharton Econometric Forecasting Associates, June 1, 1995. Wharton's analysis concluded that the economy would grow slightly more slowly during the process of balancing the budget and accelerate above baseline following the achievement of a balanced budget.

The Heritage Foundation recently used the U.S. Macroeconomic Model developed and maintained by Laurence H. Meyer & Associates to determine the economic impact of the balanced budget plan.[6] While this analysis found that the entire package of budget and tax cuts should result in generally higher economic activity, it also found that most of the economic benefits of the balanced budget plan disappear without cuts in capital gains taxes.

- ✗ A Heritage simulation of the U.S. Macroeconomic Model that contained all of the spending and tax cuts for the period 1996 through 2002, except those for capital gains taxes, would result in consistently lower Gross Domestic Product in each of these seven years when compared with a simulation that included cuts in capital gains taxes. A little more than $80.2 billion in potential GDP is lost over seven years without capital gains tax relief.
- ✗ According to the same simulation, in addition to lower GDP, the absence of cuts in capital gains taxes would lead to higher unemployment rates and slower household income growth.

Critics of the bill should note that without the stimulus to new business activity provided by the capital gains tax cut, the other changes in tax policy are simply not great enough to offset the economic effects of reductions in the rate of government spending leading to a balanced federal budget.

Third, reducing the tax rate for capital gains actually would increase tax revenues from taxpayers who own most of the appreciated assets. Experience over the last 25 years with changes in capital gains tax rates strongly indicates that rate decreases produce more declarations of capital gains and more capital gains taxes. Owners of appreciated assets who face high tax rates generally hold on to their assets in anticipation of lower future rates. When the rates come down, the amount of capital gains goes up.

Economists estimate that trillions of dollars in unrealized capital gains (perhaps has high as $7.5 trillion) exist in the portfolios of American taxpayers.[7] Some economists have estimated that significant capital gains rate changes could produce substantial economic benefits and create revenue windfalls for federal and state governments. Many politicians agree. In an article last year for the *American Economic Review*, Leonard Burman and William Randolph, the two leading tax economists on the staff of the Congressional Budget Office, estimated the response of taxpayers to rate reductions as being on the order of 6 to 1. That is, for every one percent drop in the rate, capital gains realizations would rise by 6 percent.[8]

Who would pay most of the additional capital gains taxes? As Table 1 shows, these new government revenues would come principally from taxpayers with incomes above $200,000. If, indeed, the federal government wants to draw more tax revenue from wealthy Americans, lowering the capital gains tax rate is one of the most effective ways possible to attain this objective.

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6 William W. Beach and John S. Barry, "What a Balanced Federal Budget with Tax Cuts Would Mean to the Economy," Heritage Foundation *F.Y.I.* No. 69, November 14, 1995.

7 See, for example, Jude Wanniski's testimony before the Senate Finance Committee on March 15, 1995, as cited in Stephen Moore and John Silvia, "The ABCs of the Capital Gain Tax," Cato Institute *Policy Analysis* No. 242, October 4, 1995.

8 Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," *American Economic Review*, Vol. 84, No. 4 (September 1994), p. 803.

Technical Assumptions

The data about average incomes and capital gains declarations contained in this paper come from the IRS's Public Use File for 1991. This file contains about 115,000 composite tax returns that the IRS has constructed to reflect all 114 million returns filed in 1991. When these returns are multiplied by their statistical weights, the resulting number equals the total national number for a particular tax variable, e.g. capital gains declarations.

The income numbers contained in this paper were constructed by subtracting all capital gains declarations from adjusted gross income. What remains as income after this subtraction are such things as wages, interest and dividend payments, proprietorship and partnership income, and tax refunds from the previous tax year.