WebMemo

Published by The Heritage Foundation

No. 2418
April 30, 2009

The Economic Impact of the Proposed Capital Gains Tax Increase

Curtis S. Dubay

President Obama's recently released "Budget Blueprint" proposes raising the tax rate on capital gains from 15 percent to 20 percent.[1] In real terms (that is, adjusted for inflation), the tax rate on capital gains already far exceeds 20 percent.

Inflation Drives up Real Capital Gains Tax Rate. The price of assets such as stocks, real estate, and collectibles must increase to keep up with inflation and maintain their value. The simple analogy is to wage gains. If inflation is 4 percent, then an individual's real wages—i.e., wages after inflation—must increase by at least 4 percent, or else he takes a pay cut.

The tax on capital gains, however, does not recognize that such gains are illusory in that they do not increase the asset holder's real wealth. As a result, the tax applies to both real gains and gains resulting from inflation; thus, the effective capital gains tax rate is much higher than the statutory rate (the 15 percent rate specified in law). The real effective tax rate in this case is the rate paid by an investor after accounting for the effects of inflation.

The real effective tax rate, unlike the statutory tax rate, fully accounts for the effects of inflation and therefore reflects the true disincentive effects of the tax. The effective tax rate is calculated by dividing the tax paid on the capital gain, unadjusted for inflation, by the real capital gain after adjusting for inflation.

For example, suppose a stock is purchased for $10 and held for a period during which the stock price increases $11 and sold at $21. During that same period, however, inflation doubles. Under current law, the capital gains tax falls on the entire $11 increase in price, even though $10 of the increase only maintains the stock's value compared to current prices. The capital gains tax paid is $1.65 ($11 multiplied by the current statutory 15 percent capital gains tax rate). However, the real gain after adjusting for the doubling of the price level is $1. The real effective tax rate is then 165 percent (the $1.65 tax paid, divided by the $1 real capital gain). Because it ignores the effects of inflation, the capital gains tax in this case imposes an effective rate of over 100 percent.

As Table 1 shows, the effective tax rate is higher than the 15 percent statutory rate in every year there is a capital gain. For example, the effective tax rate on a stock purchased in 1995 and sold in 2009 is 23 percent—eight percentage points higher than the statutory 15 percent rate. Thus, under current law, a taxpayer pays $71 on his gain, but if inflation were not taxed, he would pay only $47, a 34 percent savings.

While the Federal Reserve has better controlled inflation since the early 1980s, the impact of inflation is still a substantial influence on the effective tax rate and an important factor diminishing the

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/wm2418.cfm

Produced by the Thomas A. Roe Institute
for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

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.

Taxes on Capital Gains Are Higher Due to Inflation

When assets such as stocks and real estate are sold, the capital gains—the difference in sale price to purchase price—are taxed at 15 percent. However, their rise in value over time are "gains" only if they increase at a faster rate than the rate of inflation. If their rate of increase only matches the inflation rate when they are sold, the seller actually loses money because of the subsequent capital gains tax.

In the example below, one share of stock is purchased in 1970 and every five years thereafter, then each share is sold at the 2009 price of **$932**. While the capital gains tax rate is listed as 15 percent, the ***effective*** capital gains tax rate—which takes inflation into account—can be as high as 25 percent. President Obama's proposal to raise the capital gains tax rate to 20 percent would increase the effective rate to as high as 33 percent in this example.

		Standard Calculations		Calculations Factoring in Inflation				
Stock Purchase Year	Stock Purchase Price	Capital Gains *($932 Minus Purchase Price)*	Capital Gains Taxes Paid *(15% of Capital Gains)*	Stock Purchase Price, Adjusted for Inflation	Real Capital Gains *($932 Minus Stock Purchase Price, Adjusted for Inflation)*	Capital Gains Tax *(15% of Real Capital Gains)*	Effective Capital Gains Tax *(Capital Gains Taxes Paid Divided by Real Capital Gains)*	
							15% RATE	20% RATE
1970	$93	$839	$126	$424	$508	$76	**25%**	**33%**
1975	$70	$862	$129	$234	$698	$105	**19%**	**25%**
1980	$107	$825	$124	$251	$680	$102	**18%**	**24%**
1985	$165	$766	$115	$295	$637	$96	**18%**	**24%**
1990	$360	$572	$86	$551	$380	$57	**23%**	**30%**
1995	$459	$473	$71	$618	$314	$47	**23%**	**30%**
2000	$1,455	–$523	$0	$1,805	–$874	$0	**0%**	**0%**
2005	$1,188	–$256	$0	$1,310	–$378	$0	**0%**	**0%**

Source: Heritage Foundation calculations using stock prices represented on the S&P 500 and inflation adjustments from Fred II, at *http://research.stlouisfed.org/fred2/data/GDPDEF.txt* (April 24, 2009).

Table 1 • WM 2418 heritage.org

real gains of investors. In fact, the effective tax rate for the stock shown in Table 1 is still consistently higher than the statutory 15 percent tax rate even when it is purchased well after inflation was under control. If the stock is purchased in 1990, a time when inflation was tame compared to 1980 and earlier, the effective tax rate still exceeds the statutory rate by eight percentage points.

The impact of inflation heightens the damaging effect of a statutory rate increase. As explained above, the effective tax rate for a stock purchased in 1995 and sold in 2009 is 23 percent. However, if the statutory rate increases to 20 percent, as proposed in Obama's Budget Blueprint, the effective tax rate increases to 30 percent, or double today's statutory rate.

The proposed tax hike would fall on both real and inflationary portions of the capital gain. In fact, a statutory rate cut to 13.3 percent would be necessary for the effective tax rate paid on the capital gain from the sale of this stock to be 20 percent.

The Congressional Budget Office projects inflation to average 1.2 percent over the next 10 years. Suppose this figure is correct and the rate of return on investment equals the average real annualized return for the S&P 500 over the last 20 years (a little over 5 percent), and investors hold assets on average for 10 years. To keep the effective tax rate equal to 15 percent, the statutory rate would have to be cut to 10 percent. To get an effective rate equal to 20 percent, the statutory rate would have to be cut to 13 percent.

1. U.S. Office of Management and Budget, *A New Era of Responsibility: Renewing America's Promise* (Washington, D.C.: U.S. Government Printing Office, 2009), p. 123, Table S-6, at *http://www.whitehouse.gov/omb/ assets/fy2010_new_era/A_New_Era_of_Responsibility2.pdf* (April 3, 2009).

The Heritage Foundation
LEADERSHIP FOR AMERICA

The Inflationary Capital Gains Tax. Higher real effective capital gains tax rates discourage investment in new plants and equipment and in new technologies. Lower returns decrease the incentive of investors to invest, and less investment lowers long-term economic growth. A higher effective tax rate also enhances what economists call the "lock-in" effect: the tendency of investors to hold on to assets to avoid paying the capital gains tax. This results in capital not being efficiently allocated to the most deserving projects, which also lowers economic growth.

Congress should not create a further impediment to economic growth by increasing the capital gains tax rate to 20 percent as proposed in Obama's Budget Blueprint. Instead, it should index capital gains for inflation to reduce its damaging economic impacts, similar to the current indexation of individual income tax brackets to avoid raising taxes on wage gains due to inflation. An even better solution would be to index capital gains for inflation and cut the rate from its current 15 percent level. This would further increase the incentives to invest and spur economic growth at a time it is badly needed.

—*Curtis S. Dubay is a Senior Analyst in Tax Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.*