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Obama's Capital Gains Tax Hike Unlikely to Increase Revenues

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Abstract: *President Obama has proposed raising the capital gains tax rate to generate billions in new revenues for the federal government. However, according to data included in the President's own budget, if implemented this tax increase would—at best—offset the tax revenue from other sources that would be lost because of reduced total income, output, and jobs in the economy. Thus, the President is intentionally sacrificing jobs in the pursuit of his own notions of fairness with little or no hope of increasing revenues in the process. Further, this proposal is coupled with a proposed dividend tax rate hike that would also cost jobs for little or no gain in revenues. If the President is serious about making jobs his "number one priority," he should instead propose reducing the capital gains and dividend tax rates to stimulate the economy.*

President Obama has proposed raising the capital gains tax rate from 15 percent to 20 percent for married filers with incomes above $250,000. This proposal continues a long tradition of changing the taxation of capital gains, but government figures suggest it is unlikely to increase total tax revenues.

The longstanding policy tug-of-war over the capital gains tax reflects a classic tradeoff between tax revenues on one hand and economic growth and jobs on the other. A higher tax rate is usually intended to increase federal revenues, accepting the slower economic growth that follows. Proponents of higher rates argue that the revenue gains are worth the meager losses in jobs, while opponents argue the revenue gains are meager, at best, because the economic effects are substantial.

Talking Points

- President Obama has proposed a capital gains tax hike, but official revenue estimates are static in that they ignore the detrimental effects that such a rate hike would have on the economy.
- A higher capital gains tax rate indisputably would harm the economy. The debate is only over the extent of the harm and whether the proposed tax rate increases would really increase net revenue for the federal government.
- The Administration's own analysis can be used to calculate how little harm must be done before the loss of jobs and income and the resulting loss in tax receipts from all sources completely offsets the static revenue gains.
- According to calculations using the budget sensitivity table in the President's budget, a puny 0.01 percentage point reduction in economic growth each year would wipe out any revenue gains from a capital gains rate hike.

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The President's proposal to raise the capital gains tax is coupled with a similar proposal to raise the tax on dividend income from 15 percent to 20 percent for married filers with incomes above $250,000. Combined, they are expected to raise $105.4 billion from 2011 to 2020. However, this estimate ignores the dampening effects that such a policy will have on the economy. During the 2008 presidential campaign, Barack Obama acknowledged that raising the capital gains tax rate could reduce revenues, but he remained interested in raising the rate "for purposes of fairness."[1]

A general consensus exists that a higher capital gains tax rate would harm the economy, but at what point would the revenues lost due to slower economic growth exceed the revenues gained from the higher tax rate? How many jobs would be lost and how many wage gains would be missed to implement the President's notion of tax "fairness"? Analysis by the Office of Management and Budget (OMB) in the President's budget provides the basis to answer these questions: Only a slight reduction in economic growth will offset the revenue gained from raising the capital gains tax, producing little tax revenue on net. It is more likely to reduce total federal receipts.

Capital Gains Rates and Revenues

A capital gain occurs when an asset increases in value. Under most circumstances, this event is taxable only when the asset is sold and the gain (or loss) is realized. In the President's budget, the traditional revenue estimate associated with increasing the capital gains tax rate reflects an effective tax rate applied to a projection of aggregate realized capital gains.

However, projecting capital gains revenues is problematic because it requires educated guesses about the existing inventory of unrealized gains, whether that inventory is changing in size over time and the rate at which gains will be realized. Changes in the statutory tax rate add an additional complication in that changing the tax rate also changes the aggregate value of outstanding gains. For example, a higher rate reduces asset values and thus shrinks the inventory of unrealized gains.

The capital gains tax is a drag on the economy largely because it raises the cost that businesses pay to raise new capital.

A further complication is that investors will adjust their behavior both before and after a rate hike. Asset owners anticipating a rate hike are prone to realize gains before the higher rate goes into effect, pumping up their capital gains receipts before the rate hike and shrinking their inventory of unrealized gains subject to the new, higher rate. The Administration has proposed raising both the capital gains tax rate and the tax on dividends for certain upper-income taxpayers from 15 percent to 20 percent. The Administration estimates that both tax rate hikes would increase revenue by $105.4 billion over 10 years, as shown in Row 1 of Table 1.[2]

Economists have debated for years how a higher capital gains tax rate affects receipts from the capital gains tax. However, perhaps more important for federal revenues are the deleterious effects on the real economy—reduced total income, output, and jobs—arising from a higher capital gains tax rate. The Administration's official revenue estimates explicitly exclude any changes in other tax receipts that result from lower levels of output and income. To this extent, the official estimates are static and fundamentally deficient and misleading because changes in economic performance can substantially affect the full gamut of federal revenue sources, especially individual and corporate income tax receipts and payroll tax receipts.

Capital Gains and Economic Growth

The capital gains tax is a drag on the economy largely because it raises the cost that businesses pay

1. See ABC News, "Clinton and Obama Debate," transcript, April 16, 2008, p. 3, at *http://abcnews.go.com/Politics/DemocraticDebate/Story?id=4670271&page=3* (March 18, 2010).

2. See U.S. Department of the Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals," May 2009, at *http://treas.gov/offices/tax-policy/library/grnbk09.pdf* (March 18, 2010).

to raise new capital. A business raising additional equity to expand or to replace debt financing must offer prospective investors an adequate return to compensate them for the investment risks that they bear and for any taxes that they must pay on those returns. The investors' return includes dividends earned and capital gains.

The higher the taxes levied on a business, the higher must be the business's pre-tax return on investment. Therefore, a higher capital gains tax means a

Estimated Effects of the Administration's Proposed Increases to Capital Gains and Dividend Taxes

In Millions of Dollars

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total Effects, 2011–2020
1 Administration revenue estimate from raising capital gains and dividend tax rates from 15 to 20 percent for certain taxpayers	12,165	–263	3,315	8,230	11,372	12,370	13,288	14,162	14,973	15,752	105,364
2 Budgetary effects of 1 percent lower real GDP growth sustained during 2009–2019	–44,600	–84,100	–128,100	–176,800	–230,700	–288,800	–349,300	–414,300	–483,300	–557,800	–2,757,800

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total Effects, 2011–2020
3 Estimated capital gains revenue gain from raising capital gains rate to 20 percent for certain taxpayers	3,808	–82	1,038	2,576	3,560	3,872	4,159	4,433	4,687	4,931	32,981
4 Receipts effect of a 0.01 percentage point lower real GDP growth rate	–533	–1,006	–1,532	–2,114	–2,759	–3,454	–4,177	–4,955	–5,780	–6,671	–32,981
5 Net revenues from capital gains proposal	**3,274**	**–1,088**	**–494**	**462**	**801**	**418**	**–18**	**–522**	**–1,093**	**–1,740**	**0**

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Total Effects, 2011–2020
6 Administration revenue estimate from raising capital gains and dividend tax rates from 15 to 20 percent for certain taxpayers	12,165	–263	3,315	8,230	11,372	12,370	13,288	14,162	14,973	15,752	105,364
7 Receipts effect of a 0.04 percentage point lower real GDP growth rate	–1,704	–3,213	–4,894	–6,755	–8,814	–11,034	–13,345	–15,829	–18,465	–21,311	–105,364
8 Net revenues from capital gains and dividend tax rate hike	**10,461**	**–3,476**	**–1,579**	**1,475**	**2,558**	**1,336**	**–57**	**–1,667**	**–3,492**	**–5,559**	**0**

Sources: U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011* (Washington, D.C.: U.S. Government Printing Office, 2010), p. 21, Table 3-1, at *http://www.whitehouse.gov/omb/budget/fy2011/assets/spec.pdf* (March 19, 2010); U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 153, Appendix A, at *http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf* (March 19, 2010); and author's calculations.

Table 1 • B 2391 heritage.org

higher required pre-tax return and thus a lower stock of capital employed by the business. Less capital translates into fewer jobs and lower productivity.

The direction of these effects is not in doubt: A higher tax rate means a higher cost of capital, which means less capital employed, which means less output and less income. In turn, less income earned means less tax revenue from the federal government's many sources. While the directions are not in doubt, the magnitudes are very much in dispute.

The budget sensitivity table[3] in the President's budget offers an easy alternative approach to determining whether a higher capital gains tax rate would likely generate more tax revenues. The budget sensitivity table, developed by OMB in concert with the Treasury Department, shows the effects of various changes in the economic forecast on receipts, outlays, and the deficit.

For example, the budget sensitivity table shows that a 1 percentage point reduction in the real GDP growth rate relative to the budget forecast for every year from 2010 to 2020 is projected to reduce receipts by $14.5 billion in 2010 and by $2.8 trillion over the period 2009–2019. The OMB results are reproduced in Row 2 of Table 1. Such a huge decline in the GDP growth rate would also substantially affect outlays, and the combined outlay and revenue effects on the deficit would be even greater.

The Break-Even Point for Capital Gains Revenue

The budget sensitivity table can be used to estimate the break-even point between the estimated increase in capital gains receipts from a higher capital gains tax rate and the estimated reduction in all other receipts. Specifically, at what point would the decline in economic activity resulting from a higher capital gains tax rate reduce receipts from all sources sufficiently to offset the projected additional revenue from the capital gains tax? One can then judge whether the actual loss in economic output is likely to be higher, about the same, or lower than the break-even point and therefore whether the rate hike is likely to reduce, leave unchanged, or raise federal tax revenues.

Regrettably, the Administration combines the revenue effects of its dividend and capital gains proposals. Yet it is possible to deduce the Administration's estimate of the capital gains tax hike alone using Appendix A in the explanatory information presented by the U.S. Treasury's Office of Tax Policy that accompanies the budget proposal.[4] The table shows the revenue gains from raising the capital gains tax rate to 20 percent for all taxpayers and the revenue gains from raising the dividend tax rate to 35 percent.

As shown in Table 1, holding proportions constant and comparing the resulting ratio to the estimated dividends and capital gains (Row 1) produces an estimate of the capital gains revenues (Row 3).[5] The 10-year revenue loss from a persistent 1 percentage point reduction in real gross domestic product (GDP) is almost $2.8 trillion (Row 2). The estimated gain in capital gains revenues from the proposed capital gains tax rate hike is $33.0 billion (Row 4). Taking the ratio of these two figures indicates that a persistent reduction of just 0.01 percentage point in the GDP growth rate would reduce federal tax receipts from all other sources sufficiently to offset the entire projected gain in capital gains receipts (Row 5). For perspective, GDP in 2009 was $14.3 trillion, and 0.01 percent of GDP is equal to about $1.43 billion.

3. See U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011* (Washington, D.C.: U.S. Government Printing Office, 2010), p. 21, Table 3-1, at *http://www.whitehouse.gov/omb/budget/fy2011/assets/spec.pdf* (March 19, 2010).
4. U.S. Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals*, February 2010, p. 153, Appendix A, at *http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf* (March 19, 2010).
5. The calculation takes two steps. The first step involves calculating the ratio of the capital gains and dividend estimates from Appendix A for each year. The second step involves multiplying this ratio by the revenue estimate from the Administration's proposal to raise the capital gains and dividend tax rates. The result is an upper bound because the Administration has proposed raising the dividend tax rate to 20 percent, whereas the figures in Appendix A assume that the rate will go to 35 percent, thus raising proportionally more revenue. *Ibid.*, p. 153, Appendix A.

Break Even for Capital Gains and Dividends

As noted, President Obama has proposed raising both the capital gains tax rate and dividend tax rate from 15 percent to 20 percent. Like the hike in the capital gains tax rate, raising the dividend tax rate increases the cost of capital for corporate investment, thereby reducing the amount of capital employed in the economy and therefore total output and incomes. Like the capital gains tax rate, economists have argued for years about the extent of the economic harm inflicted by the dividend tax.

President Obama has proposed raising both the capital gains tax rate and dividend tax rate from 15 percent to 20 percent.

Using a parallel methodology taking advantage of the OMB's budget sensitivity table, one can find the economic break-even point at which lower revenues due to a weaker economy offset the additional revenues specific to the increased tax rates. As shown in Table 1, the Treasury Department projects that the higher capital gains and dividend tax rates would generate $105.4 billion in additional dividend tax and capital gains tax revenues from 2011 through 2020 (Row 5). The budget sensitivity table indicates that if this proposal reduces total output by 0.04 percentage point per year, then it would completely offset any increased revenues generated by the higher tax rates (Rows 6 and 7).

Whatever the ultimate outcome, the 0.04 percentage point hurdle is sufficiently low to suggest that raising the capital gains and dividend tax rates as President Obama has suggested is unlikely to generate appreciable revenues for the Treasury. In fact, such tax increases would likely reduce revenues.

Choosing Higher Wages over Ideology

Raising either the capital gains or the dividend tax rates would permanently reduce the level of economic activity. The only debate is by how much. Permanently reducing total output and income means permanently reducing federal tax receipts. According to the Administration's own budget sensitivity table, a minuscule 0.01 percentage point reduction in the economic growth rate would offset the projected increase in capital gains receipts. Similarly, a 0.04 percentage point reduction would offset projected gains from raising the dividend and capital gains tax rates, rendering the Administration's proposal revenue neutral at best.

However, Obama was very clear in his campaign debate with then-Senator Clinton that raising revenues was not his primary reason for suggesting the capital gains tax hike. Obama is willing to trade losses in jobs and wages to advance his political ideology for tax fairness. This seems an odd choice when the Administration's own economic forecast has the unemployment rate hovering above 9 percent well into 2011.

At the very least, the President should set aside his ideological preferences and press Congress to maintain the current 15 percent tax rates for capital gains and dividend tax rates until the economy approaches full employment. Jobs cannot be the President's "number one priority" as he claimed in his State of the Union Address if he is willing to sacrifice jobs to implement his tax policies.[6]

However, as this analysis also shows, cutting the capital gains tax, whatever the specific consequences for capital gains tax revenues, would very likely increase total revenues as the businesses and individuals respond with more investment, more hiring, and more income and thus pay more taxes. Cutting the rates further would demonstrate the President is serious in making jobs his "number one priority."

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6. See Barack Obama, "State of the Union Address," January 27, 2010, at *http://www.whitehouse.gov/the-press-office/remarks-president-state-union-address* (March 18, 2010).