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TAX TREATMENT OF CAPITAL GAINS AND LOSSES

HEARING

BEFORE THE

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UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

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TAX TREATMENT OF CAPITAL GAINS AND LOSSES

THURSDAY, MARCH 13, 1997

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:35 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Grassley, Hatch, Mack, Moynihan, Breaux, Graham, and Moseley-Braun.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order. Before we begin today, I would like to respond to a comment one of my House colleagues made the other day about the possibility of delaying the tax cuts. My answer is, read my lips: no delay.

Senator MOYNIHAN. Now, what does that mean, however? The last time we heard that——

The CHAIRMAN. Time will tell. Anyway, I believe the American people deserve a tax cut now.

So now to the subject of our hearing. Let me begin by welcoming you, Mr. Chairman, to this hearing on capital gains. We have a number of distinguished witnesses who will be testifying, and I look forward to hearing from them.

Last week, Deputy Treasury Secretary Lawrence Summers and other witnesses told the Finance Committee that expanding IRAs will encourage more savings and investment, and increasing America's rate of savings is critical to a healthy economy. According to Federal Reserve Chairman Alan Greenspan, our Nation's low rate of savings is the single most important economic challenge we face today.

The problem is that our current tax system does little to promote savings and investment. The capital gains tax is a prime example. This tax now stands at 28 percent for individuals and 35 percent for corporations. Many people say these high rates discourage savings and investment. Furthermore, capital gains are not adjusted for inflation, forcing investors to pay tax on gains attributable solely to inflation.

Senators from both sides of the aisle have introduced legislation that would reduce the tax burden on capital gains, and there seems

to be movement in the Administration on capital gains and this is encouraging.*

Today, however, we look forward to hearing what our panelists have to say about capital gains. I am very pleased that Jack Kemp and Paul Volcker are among our witnesses for today.

I might say that both of these witnesses have commitments in other cities today, so I will ask Senator Moynihan to share his opening remarks with us, then we will proceed to you, Chairman Volcker, as I understand your flight is scheduled to leave quite early.

Pat.

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Sir, I want to welcome our friends and distinguished witnesses. I would hope that Chairman Volcker and Jack Kemp would speak to the question of the deficit in our budget right now, as well as the question of tax reduction, and I look forward to their testimony.

The CHAIRMAN. Thank you, Pat.

As I mentioned, our first witness will be Chairman Paul Volcker. It is always a pleasure to welcome you. I think I can say that few individuals have left such a positive and lasting legacy when it comes to our Nation's economy. Those who followed your activities as chairman of the Federal Reserve know that this country owes you a debt of gratitude for the work you did to bring down inflation.

Chairman Volcker.

STATEMENT OF HON. PAUL A. VOLCKER, FORMER CHAIRMAN OF THE FEDERAL RESERVE SYSTEM, NEW YORK, NY

Mr. VOLCKER. Well, thank you very much, Mr. Chairman. Senators, I particularly appreciate your courtesy in permitting me to go first here and to be able to make the airplane. I was looking forward to being here with Mr. Kemp.

The CHAIRMAN. Do not take him too literally.

Mr. KEMP. It is an honor to be with you, Mr. Chairman.

Mr. VOLCKER. Well, nice to have you here. We may not agree on everything.

I am staring at something that says, "Please limit your testimony today to 5 minutes," so I will try to make a few simple points at the beginning here to kind of summarize my written statement.

The CHAIRMAN. Which will be included as part of the record.

Mr. VOLCKER. Thank you.

Let me say, first of all, I do not think this is an area where dogmatism is justified. There is little or no accepted truth in this area, empirical or theoretical, and there are a lot of important equity and administrative considerations that cut across what might otherwise look conceptually right.

But I do think it is very important that we keep things in perspective. The U.S. economy has been doing very well. It is doing

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*For further information on this subject, *see also*, Joint Committee on Taxation Committee Print *"JCS-4-97—Tax Treatment of Capital Gains and Losses."*

better than any other major industrialized country, has been for some time. As part of that, financial markets, I think, have been alive in many respects. They are certainly the envy of the world.

Venture capital is in good supply. There is a lot of innovation in our economy. It is interesting to put that success of the American economy against the fact that our capital gains taxes are probably the highest of any advanced country, and have been for some time.

As I say in the statement, I am not going to argue cause and effect, that the high capital gains taxes actually caused a good economy, but it is very hard to argue, I think, that a reduction in capital gains taxes is vital to economic activity. Certainly we do not need any additional stimulus to the economy at this point, certainly not fiscal stimulus.

I think we are dealing here with what is in the long-run interest in terms of growth and productivity. There is no short-term case, frankly, for capital gains tax reduction that I can see under current circumstances.

In part, that comes down to the question of savings that you emphasized. You quoted Chairman Greenspan, and I certainly agree, that savings is our No. 1 problem. We need more savings to get more investment over time.

If there is anything that is linked with productivity improvement over time, it is the effort to get more investment. Our investment is not particularly high for all of the other glories of what is going on, so let us look at savings and look at its impact on productivity.

The best thing you can do for savings is deal with the budget. I do not think there is any question about that. If you want to improve the savings situation in this country, this is something that is directly under your control. Move as fast as you can to balance the budget.

I would say, beyond that, move to a surplus. We should be operating in this country at a surplus to build up a capital stock to take care of all of those problems that arise as people age, and all the rest. So do not let anything divert your attention from moving, it seems to me, on the budget.

But there is a question of the structure of taxes. Let me just say, in general, that the most important thing you could do in the structure of taxes, and I do not think you could do it immediately, is move toward more consumption tax and less reliance on the income tax. You have got to do that in a big way, I think, to have a real impact on savings, and thus, investment. You are not going to get it, I think, by tinkering around the edges.

Now, where does capital gains tax fit into all this? I think you have to make a case, if you are going to reduce the capital gains tax, that it does stimulate risk-taking. And not just risk-taking, but risk-taking to the point that it is going to remain productive and have a payoff. We do not want simply to stimulate a gambling casino that has no payoff.

Will the capital gains tax reduction do that? Well, I think you can make some kind of common sense case that when it comes to venture capital, risk-taking, innovation, a lower capital gains tax can make a contribution.

Is it the most efficient way to do it? There is no shortage of venture capital today. More and more venture capital suppliers are

non-taxable these days so they are not affected by the capital gains tax one way or the other. So you do not want to give up, I would think, much revenue in order to get a marginal gain here.

If you have a general reduction in capital gains taxes, you may get some revenue in the short-run. You probably will, if you unlock things in the short run. In the long run, it is very hard to assume that you are going to get increased revenues; you will make the budget problem worse.

So that leads to a kind of thought that maybe we just ought to target the capital gains tax reduction at risk-taking, at venture capital. Sounds nice. I think it is very hard to do. And, as a political matter, if you begin targeting, will you target it there at venture capital or will you target it at areas that have more political support? I think there is a real danger in that.

Now, the greatest conceptual case for capital gains tax reduction I think that can be made, the easiest conceptual case, is the inflation case. We do not want to tax illusory gains. If you have inflation, you have illusory gains.

Now, the problem with that is, again, it sounds good, but I think it is very hard to administer. You will get very complicated situations—you will get an unreasonable, and I think unmanageable, situation—if you exempt capital gains but you do not do anything about interest, for instance, if you do not do anything about borrowing.

You will give an artificial incentive to borrow to get an asset that will then create a gain, and you get protection on the inflation on the gains side and you do not get any costs from the inflation on the loss side. In fact, you should only tax real interest if you are going to only tax real gains. I think that just leads you to a morass.

So that leads me, frankly, to a conclusion that there is nothing very pressing here in the general gamut of tax reform. Do not do anything that loses sight of the importance of dealing with the budgetary situation here and now.

One area of the capital gains tax that I would like to see debated is whether you graduate the scale down for a longer term holding. I would just throw out arbitrarily here 5 years: whether we could not have another notch lower at 5 years to encourage patient capital and deal, to some extent, with the lock-in effect. I do not set that out as a matter that I think should be a big priority for the committee, but I would like to see it explored a little further.

[The prepared statement of Mr. Volcker appears in the appendix.]

The CHAIRMAN. Let me ask you this, Chairman Volcker. Chairman Greenspan has indicated that growth above 2.5 percent may be harmful to the economy. Do you agree with that?

Mr. VOLCKER. Well, I would hate to put it in a precise number that I do not know, but I would say the economy, in my judgment, has been growing as fast as it can reasonably manage if you want to sustain the growth. I think it is terribly important that it gets sustained. We have had a very encouraging economic picture, where we have had 6 years of growth.

While it has not been at breakneck speed, the fact it has not been at breakneck speed may have made it possible to have this 6 years of growth. We have not got strong inflationary pressures.

We have got good indications that the growth can continue. To try to force growth at this point at a greater rate of speed I think would be a mistake, because it may bring the whole thing to an end.

The CHAIRMAN. You do not think that greater savings on the part of the American people would make it possible to have an increase in productivity?

Mr. VOLCKER. I very much agree with that. But you are talking about 5 years from now, and 10 years from now. You need that increase in savings to build up capital and build up productivity that will have a payoff over a long period of time. But there is nothing you can do this year to increase productivity next year. I mean, it's just too short a period of time. These trends are very long-term.

The CHAIRMAN. But if we are going to do anything down the road 5 years from now, don't we have to start now?

Mr. VOLCKER. By all means. Deal with that budget situation. That is the urgency of the budget situation. 2002—I do not know how that number got in there, except it is beyond a Presidential term or two. But I do not see any reason to wait that long to balance the budget. By 2002, we should be comfortably in surplus.

The CHAIRMAN. Well, it looks a little more difficult from up here.

Mr. VOLCKER. I understand. I can imagine it looks a more difficult from up there. But you can't dodge it. Your opening statement and Senator Moynihan's opening statement both pointed to that conclusion.

The CHAIRMAN. And we, of course, passed a balanced budget in 1995.

Let me ask you this question, because I admire and respect both you and Chairman Greenspan, your successor, as a matter of fact, as the Chairman of the Federal Reserve. Chairman Greenspan says that the appropriate capital gains tax rate should be zero. He said the tax is a poor means of raising revenue and it does not really serve any other purpose. What is your comment?

Mr. VOLCKER. Well, I am afraid we have some disagreement on that, it seems to me.

The CHAIRMAN. How can I respect both of you?

Mr. VOLCKER. Well, by convincing him that I am right. [Laughter.]

I do not see how you can make this distinction between one form of income and another. Maybe I have now been in the investment banking business longer than he has, and there are a lot of high-priced people in New York who are experts at converting current income into capital gains, or vice versa, depending upon what incentives they have in the tax law.

Obviously, if you do not tax capital gains, there is going to be a whole industry created of people who are going to tell you how you can forego what is called current income in the Tax Code and turn it into capital gains.

The CHAIRMAN. Chairman Volcker, you say that capping the capital gains tax rate so that it is lower than the top rate on other income makes sense. At the same time, you say that our capital gains tax rate is high by world standards.

What are the ramifications of that, does that seriously handicap us?

Mr. VOLCKER. Well, the point is, I think there is no evidence that it does in terms of our higher rate relative to others'. We, I think, without question, have the most vibrant, flexible, productive, risk-taking, supporting, capital markets in the world. At the same time, we do have the highest capital gains tax. So I think at least within parameters of what we have been taxing, it has not been damaging.

I made the comment I did—I am glad the cap was kept when marginal rates were raised—because I think at some point obviously a very high capital gains tax would be damaging. I do not think we have demonstrably reached that point. Empirically, apparently, we have not.

But I would not like to see the capital gains tax at a highly marginal rate. When you get into New York State and New York City, the marginal income tax rate comes close to 50 percent. I am not advocating that we go along with that kind of capital gains taxation. So, there is kind of a pragmatic compromise here.

Right through, what, 50 years, I suppose, the long-term capital gains tax in the United States has been between 20, and now at the present, 28 percent. It has been in that band. It seems to be consistent with an effective capital market.

The CHAIRMAN. My time is almost up, but let me ask one final question. In your statement you discussed the effect of a capital gains tax cut on savings and you refer to other tax proposals that might stimulate.

Now, we understand and agree with you as to the importance of balancing the budget. Beyond that, I think your testimony states, in part, "Moreover, as a matter of relative priority, any effect of a capital gains tax cut should be gained in the light of other tax benefits afforded retirement savings and changes that might be made in that area."

Are there any other changes that we could make that you think would be positive?

Mr. VOLCKER. Well, actually my view on this is quite radical. I think there are changes you can make, but they take a rather fundamental revision of the Tax Code. I would like to see you go in that direction. Congress and the country is going in that direction only around the edges, with IRAs and other things.

My reading of the evidence is that an approach really is not powerful enough to change things. It changes the direction of savings. People will obviously put savings in IRA accounts rather than in some other form if they are tax-favored. There is little or no chnage in the total amount of savings.

I think that some people think that is an open question, but there is not much evidence that it has. If you went powerfully toward a consumption tax, then I think it would make a difference. Of course, that is not something you can do this year. But I would certainly advocate that that is what this committee look at and study very carefully. If you want fundamental tax reform, I think that is the way to go.

The CHAIRMAN. Well, it is my intent for this committee to have hearings on the question of tax reform. When that situation arises, which I hope is not too long in the future, we would welcome your coming back to discuss that matter.

Senator Moynihan.

Senator MOYNIHAN. Thank you. Just conscious of the Chairman's time pressure, I would just ask two questions. First, just to check out that syllogism you made. The United States has the highest capital gains tax rates in the world, and the United States has the most vibrant capital markets in the world. Therefore, it must follow that the capital gains tax rate is conducive to the capital market's success.

Mr. VOLCKER. I did not draw that conclusion.

Senator MOYNIHAN. No, you backed away from that. But it is there as a possibility, and we do not have to pursue it further.

Could I just ask, sir, if you wanted to increase savings, would you not agree—I think you do, you said so—that what we have to have is a balanced budget and a surplus?

Mr. VOLCKER. Yes.

Senator MOYNIHAN. A surplus in our sixth year of economic expansion. It is time for a surplus. That surplus immediately translates the pure inverse into increase in savings.

Mr. VOLCKER. Yes.

Senator MOYNIHAN. That is the one thing we can do.

Mr. VOLCKER. Yes.

Senator MOYNIHAN. As against, influencing the behavior of 140 million people who have IRAs.

Mr. VOLCKER. Correct.

Senator MOYNIHAN. Thank you, sir.

Mr. VOLCKER. No, I feel very strongly. Of course, we have been preaching that for a long time. But I think, nonetheless, it remains true even though we have been preaching it for a long time.

If you want to do something that has a direct effect on national savings and within your control, go to a budgetary surplus.

Senator MOYNIHAN. Thank you, Mr. Chairman. I would like to spend the morning with you, but you cannot with us. There are other Senators who want to talk to you.

Mr. VOLCKER. Thank you.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. I apologize for being late. I take it, Jack, you have already made your comments. You have not? All right. Well, I am sorry, Mr. Volcker, that I did not hear your comments. I respect your thoughts and the good work that you have done.

I take it, and I do not want to put words in your mouth, that your concern is that a capital gains reduction would result in less revenues and increase the size of the deficit.

Mr. VOLCKER. That is one concern, yes.

Senator BREAUX. One concern. I had suggested years ago, because of this argument about whether it increases revenues or loses revenues and there is a split among economists as to what would happen, something which I guess you could call a capital gains tax cut with a safety net.

My suggestion was, let us put a capital gains tax in place, a reduction in place. If it, in fact, results in increased revenues and greater productivity and growth, well, then we all are winners. If, however, it results in lost revenues and the threat of an increased deficit, that we would have a standby tax increase by increasing

the top rate to cover the amount of revenues that a capital gains tax lost.

I said to all my friend who supported a capital gains tax cut and said it would increase revenues, you should not be worried because obviously you think it is going to increase revenues, so we are all winners.

Mr. VOLCKER. Right.

Senator BREAUX. So you should not object to an automatic standby increase in the top rate if, in fact, it does not produce more revenues. I got a lot of umm, ugh, well, I do not know about that response from a lot of people who would be affected by the increase in the top rate.

Mr. VOLCKER. Right.

Senator BREAUX. Do you have any comments just about that thought?

Mr. VOLCKER. Well, I had not thought about it before. I am sorry. I had not focused on that and had not heard about it. It is an interesting challenge to put to these people who are so convinced it may raise revenues in the long run.

Now, a capital gains tax reduction quite easily could raise revenues in the short run. I do not think anybody contests that. We are really talking about what it does in the long run. It will be very hard to tell what it does for productivity, because so many other things are affecting that. So, I do not know how you could put that in the test.

When you said you would look and see what it did to revenues and then make a change, I thought you were going to say, put the capital gains tax back up, which, of course, would be self-defeating. But you have a different and more interesting twist on that. I do not know. It may be an interesting challenge to see how it gets answered if you did reduce the capital gains tax. I guess you can measure rather specifically the receipts you get from that, certainly the direct receipts.

I think most of the people who argue that it might increase revenues—maybe Mr. Kemp would argue this—that the increase in revenues will not show up in the capital gains line, it will show up in improved economic growth and, therefore, it is diffused over all revenues. That then depends and comes back to the question of what it does for real growth, which is going to be very hard to distinguish. I think it is probably not enough to be identifiable.

Senator BREAUX. The only point that I would make is that——

Mr. VOLCKER. I am not that pressed for time.

Senator BREAUX [continuing]. It is difficult for us to accurately gauge whether it is going to increase revenues or lose revenues before we do it. So I just suggested that after we do it, somebody ought to be able to tell us whether it increased revenues or lost revenues. Then let us decide at that point if, in fact, that lost revenues would have some type of a mechanism to increase revenues in another area.

Mr. VOLCKER. Well, again, I think the difficulty is, you may not be able to measure the revenue effect purely by looking at the capital gains tax line. I think you have to make extremely strained assumptions to assume that a capital gains tax reduction will in-

crease capital gains tax revenues as reported on the budget over time. It will in the short run, but not over time.

So you have to argue that it is increasing economic growth and, therefore, indirectly increasing revenues that appear in another line. But identifying that in practice becomes very difficult. I am sure you will get an argument. If productivity does not increase at all, people would say, oh, but it would have gone down if we had not had the reduction in the capital gains tax. So I think, in practice, it is an interesting idea, but it is probably a statistical morass.

The CHAIRMAN. Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

Mr. Volcker, I would like to go back to the discussion that the Chairman began on the issue of growth at 2.5 percent. I just want to get a sense about where you are with respect to what level of growth do you think is attainable, not in the short run, but in the long run?

Chairman Greenspan, I think, always reminds us that when he talks about growth he generally uses the term "the potential growth rate of the country." So I would throw into this question also, in essence, what can we do over the long run to increase the potential growth rate of the country?

Mr. VOLCKER. Well, what you can do, again, is increase savings. I think you just cannot avoid that.

Senator MACK. All right. I got that one. I was just wondering whether there were others.

Mr. VOLCKER. Well, that is so overwhelmingly the important one that you at least can control, I have to keep repeating it. Now, you can argue, obviously, it will make an impact. To improve the educational system in the country, to improve the ability of many disadvantaged people to hold a more skilled job. Obviously important. very hard to measure, but very important.

Now, what we are talking about this morning is, can we further stimulate a particularly crucial sector of the economy, risk-taking, entrepreneurship, venture capital.

I think maybe, but that is not the area that appears to me any way to be under the most pressure. Now, that is not where we are suffering, very obviously, anyway. I also think it is true and not insignificant that an awful lot of this is now financed by non-taxable money.

So you are operating not just on the whole framework of venture capital when you change taxes, you are operating on that fraction of it that remains with taxable money.

The institutionalization of savings through mutual funds and so forth changes this too, because mutual funds, you tend to pay the capital gains tax as you go along. It does not affect the investment decisions the same way as it does, I think observably, for an individual.

Mutual funds, unless they are dedicated tax-sensitive mutual funds, which there are not many of, are not affected by tax policy and capital gains tax in the same way as an individual is.

Senator MACK. Is overall tax reform?

Mr. VOLCKER. I think overall tax reform I would put in after you get the budget surplus. Moving toward much more reliance on consumption taxes and away from the personal income tax that ad-

versely affects corporate, and particularly individual behavior, I think is important.

Senator MACK. Are you suggesting that we should not be concerned with the effect of a consumption tax on the economy?

Mr. VOLCKER. Well, it would be positive over time.

Senator MACK. To tax consumption?

Mr. VOLCKER. To more heavily tax consumption. The present system is very hard on savings, investment, double taxation of dividends. In a general sense it is a double taxation on savings and investment. You get taxed when you earn the money and you get taxed again after you invest it on the earnings from the investment.

So, to the extent you move away from that—at the extreme, if you move to a purer consumption tax a là the Domenici-Nunn ideas—then you do not have to worry about capital gains taxation, you are not taxing investment income at all. If you want a motive for savings and investment, I think that provides it. You can argue about how much, but it certainly would seem to move in that direction.

Senator MACK. Again, back to the original question or point. When I was taking my basic economics courses years ago, there was a sense that the economy could grow in the neighborhood of 4 percent.

Mr. VOLCKER. Right.

Senator MACK. Is that impossible today? I should know. Let me rephrase that.

Mr. VOLCKER. Oh, yes. I think it is impossible to sustain that growth rate today.

Senator MACK. I want to change that. Is it impossible for the United States to get back into a situation where its growth is at 4 percent?

Mr. VOLCKER. Well, I forget what the labor force is growing at when you project 10 or 15 years ahead. It is not as rapid as it was in the early post-war period, which is one factor that would make it very hard to get to 4 percent.

It takes a very big increase in savings and investment by most calculations to raise the productivity rate, which is what is central here, by as much as 1 percent. I could throw out some numbers if I remembered them, but I do not remember them precisely. But they are big.

So I think they are beyond anything that, realistically, people are talking about in terms of the budget. You are not going to get there by balancing the budget. I mean, it is going to require a great big surplus in the budget, I think.

Given all the evidence about how good we are at consuming and how poor we are at savings—I am talking about the public-at-large now, as well as the Government—I do not see anything coming along to radically change that. As a matter of American birthright, we like to spend, like to consume. The tax system helps it.

If you run a big surplus and move toward consumption taxation, I think you could make a sizable change. But getting to 4 percent growth, you are going to have to have a 3 percent, more or less, increase in productivity per year, per man hour. That is pretty

tough. We have never had it that big, at least for any sustained period.

Senator MACK. Thank you, Mr. Chairman.

The CHAIRMAN. Let me just ask one question on the basis of what Senator Breaux asked you. If the capital gains did not have the beneficial results, the suggestion was made that you raise the marginal rate, or at least the top marginal rate. Would that not be counterproductive as far as savings is concerned?

Mr. VOLCKER. Yes. I am not prepared to tell you how much, but certainly the top bracket people are savers. And it would have a counter-effect, but I cannot balance it out for you.

The CHAIRMAN. Senator Grassley.

Senator GRASSLEY. I have a couple of questions of Mr. Volcker. But before I do that, I would like to point out to my colleagues on the committee, as it relates to capital gains and as it relates to the $3,000 limit on capital loss. That is a barrier to the Freedom to Farm bill working the way we wanted it to out of the Agriculture Committee.

During the years of government control of production there was some steady, reasonable bounds within which prices went up or down. Now with the market making these decisions rather than government, we are going to have more volatility in prices.

One of the things that we are trying to do through Freedom to Farm is to promote each individual farmer doing risk management. That can be done on crops by the crop insurance we have. But on the other hand of price, that can be done by using futures in the options market to protect yourself from the volatility of the prices. In other words, use that as a tool to manage your own risk.

Well, now with this $3,000 limit, this is going to very much limit the farmers managing their own risk. So if we want the Freedom to Farm bill to work and encourage farmers relying upon their own management skills rather than the management skills of the bureaucracy in Washington, we are going to have to take a look at that $3,000 limit or it is not going to benefit the Freedom to Farm bill. Options and futures as a tool is not going to benefit agriculture as much as we intend, and consequently, they are going to be hamstrung on managing their risk.

Aside from that, Mr. Volcker, and also related to agriculture—I hope you do not feel uncomfortable answering some questions directed toward agriculture—Iowa State University found that in the next 5 years—they have annual surveys of this, so they can kind of keep up. One of the questions asked each year is the percentage of farmers that plan to retire in a certain period of time in the near future, and it is 21 percent.

We think of this in regard to passing on the family farm within the family rather than outside interests coming in. The real seed corn of our next generation of agriculture, is not people coming from the city to farm, but people that are already in agriculture continuing to farm if we are going to keep our food production up the way it is.

Do you feel, or have you found, that these farms will be all locked in ownership by the present capital gains tax, and that by reducing the capital gains tax it would help to some extent, passing on what unlocking the assets will save for another generation?

Mr. VOLCKER. Well, this is one of the reasons why I throw out this idea for your exploration. I know it has got complications, so I am not saying I am here as a hard advocate.

But I would think it is interesting to explore whether for people that really have held an asset over a considerable period of time, which would certainly be a farmer, that he does not have to wait until he dies before he escapes capital gains tax.

I am not suggesting you reduce the rate to zero, but there certainly is a case for looking at it as to whether a progressive reduction in the capital gains tax for a really long-term holding, which also partly goes to this inflation question, would not be a useful addition to the Code.

I know there are counter arguments about the arbitrariness and the distorting effects of that, but I think it is something you ought to have a debate about. For all of its disadvantages, I do think it would obviously help your problem.

Senator GRASSLEY. All right. Well, unrelated just to farming, are you an advocate for the position that a high capital gains does tend to lock up assets?

Mr. VOLCKER. Well, I don't think there's any question that in many circumstances it will lock up assets. The same thing will be true for the local drug store, for instance, or the local small business, or the not-so-local business, as you suggest for farmers.

Senator GRASSLEY. Yes.

Mr. VOLCKER. They get a big tax break at death, of course. The final unlock-up, I guess.

Senator GRASSLEY. Yes. In the case of farming, if you were 60 now and you started farming at 25, so 35 years ago you bought farmland, you could have paid an average price in my State of maybe $300 an acre, and you could have that be $2,000 an acre today.

Mr. VOLCKER. Right.

Senator GRASSLEY. There is just a tremendous penalty for passing that on to another generation.

Mr. VOLCKER. Well, you will get, of course, into estate tax problems when you are talking about your own family. There is not a capital gains problem at death.

Senator GRASSLEY. It is a capital gains problem, though, if he wants to sell it while he is alive.

Mr. VOLCKER. That is correct. That is correct.

Senator GRASSLEY. Yes. One last thing, then the light is on. That is in regard to, where do you come out on the capital gains costing or benefiting the Treasury over the period of time like 5 or 7 years that we on this committee has to use as scoring things for revenue neutrality?

Mr. VOLCKER. Well, one of your problems is, I do not think there are good estimates of this. It is inherently very difficult. But I think the common sense of it is, with certain cuts anyway, if you unlock things in the short run, you will get revenues for a year or two.

But I think you have to, as I said, make very strained assumptions to think you are going to get gains moving out into the future; you are going to get a loss. How that balances out within a particular 3- or 4-year period, or even a 5-year period, is very difficult. If

you wanted to maximize the gains, you do something really foolish for the long run.

You would say, I will reduce the capital gains tax for 3 years, then increase it again. But that, of course, defeats the economic purpose of doing it in the first place, and you would get no economic benefit, but you might bring revenues you would otherwise get later brought forward. But that is a game. That is not important.

Senator GRASSLEY. Yes. I am done asking questions. But if I could ask Mr. Kemp, I am not going to be able to be here——

Mr. KEMP. Yes.

Senator GRASSLEY [continuing]. If you could maybe answer my same questions for the record, I would appreciate your response.

Mr. KEMP. Yes, I will.

The CHAIRMAN. Paul, we appreciate your being here today.

Senator MACK. Mr. Chairman, can I just raise one additional question?

The CHAIRMAN. Sure. Please.

Senator MACK. I just wanted to get your sense about indexing. If you do not support a lower rate, what is your attitude about indexing?

Mr. VOLCKER. My attitude about indexing is, it sounds logical, but you cannot do it effectively for particular sectors of the economy without getting in trouble. Particularly in this area, if you index the asset side, you ought to index the liability side, which is very complicated and very few people are suggesting.

The way to deal with indexing is to have price stability. We have moved a long ways in that direction. I think what the Congress and everybody else can do is to support the general efforts of the Federal Reserve, and otherwise through your budgetary actions, to maintain price stability, which is certainly one of the factors, a very important factor, counting for the longevity of this expansion and the continuation of this expansion.

If you achieve reasonable price stability, which has been characteristic of this country most of the time except in war time and except in the 1970's and 1980's, this is not an important argument.

Senator MACK. I certainly agree with you with respect to price stability. But, again, that does not help the people who, let us say, at age 40 or so in the 1970's who are now facing retirement or education costs and so forth.

Mr. VOLCKER. I agree that people who were stuck in, effect, the 1970's and the first year or two of the 1980's lost. Now, the capital gains tax is a preferential tax, or it was during some of this period anyway, to start with. But, again, that is another reason why I think you ought to look at it.

Again, at this point I may turn out to be a great advocate, but if you reduce the tax further, let us say after 5 years just to take a number, it is arbitrary, but it goes a long way toward taking care of any kind of gradual inflation problem because you would have a substantially preferential rate which, in a kind of arbitrary way, would offset the problem you are concerned about.

The CHAIRMAN. Again, thank you very much for being here today, Paul. We look forward to having you return when we have the general discussion on tax reform.

Mr. VOLCKER. Well, thank you. I appreciate your courtesy again in permitting me to get off to my other appointment. Thank you for delaying. I am sorry I cannot stay.

Mr. KEMP. And hear my rebuttal.

Senator MOYNIHAN. We will keep notes and we will tell you what he said about what you said.

Mr. KEMP. He knows already.

Mr. VOLCKER. Can I have a surrebuttal?

Mr. KEMP. Right.

The CHAIRMAN. It is a pleasure to welcome my old friend and tax cutter, Jack Kemp, who continues to play such a leadership role in matters of taxation in the economy.

Senator MOYNIHAN. That is the bill we call Roth-Kemp, is that not right?

The CHAIRMAN. That is correct, Senator Moynihan. I am glad you got that right.

Mr. KEMP. Reagan-Roth-Kemp.

The CHAIRMAN. We will put your full statement in the record. Please proceed.

Mr. KEMP. Thank you.

STATEMENT OF HON. JACK KEMP, CO-DIRECTOR OF EMPOWER AMERICA, FORMER SECRETARY OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC

Mr. KEMP. I usually like to start these appearances, Mr. Chairman, by quoting a Chinese proverb, which says that there is a great deal of wisdom in the world, but unfortunately it was all divided up among people. I am just here to share my little slice of that pie of wisdom that is spread among the people of the world, and offer my perspective.

I am very grateful for your leadership in holding these hearings at this propitious time when the debate between the budget and cutting tax rates seems to be a replay of the debate through which you and I lived back in the late 1970's and early 1980's.

I can remember, Mr. Chairman, you and I, among other radical tax rate cutters, quoting President Kennedy. I never thought I would have to say it again, but I want to repeat it. I wish Paul Volcker were here, because I have great respect for Chairman Volcker, as we all do, and equally profound respect for Chairman Greenspan, who says that there is a solution to all of these problems. He says the appropriate capital gains tax rate is zero. It is a stupid tax. It is a tax on the creation of wealth.

However, John F. Kennedy in 1962 said, "Our choice is not between a balanced budget and cutting tax rates. That is not the choice that we are presented with." He said, "It is not between tax reduction on one hand, or the avoidance of a deficit on the other." He said, "An economy hampered by restrictive tax rates cannot produce enough revenue to balance the budget." That is the issue, how do you balance the budget through growing the economy, because it should be an a priori self-evident fact that you get more revenue from a bigger economy than you do from a smaller economy. That ought to be the debate.

With all due respect to the Chairman's statement about balancing the budget as the single greatest thing we can do to in-

crease savings, how can it be said that balancing a budget at high tax rates to improve savings, if high interest rates crowd out savings and large spending crowds out savings, so do tax rates crowd out savings. We never hear about the crowding out theory applied to taxes because we never talk about the behavior.

That is where I would depart from my fellow budget balancers. I think the budget should be put in balance, but I think it should be done at a high level of growth, a much higher rate of employment, and a much greater access to capital because, in my opinion, Mr. Chairman— and I say this not from the left or the right because I think both sides probably would disagree, but there are those who would agree—this economy is distorted. It is doing very well for those who have, it is not doing well for those who have not. The have-nots in our society do not have access to property ownership or capital.

Now, I want to make the point that I wish Chuck Grassley were here, because he raised something that has to be addressed. That is, what happens to a farmer who buys a piece of property for $300 in the 1970's and sells an acre of farmland in Iowa or New York— I was up there last night, Senator, and saw many of your friends in western New York—and sells that property for $2,000 or $3,000 in 1997, but the value of the property, the value of the asset is mostly inflated value.

So there is a locking in effect because people can borrow against the asset, write off the interest on their taxes. But if they sell, they pay a capital gains tax, an estate tax, an alternative minimum tax, and the locking-in effect is absolutely, in my opinion, keeping capital in the hands of those who have and keeping it out of the hands of those who do not have capital. Without capital, capitalism cannot work.

I was not going to read anything, but you gave me a chance to introduce my testimony, so I will tell you that I got a letter the other day from a friend of mine who is a financial service planner. He had a great example of this whole problem.

He said, I have a client whose mother lives in a one-bedroom apartment in a large midwestern city. Her sole and meager income comes from Social Security and her deceased's husband's pension, but she has 32,000 shares of blue chip stock in the company where her husband worked, and it pays no dividends.

She will not part with the stock—it is worth $2.5 million—because in so doing she would pay $800,000 of capital gain tax. She told him that her needs are simple. "I do not need the money. She knows that when she dies, they will inherit her stock free of capital gains, and neither I nor her children can convince her to sell." So instead of collecting $800,000 in capital gain taxes, the government collects nothing, zip, nada, zero. Worse, she is not enjoying her money, neither are her kids or her grandkids. The money is tied up in stock in a company that does not need it. That is another story. But others do need it.

There is a plethora of young companies, young men and women, without any capital or access to the venture capital, that investment capital that Chairman Volcker said is plentiful. It is plentiful if you have got access to capital, it is not plentiful if our capital is locked up in a system that punishes the sale of an asset. I favor

eliminating it, but we are not going to do that. I would suggest, cut it. Cut it across the board. Do not play any games with the Tax Code. Index it.

And, with all due respect to Chairman Volcker, I do not know why I am spending all my time answering the Chairman, but indexing has been accomplished in Great Britain, both prospectively and retrospectively. I know I have got to stop. But it can be done.

And I would suggest, Mr. Chairman, one last point in postscript. Capital gains is not ordinary income, it is extraordinary income, in other words. It is income from taking your income after it has already been taxed and putting it to work in a risky farm business, widget factory, to create jobs, create the wealth.

All of the wealth of our society does not come ipso facto just from savings, it comes from the reward for taking risk. If you remove the reward for taking risk you get less of it, then you get an economy, in my opinion, that will be hampered by high tax rates and will reduce revenues and ultimately put pressure on the Fed to try to spur the economy by pumping up the money.

That was what happened, in my opinion, in 1969 when Richard Nixon balanced the budget off the backs of higher income taxes and higher capital gains taxes, he put pressure on the Federal Reserve Board to spur the economy when it should have been cutting tax rates, as was done by Ronald Reagan in 1981. Thank you. I will be glad to respond to any questions.

[The prepared statement of Mr. Kemp appears in the appendix.]

The CHAIRMAN. Thank you, Jack. You say that if the capital gains tax cannot be eliminated, then Congress should cut the capital gains rate in half and, I believe, allow a 2-year period where the assets would be indexed for all inflation.

I believe you stated this would unlock an estimated $5 trillion in capital gains during the 2-year period. What short-term effects do you think your proposal would have? For example, with all of this selling activity, what would be the short-term effect on stock prices and on the economy in general?

Mr. KEMP. Well, I am certainly not an econometrician, so this is all coming from belief in the behavioral response of men and women in a free society who are willing to take a risk in the greatest capital market in the world. I certainly agree with the Chairman, I think we are entering a golden age. I am irrationally exuberant, Mr. Chairman. Do not tell Alan Greenspan.

The CHAIRMAN. I share that optimism.

Mr. KEMP. But our dollar is strong, our interest rates have come down, the Congress has done a good job of managing the budget notwithstanding the heat you take. The budget deficit is 1.5 percent or less of gross national product.

With all due respect, get it to zero, but do not do it by raising taxes on working men and women and families and the risk-takers of America who create wealth and those that want access to wealth. So I think the economy would grow a lot better than 2.3 percent, Mr. Chairman. I think we should target 4 percent growth and 4 percent unemployment. I think that will cause a lot of heartburn in a lot of places.

But no one has to worry, I have absolutely no impact upon the decision by the Republican leadership in the House to put off cut-

ting taxes this year and waiting until next year. I hope that is not true, and I am glad you said read your lips. We are going to get it, and I think you will see a market response. I think markets respond to information.

I made the point earlier, and I think this is why I favor indexing so strongly. We index bonds. Everybody said that could not be done. We index income tax rates, thanks to you, Mr. Chairman and a lot of other people, including Bob Dole, Jim Buckley, and Pat Moynihan. I think, Pat, you were involved in the indexing of income tax rates.

Indexing the capital gains rate prospectively and retrospectively would unlock the $5–6 trillion of estimated assets now held in farmland, ranch land property, home ownership, small businesses, and it is not being sold because people forget the capital gains is a voluntary tax. You do not pay it if you do not sell. You can borrow against it.

Our Tax Code, as I said, is encouraging borrowing and consumption, as it were, and punishing equity, and ownership, and investment and risk-taking. I think that should be changed with fundamental tax reform, as the Chairman pointed out, and you are working diligently on it, Mr. Chairman.

But I would suggest that, by indexing, we would unlock trillions of dollars of assets, remove that tax liability that hangs over the farmland of Iowa and the farmland of Western New York, or Louisiana, Florida, or wherever, or Utah, Illinois. Did I get everybody in?

The CHAIRMAN. Almost.

Mr. KEMP. People would be able to sell and not be punished. It is fundamentally unfair, Mr. Chairman, to tax someone on the inflated value of their assets. I do not think that is right or left. I think Democrats and Republicans agree that it is fundamentally unfair to tax a man or a woman on the inflated value of the asset, and we should do something about it, hopefully retrospectively, but at least prospectively if we are going to cut the rates.

The CHAIRMAN. Let me ask you this. How do you answer the critics who say a capital gains tax cut is for the wealthy?

Mr. KEMP. The wealthy are already wealthy. They are going to get wealthy almost under any tax system. It is the poor who get hurt by not getting access to capital. I have quoted Jesse Jackson. It makes him very upset with me. I do it in a very friendly way and I say publicly that I am one of the few Republicans that can quote him. I will probably get a letter or a call from him this afternoon.

But he said one time that. "Capitalism without capital is nothing but an ism." It is an abstraction. If you live in Chicago and you do not have access to capital and you are John Johnson, you will never start "Negro Digest" in 1945. He had $400 in 1944 or 1945 and started "Negro Digest." Today he is a very wealthy man. It is now "Ebony" and "Jet." Bless his heart. The problem is, not enough low-income people can get access to capital so they can bring their dreams to fruition.

That is neglected, in my opinion, in those who look at the economy in a static, Keynesian model where we are all a bunch of numbers and digits, and whether the factories are operating at 83.2

percent of capacity, or 82.9 percent of capacity, and oh, we had better watch out, if the economy goes above 2.3 that is inflationary, and if the stock market goes over 7,000.

What a stupid comment, that the stock market at 7,000 is somehow prima facia evidence of inflation, Mr. Chairman. In real terms, the stock market is lower than it was under John F. Kennedy in 1963.

In real terms, in dollar-denominated terms, adjusted for inflation when the stock market reached 1,000 under John F. Kennedy's economic policies, at least, that would be the equivalent of close to 10,000 Dow-Jones today.

Now, the Dow-Jones is doing pretty good, but look at the Russell-2000. Look at NASDAC. Look at small-caps. They are not doing as well, they have not risen as much. I would make a prima facia case that we are over-taxing the risk-takers of our society. We are not punishing the rich, we are hurting the poor who want to get access to that capital so they can launch their version of the American dream.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Wow. Can I just say it was refreshing and nostalgic to hear someone speak of a 4 percent unemployment rate. President Kennedy, in his 1963 economic report, proposed a 4 percent rate as our National goal.

The Labor Department thought that was outrageously high, and we managed to get the text adjusted to say an interim goal of 4 percent. Although we now find ourselves thinking that unemployment below 5.5 percent is inflationary, which is a new thing. You do not think that?

Mr. KEMP. How can too many people going to work be inflationary? How is it possible that we can get inflation from too many people? Are they going to go out and get higher wages? Yes. But, as Connie Mack has pointed out, if the wage is based upon the productivity of the worker, i.e., the amount of capital investment per worker makes him or her more productive, then it is non-inflationary economic growth. If it is just pumping up the money supply and throwing money out there or asking people to go out and spend it, that is, ipso facto, inflationary. So it is how you get to 4 percent unemployment, I guess, that is more important than just the raw figure.

But John F. Kennedy got the unemployment rate to 3.5 percent. The Democratic platform of 1960—I am an expert on Democratic economic policies from the 1960's—the growth rate targeted by John F. Kennedy, the Presidential candidate, was 6 percent growth, 4 percent unemployment, and keeping the dollar as good as gold.

Senator MOYNIHAN. Yes. I worked on that platform.

Mr. KEMP. You did a good job.

Senator MOYNIHAN. I did not believe a word of it. [Laughter.]

Mr. KEMP. I did. There ought to be one American who believed him.

Senator MOYNIHAN. Could I just point out that you surely would agree that the most valuable way to deal with the problem of taxation of capital is to maintain price stability, it is the inflation that really is robbing people.

Mr. KEMP. That is one element. A very important element. It is not the only element. You could have price stability and very high tax rates——

Senator MOYNIHAN. Right.

Mr. KEMP [continuing]. And end up with a slow-growth economy and no inflation.

Senator MOYNIHAN. But if you have price stability, the rest of the problem is a lot easier.

Mr. KEMP. Yes, sir. Absolutely.

Senator MOYNIHAN. Dale Jorgenson at Harvard, whom I think thinks of himself as a Democrat, shares your view that there should be no tax on capital gains. But he estimates that the effect rate now is only about 5 percent.

Mr. KEMP. Effective?

Senator MOYNIHAN. That with all the ways to avoid taxes, capital gains really ends up at about 5 percent.

Mr. KEMP. Oh, I see. That is an interesting point. I had not thought about it, Senator. That is a very interesting view, that it is effectively five, because that is how we—I do not know, what is the total revenue from the capital gain tax?

Senator MOYNIHAN. About $40 billion.

Mr. KEMP. Forty billion dollars.

Senator MOYNIHAN. Yes. That is a book of Jorgenson and Landau, *Tax Reform and the Cost of Capital: An International Comparison*, Brookings, 1993. You do not have to read it. Call him up and he will tell you.

Mr. KEMP. He testified before our committee. Very interesting testimony.

Senator MOYNIHAN. Yes. Yes. You make a powerful case, or you make your case powerfully. I do not know which way I would put it. [Laughter.]

Mr. KEMP. At least loudly.

Senator MOYNIHAN. But I want to thank you very much, good friend.

Mr. KEMP. Thank you. Yes. You have been a great friend. Thank you.

The CHAIRMAN. Senator Hatch.

Senator HATCH. Thank you. Jack, President Clinton proposed an exclusion from capital gains for home sales under certain circumstances. Do you see any economic growth resulting from that proposal?

Mr. KEMP. It would have to be at the margins. I do not oppose it because I believe that home ownership is at the heart of the American dream. Being an old HUD Secretary, I would like to see everyone in America own his or her own home, ergo, I would support it.

But it does not make any sense to distort the Tax Code only for home sellers. What is wrong with holding a home which is the primary asset of a family, but also being able to invest in real estate, stocks or bonds?

Senator HATCH. Most people do it for pension programs and otherwise.

Mr. KEMP. Absolutely.

Senator HATCH. So I do not see that.

Mr. KEMP. It is a weird view, though, that if it is good for home building, why would it not be good for—you know what was said by one of the Administration, and I am not picking on them.

Senator HATCH. Go ahead.

Mr. KEMP. I may have to sometime. [Laughter.]

Some people think I should have done more of it. They said, well, the stock market is already high enough. I think it was Franklin Reines, a very nice guy, OMB Director. He said, you only cut tax rates to influence stock behavior. That is not why you cut the tax rate on capital gains. The stock market is a manifestation of people's future expectations of earnings. We have a healthy stock market, but that is not why you do it.

You increase the amount of capital invested per capita, and the greater degree of capital investment per working man and woman in America the greater the output, the greater the output, the higher the wage in a competitive wage market. That is why we do it. That is how to get wages rising in America. We cannot get wages rising in America unless we invest more capital.

Senator HATCH. Well, as you know, along with Senator Breaux, Senator Grassley, and others, Senator Lieberman and myself, we have been the authors of the basic capital gains bill that would basically cut the rates in half, at least down to 19 plus percent, and 14 percent for those in the middle class.

As you have indicated, there is about $8 trillion locked up in capital assets in this society. So if we cut these rates in accordance with the Hatch-Lieberman-Breaux-Grassley bill, what will that do?

Mr. KEMP. I would strongly support it, with you, Joe, and other members of the Senate. I think it should be eliminated in the inner cities, I will tell you, if you really want to draw capital back into Shytown or Motown or Washington, DC.

Eleanor Holmes Norton wants to eliminate it. She said the only way to attract capital is to put in an incentive, a carrot. She wants to eliminate it in this city. I strongly favor that. If you cut it to 19, I would like to see it indexed, as I have mentioned repeatedly, and cut it to 14 or lower for lower income people.

To eliminate it in the inner city, that would be a darn good start. But you have got to do something about the alternative minimum tax too, because the AMT and the capital gains tax and then the estate tax are causing the problems alluded to earlier by Senator Grassley of Iowa.

Senator HATCH. Let us say we cut the rates in accordance with this bill that we are talking about. How much of those $8 trillion do you think would be unleashed?

Mr. KEMP. Oh, gosh. You have got so many better experts than I.

Senator HATCH. Well, let us say it was 5 percent or 10 percent.

Mr. KEMP. I would just have a rough estimate.

Senator HATCH. Five percent would be $400 billion a year.

Mr. KEMP. I would hesitate to even offer, Orrin, because it would just be out of the wild. I would say this. If we indexed, I think you would get more of an unlocking effect. Now, everybody says it cannot be done. Chairman Volcker said it could not be done.

Prime Minister Margaret Thatcher indexed retrospectively the capital gains rates in the United Kingdom and it unlocked a lot of

capital assets. Your estimate of $8 trillion locked up in physical assets in the United States, there is a tax liability of close to $2 trillion on that. As we have been talking about, it is a voluntary tax.

So I think if people were willing to go through that tax gate and it were indexed and it was cut, as you want to do, I think there would be $150–180 billion of revenue coming into the government that would more than bring our budget into equilibrium and also pay for the IRAs and pay for middle class tax cuts, as it were.

Senator HATCH. Well, some people have suggested, as Mr. Volcker has suggested, that if you are going to have a capital gains rate reduction you should have a longer holding period before you can trigger the reduction as a tradeoff for the reduction in the capital gains tax rates. I personally think that is bunk. If you are going to have it, you ought to face it straight up.

If you look back over the last 30 years, the one time we really cut capital gains rates we had a dramatic increase in revenues. The one time we increased them, we had a dramatic decrease in revenues.

Now, I suppose nobody really knows what is going to happen if we say pass a bill like we have been discussing, but I personally believe that you will have an increase in revenues, as you have been stating here today. But would you tradeoff to get the capital gains rate reductions a longer holding period?

Mr. KEMP. No. What do we have, a 2-year holding period now? What is the holding period?

Senator HATCH. Well, it does not make any difference right now.

Mr. KEMP. In Germany, the holding period is 6 months.

Senator HATCH. That is what it used to be in this country.

Mr. KEMP. They have very high income tax rates and that is why their economy is really being hurt. Is it not interesting, of all the countries in Asia, there is no capital gains in Asia. None in Hong Kong, Taiwan, Japan. China. Red China. Everybody is worried about China. Deng Xiao Peng said, "To get rich is glorious in China." They do not tax capital gains.

From Shanghai to Quanjong, no tax on capital gains. Hong Kong. They are not going to mess with the Hong Kong tax code. No tax on capital gains. Total expensing of investment in plant, machinery, equipment and technology. Twenty-seven years of budgets in balance. The only answer I have ever heard is, oh, they are Chinese. How is that for a great answer? They are Chinese.

Senator HATCH. I think that kind of sums it up. We are Americans and do not seem to understand these principles.

Mr. KEMP. Yes.

Senator HATCH. I agree with you. I think we have got to move this way. I am happy to see the Chairman moving. I know that our distinguished leader from New York is going to give some consideration to this as well. I just know it. I feel it in my bones.

Mr. KEMP. I do, too. Especially when Chairman Volcker said New York has a capital gain tax, New York City has a capital gains. You total the New York State and New York City income and capital gains tax on top of the Federal income tax, all of which are unindexed, the effective capital gain tax rate on any asset held longer than 5 or 6 years in the city of New York, I would venture to guess, is over 80 percent.

Senator HATCH. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. Thanks, Jack, for being back with us. In 1991, the Republican staff of the House Committee on the Budget, which was under the direction at that time of our colleague, Congressman Bill Gradison, issued the Budget Committee's report.

They tried to analyze in that report the relationship between tax incentives, including the capital gains tax cut and also the IRA expansion in savings and investment. I want to read to you what they said.

They said, "Whether aimed at increasing efficiency or growth, many growth enhancements backfire. This is due to two factors. First, few incentives are very powerful. They simply do not result in huge increases in output. Second, they typically lose revenues, increasing government borrowing as a consequence.

Sadly, most evidence suggests that saving is unresponsive to any tax incentives designed to increase it, and capital gains tax cuts and IRAs only affect a very small part of saving. Even the most optimistic estimates of the responsiveness of savings to taxes are too low to support the argument that such incentives significantly boost savings and growth."

That is from the Republican Budget Committee and it pretty much nails the concept of a capital gains reduction, and the IRA bill, for that matter. Why were they wrong?

Mr. KEMP. I guess that is a fairly conventional view, John. That is all I can say. It is in your party, it is in my party. Then there are those like John F. Kennedy and Pat Moynihan who did not agree with that, including Roth and Kemp. I do not have any macro or micro. All I can say is, I think what that report leaves out is the behavioral response of people as measured not by statistics, but by risk-taking and putting their capital at risk.

I would just ask you the question, if you earn $1 of income and you spend it, you only pay one tax on income. But if you save it, you pay two. If you invest it, you pay three. If they tax for corporate profit, that is four. If it is unindexed, that is five. When you die, they tax it again. That is six.

At some point, we have got to come tc the conclusion that there ought to be some form of simplification matched with a single tax rate system on income but once and stop this nonsense and mindless velvet tyranny that DeToqueville talked about in which the government does not confiscate our estates, it just manages our estates and leaves us with the people leaving $22 million—you see this story in the *New York Times*, Senator, where Annie Schieber left $22 million to Yeshiva University.

She put $4,000 in 1945 as a waitress into Merck, Coca Cola and IBM, and she did not sell, according to the *Wall Street Journal*. She has left it to Yeshiva, which is a very admirable thing to do. But she said she did not sell it because of the capital gain tax.

Now, for all these years that money has been locked up and ends up as $22 million. It is split 28 times. Think of the number of men, women, and poor people who are going in America without access to capital. I am saying the system is not working, and it cannot when we overtax.

Senator BREAUX. One of the problems that we face as a committee and as Members of the Congress is the differences of opinions. I mean, I just read you the Republican Budget Committee's opinion on this issue. We have some economists who say it will lose revenues, others say, no, it will increase revenues. They fight over whether it is going to be dynamic scoring or static scoring.

So I said, look, and threw up my hands. I do not know which one is right. We have got this real problem here. What about us? The question I asked Mr. Volcker I would ask you. What about going ahead and reducing the capital gains rate and admit up front that no one really knows what the result will be, but that after it has been in effect for a period of time, 5 years or whatever, we will know because we will have actual information.

Did it increase growth, did it increase revenues, or did it stymie growth and lose revenues? Have some type of a safety net, i.e., a tax proposal, that says if, in fact, it increases revenues like we believe, well, everybody is a winner and we just keep on moving in that direction.

If, however, we were wrong, that they would be an automatic tax increase in the top rate or in some rate in order to cover the loss, we would then have the real data on the results of it. When I have asked the people who support it, they are very sure it is going to increase revenues and it would never result in a tax increase. When I ask them whether they support it, they hem and haw and do a soft shoe around it saying, well, I mean, I do not know.

Mr. KEMP. Right.

Senator BREAUX. So the question is, is that something that is reasonable to pursue or not?

Mr. KEMP. Well, I agree with Chairman Volcker. I think it would be very difficult to measure the response to the actual cut.

Senator BREAUX. But if we cannot measure it before we cut it——

Mr. KEMP. Well, I am using John Johnson because I know Carol is a friend, and it is a beautiful story. What would be the response to an entrepreneur to think that his or her investment 5 years down the road would be taxed at a higher level, would he or she go into a long-term investment? Is that not what we are trying to do, encourage long-term investment?

If they know that a tax rate increase is coming or think it is going to come or it is going to be taken away, would that not influence behavior? I do not know, John, what would happen. I would be willing, probably, to try it because I do have the confidence, as I think you do knowing your strong beliefs in some of these things that it would work.

But I hate to be gimmicky when I just feel intuitively if we look at our competitors in the world economy the countries that are doing the best have the lowest tax rate and the soundest money, and the countries that are doing the worst have the highest tax rates and the weakest currency.

So I have come to the conclusion empirically that hard money, sound money, stable prices, as Pat Moynihan talked about, coupled with low tax rates and less regulation, we can get more out of the American people, the American economy, and the American system of entrepreneur capitalism than we can reversing that. So I do not

favor devaluations, and I am glad Bob Rubin does not either. I praise him for that. I thank his support for Alan Greenspan, and yours, Connie, have been just spectacular. Pat Moynihan is right, keeping price stability—and I believe we are at price stability.

I do not see any inflation out there. What is he talking about? What is he talking about? Commodity prices are up, price of oil is from 26 down to 20, futures markets and commodities are stable. The dollar is strong. It has risen against the yen, the Deutsche mark so much that Detroit is complaining. The chairman of the Fed sees inflation? I do not. Not Paul Volcker, but Alan Greenspan. I do not see it.

I do not think stock prices are measures of inflation, I think they are a measure of the confidence that the world has in the U.S. economy and this golden age into which I think we are moving. How is that for a rational, exuberant statement? Thank you, John. I would be willing to try it, I would say to my friend from Louisiana.

Senator HATCH. Senator Mack.

Senator MACK. I do, John, hear people say that they do not know exactly what would happen. They are worried, if the rate is cut, that there will be a loss in revenue. I go back to at least my recollection of the last time that we had a debate at this level, of this significance, which I think was 1978 or 1979.

Secretary Blumenthal—maybe it was before this committee, I am not sure—testified that if we cut the capital gains tax rate from roughly 48 or 49 percent, I think to 28 percent, he testified that the loss of revenue to the Federal Government would be 25 percent. I think that is close. I do not think that there was any year since 1978 that there was a reduction in the capital gains tax collection.

My point is, I think that the evidence indicates that, in fact, if you lower capital gains taxes, that you get more revenue. The second point that I would make—Jack has used it already—I have said many times that capital gains is one of the relatively few voluntary taxes.

I mean, our job ought to be trying to figure out, at what rate do you maximize the collection of the tax from capital gains and at the same time encourage investing and a willingness of people to sell an asset? I think 28 percent is too high.

It seems to me, I would say a 50 percent reduction, but some rated lower than where we are today will, in fact, increase revenues to the Federal Government, increase savings and investment, and allow for a greater mobility of capital in our country.

Now, the reason that I think it is so important today is because we are in a period of time that we have never seen before in the history of this Nation with respect to technology. We held a hearing yesterday and several before in the area of biomedical research, biotechnology. I mean, there is an explosion that is taking place. What we have experienced now with this higher capital gains tax rate, we have locked up investments in old technologies.

So it seems to me one of the things we ought to be doing, I look at it in the sense that this high rate is like a wall that has been built around the old investment, and the wall is so high that very little capital gets out into the new technologies. Our objective, our job, again, ought to be to bring that wall down and to all the cap-

ital to flow into the new technologies which are going to create the jobs for the future.

I would support a zero capital gains, but frankly it would have to be done, I believe, in the context of overall tax reform. But, in the meantime, our job ought to be to find the rate that, in fact, creates an increase in income or revenue flow to the Federal Government and at the same time encourages savings and investment and creates the mobility.

Maybe I misinterpreted the 1978 data. I think most people who have gone back and looked at that, Blumenthal was just fundamentally wrong. It is the same argument that is being used today. It is fundamentally wrong. So people who want to find some kind of guidance about what happens with a lower rate, go back to 1978.

Mr. KEMP. Yes.

Senator MACK. You want to hop in on any of that?

Mr. KEMP. Well, I fundamentally agree with what you have said. I think it protects old wealth and punishes new wealth. It rewards maturity and punishes entrepreneurial risk-taking in this society and finding the level of rate at which you can maximize your revenue. I should put to bed once and for all that we want to deny revenue to the Government.

I do not want to cut tax rates to lose revenue, I want to cut the tax rate at the margin where it will do the most good in creating jobs and access to capital so we can get more revenue. I think there is historical, and empirical, objective, analytical evidence that at a lower rate of tax on income and capital gains we will get more revenue from a bigger economy than we will get from an economy growing at 2.3 percent and keeping our budget out of balance, out of whack, out of equilibrium.

Senator MACK. I would suspect, if Chairman Volcker were here, he probably would challenge the data from 1978. I suspect what he might say is that if we had maintained the old rate, that we would have had more revenues collected.

Mr. KEMP. He did say that was too high, though, remember? He said that he would not take capital gains rates up, they were higher. Before Bill Steiger cut the tax rates in 1978, the top rate was 49 percent. Forty-nine percent. It went up under Richard Nixon in 1969.

Senator MACK. What was the top marginal tax rate on income?

Mr. KEMP. Seventy.

Senator MACK. Yes.

Mr. KEMP. Seventy. So the people who make the argument that you cannot cut tax rates and increase revenue have to tell us that 70 percent rates and 49 percent capital gain revenues raised more revenue. It did not. It demonstrably did not. That is the myth of the whole 1980's. And I think that is something that sounds self-serving, but I think there is enough to support it.

Senator MACK. Thank you, Mr. Chairman.

Mr. KEMP. Thank you, Mr. Mack.

Senator MACK. Oh. I am the Chairman. Boy, what a promotion. [Laughter.]

I thought it was a pretty good presentation myself.

Mr. KEMP. A sitting ovation.

Senator MACK. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much.

Jack, when I go out and speak to people about the Tax Code and issues of tax reform, the single loudest voice and the most consistent complaint that I hear is that people want the taxes and Tax Code to be simpler, that it is too complicated, it is too complex. You have to hire a battery of lawyers to get through it. They are terrified that if they make a mistake they will have a problem with the IRS.

The complication, the complexity issue of our Code as is, is really a huge issue, going even to compliance. We are beginning to see some impacts and falling compliance rates because people find the Tax Code to be so complicated.

At the same time, when I go out into certain circles there is discussion about the capital gains reduction almost as an article of faith. We need to reduce capital gains, we can target it for you, hold on for a particular time. You do not want to have art work, and all of those debates, which obviously this discussion was about this morning.

So taking those two things together, I am concerned, as Chairman Volcker raised in his testimony, that targeted indexing would require not only an accurate measure regarding rates of inflation and economic performance, but also, if you will, truth in advertising regarding the targets.

Now, we have been spending a good deal of time looking at the CPI and talking to the academics and the experts about what goes into providing us with an accurate measure of the consumer price index. The trouble that we are having with the CPI just as a fundamental measurement, how would you respond to the notion or to the issue that these proposals not only have the distorting effect that Chairman Volcker spoke of, but that they will also have the effect of creating what he called an administrative nightmare—I would suggest it may be worse than a nightmare—in terms of making the Code so much more complex, making compliance so much more difficult, making it so much more impossible to wend the way through our Tax Code, which not only has an impact on domestic performance in terms of economic performance, but the way the rest of the world sees investment in our country.

Mr. KEMP. Right. Well, that is a very important question, Carol, and certainly well-put, because it is an issue around which this debate, as you said, is centered. We index bonds. This Administration, Bob Rubin, Secretary of Treasury, indexed bonds. We tell bond holders we are not going to take away the value of the bond that is only measured a nominal asset, we are going to only tax the real value of that bond.

I would make a point that if you bought a piece of property in any district in this country for, say, $100,000 back in 1980 and you sell it for $160,000 in 1997, the $60,000 is all inflation. One hundred sixty thousand dollars today will buy one hundred thousand 1980 dollars. But the capital gain on that $60,000 nominal profit is $17,000, roughly.

So it is not a tax on the capital gain, it is a tax on the inflated value of the asset that is fundamentally unfair. My point is, Carol, that people are not selling for that reason. They are locking up that

capital and they are keeping it out of the hands of your poorest constituents and the people that we care about.

So, I do not think it would complicate the Tax Code to index it. we index income tax rates. We index the bonds. We should index estates, we should index capital gains, in my opinion.

And you are right about the complication of the Code. It is stupid. It is 7.5 million words long. It is 83 years old. It was a product of a hot war/cold war. It should be eliminated and we ought to start over, tabula rosa, with a sheet of paper and have a single rate system that only taxes income once.

We can argue between, I do not know, 20, 25, or 30, but I make a case that in peace time there should be no tax above 25 percent, just as a rough estimate. Keynes said that. Maynard Keynes said it in peace time, no tax higher than 25 percent. We are at peace. We won the cold war. Tell the warriors on the left and the right we won. Now get the rates down to normal levels and you will have the simplification, Carol, that both you and I, Democrat and Republican, want to bring to this country so that low-income folks can get access to property, equity, ownership, capital, credit, jobs, education, and lift themselves into the American dream.

Senator MOSELEY-BRAUN. Well, Jack, I think we do not disagree in terms of principle, in terms of the direction that we want to head. Obviously we want to stimulate investment and savings and those kinds of productive uses of capital. But I fear that the contradiction here really is in the details, or the expression, the devil is in the details.

Mr. KEMP. What is the contradiction, though? I would like to know, just for my own——

Senator MOSELEY-BRAUN. The devil being in the details goes to the question of, how do we measure these things?

Mr. KEMP. The same way we do bonds.

Senator MOSELEY-BRAUN. How do we get truth in determining both the indexing as well as the targeting aspect of the proposal.

Mr. KEMP. Well, for lack of a better one right now I would use the CPI. I know that is a big debate, but I would use the CPI. We do it on income taxes and bonds. Let the argument rage about CPI, but that would be at least a measure of the nominal value of an asset as opposed to the real value of the asset.

Connie Mack said the tax on capital gains is 28 percent. The effective capital gain tax on any asset held longer than 6 years in the United States of America today is 65 percent, because it is taxed on the inflated value of the asset. That is unfair and it is hurting the poor.

Senator MACK. Senator Grassley asked me to ask one question for him. I am going to read the question. I am not sure I totally understand it, though. "What is the level of risk that reducing the capital gains tax rate could increase non-farm investment and farm animals held for draft, dairy, and breeding purposes? If there is an appreciable risk, what can be done to minimize it?"

Senator MOYNIHAN. Yes or no. [Laughter.]

Mr. KEMP. Maybe. Can I submit it in writing? I would like to get somebody to—that is probably the reason why the rates should come down across the board and why I would support indexing, because it would then tend to level the playing field for investment

in real physical property or financial assets. I do not think we should distort the Code anymore. It is too distorted right now and people are looking for circuitous ways of getting around it.

I do not favor tax shelters at all, I favor making the system fair, simple, low, flat as possible, leaving in certain deductions for charities and mortgage interest, and then letting the American market work. Then, as Felix Rioritan said in his article April 11 in the *Wall Street Journal*, do not use the Tax Code to redistribute wealth, use spending. You can measure spending.

We can argue about how much it should be, but build a safety net under the poor, the aged and the infirm with spending. But do not use the Tax Code to redistribute wealth, because you do not end up redistributing wealth. You hamper and smother the creation of wealth, and that hurts everyone.

Senator MACK. Jack, thank you very much. We appreciate your being here.

On the third panel, we are joined by three distinguished panelists with extensive knowledge on the tax treatment of capital gains. I would like to welcome Professor Alan Auerbach, Mr. Mark Bloomfield, and Dr. Allen Sinai.

I understand that Dr. Sinai has a scheduling difficulty here, so why do we not then let you go first.

STATEMENT OF ALLEN SINAI, PH.D., CHIEF GLOBAL ECONOMIST, PRESIDENT AND CHIEF EXECUTIVE OFFICER, PRIMARK DECISION ECONOMICS, INC., NEW YORK, NY

Dr. SINAI. Thank you, Senator. I very much appreciate the change in the order, and I apologize to my colleagues here for the fact that I have someplace I have to be not too long from now.

After 6 years of an extraordinary business upturn and now an economy near full employment, extending and preserving the expansion without accelerating price inflation has become the major challenge for economic policy.

Against this backdrop, changes in tax policies that increase saving, induce productive investment and capital formation, raise productivity growth, increase the labor force and jobs, and raise potential output should be considered.

Given the need to balance the Federal budget and eventually run a surplus in times of prosperity, any new tax reductions must be balanced against the costs and lost revenues and of offsetting reductions and outlays with the best tax reductions. Those have produced the biggest bang for the buck in supply side potential with the lowest cost.

Once again, this year capital gains tax reduction has become central in this debate over tax policy. Most studies of capital gains tax reduction have been microeconomic in nature, with few performed on the full scale of macroeconomic effects.

Only a few have tried to assess the overall macro effects of capital gains tax reduction, although the intuition and framework of many would suggest that lower capital gains taxes should stimulate the economy, jobs, capital formation, new ventures, and raise the maximum sustainable rate of economic growth.

Let me talk briefly about the macroeconomic effects of capital gains tax reduction. Currently, ongoing research is being under-

taken in my organization to examine the macroeconomic effects of current capital gains tax proposals, including reductions in effective capital gains tax rates for individuals and corporations, the indexation of capital gains for inflation, and more specific targeted capital gains tax reduction proposals.

By and large, work with a full system, large-scale econometric model of the United States which includes numerous channels by which capital gains taxes affect financial markets, the cost of capital, economic activity, entrepreneurship, supply side potential and feedback on tax receipts from changes in activity in the stock market qualitatively produces the following.

Capital gains tax reduction increases savings, capital spending, and capital formation, economic growth, jobs, productivity, and potential output. The increase is relative to what might have happened otherwise are definitely significant, but small to modest in magnitudes in comparison with the size of the economy, which is quite massive now.

The cost of the capital gains tax reduction in terms of lost revenues vary depending on whether the calculations are static or include the macroeconomic feedback on tax receipts at all levels of government, whether they include realizations as a consequence of changes in economic activity, the stock market, and new capital gains or take account of unlocking previously unrealized capital gains.

Capital gains tax reduction is unique among tax policies in its financial market effects and generation of capital gains, which in turn can provide additional tax receipts at the new lower capital gains rate, along with additional funds from unlocking to be spent or saved.

All taxes that stimulate economic activity produce additional tax receipts in response, none can induce additional tax receipts from higher economic activity alone that will fully pay for the original tax cut.

However, because of the direct effects on equity market prices and new tax receipts from the unlocking of realized capital gains, capital gains tax reduction is unique. It has the greatest chance of minimizing the loss of tax receipts from a tax reduction and, depending on unlocking, could actually produce a net revenue gain.

Now, in the testimony are some preliminary estimates based on examination in our model of a program of a 50-percent exclusion of long-term capital gains for individuals, and a 25-percent capital gains tax rate on the long-term capital gains of corporations. These are preliminary and the numbers could change, but they will give you an idea of the general thrust of research over the years that I have done on this topic.

The simulation shows that real gross domestic product, compared with a baseline, rises significantly, eight-tenths of a percentage point from the baseline at its peak, and that real GDP grows a tenth of a percentage point a year.

There is a long-run decline in the unemployment rate of 0.2 percentage points. The increase of jobs peaks at nearly half a million 3 to 4 years after the tax change before diminishing somewhat to a permanent approximate 250,000 level.

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In the statement there is an explanation on page 3 of how it works. I am not going to read that because you would be able to read that yourself, and time is short.

National savings rise with a capital gains tax reduction. That is a consequence of increased personal and business savings and arise in the personal savings rate. In part, the greater savings is generated by the increased income of a stronger economy in response to the reduction in the capital gains tax, but also is due to the increased flows of funds from higher capital gains realizations, especially at the individual level, some of which go back to the government at the new lower capital gains tax rate, but most of which are available for spending or saving by individuals and for corporations on new investment or in cash-flow.

The additional savings generated by increased realizations, both unlocked and because of a higher equity market, are assumed to be mostly saved rather than spent in a pattern different from the consumption and saving out of current disposable income because of the income distribution nature of those who take realizations and the notion that gains that are somewhat windfall in nature will have a lower, what we call, marginal propensity to consume and a higher marginal propensity to save.

Depending on the unlocking that occurs at the new lower capital gains tax rates and the increased realizations that generate new tax receipts at the lower capital gains tax rate, the full exposed cost of the capital gains tax reduction could be very small, even positive, and there are some numbers presented on that in Table 3.

More than any other tax policy, capital gains tax reduction has the best chance at minimizing the loss in tax receipts net relative to the gains in economic activity, entrepreneurship, productivity, and potential output.

Just a couple of brief comments on the questions, Chairman Roth, that were put in the letter. More targeted capital gains tax relief, for example, the capital gains allowed on home sales or a change in the rule requiring the purchase of higher priced homes within 18 months on the sale of an existing home can stimulate economic activity some, but not nearly in the magnitudes of the broad-based capital gains tax reductions.

Certainly there would be increased housing activity on this kind of incentive and perhaps higher home prices, but much less benefit to savings in general and capital formation, productivity, and the maximal sustainable rate of economic growth. It is a subsidy to owners if done, and if one wants to do that, one would be in favor of it. I would favor broad-based capital gains tax relief.

The sliding capital gains tax rate, lower as the holding period of the asset lengthens, is an interesting idea, but I think it would not do very much at all in terms of the overall impact on the economy.

Indexing capital gains for inflation is desirable in any situation, I believe, because of the stimulative effect of it on the economy and enhanced economic performance, but also to remove a distortion in relative prices of equity and debt, along with the higher cost of saving and capital formation because of the indexing for inflation.

The distortion that it creates in the system, removing that, I do not think it is administratively that difficult on the inflation indexing issue, is something that I definitely favor.

To conclude, it is time. It is long overdue. Broad-based capital gains tax reduction should be undertaken now in the context of this year's budget and in the context of a credible plan to balance the budget by 2002.

The CHAIRMAN. Thank you, Dr. Sinai.

[The prepared statement of Dr. Sinai appears in the appendix.]

The CHAIRMAN. Dr. Auerbach.

STATEMENT OF ALAN J. AUERBACH, PH.D., ROBERT D. BURCH, PROFESSOR OF ECONOMICS AND LAW AND DIRECTOR OF THE BURCH CENTER FOR TAX POLICY AND PUBLIC FINANCE, UNIVERSITY OF CALIFORNIA, BERKELEY, CA

Dr. AUERBACH. Thank you, Mr. Chairman. In the short time I have, I will just try to summarize the comments in my testimony.

First, let me start by commending you and the committee for looking for ways to encourage capital formation and growth. The United States has a very low saving rate. I believe that is a very serious problem. It has contributed to our low rate of productivity growth over the last several years.

That said, and I think it is important to say that first, I must say that I am not at all impressed by a general retroactive capital gains tax cut as a method of spurring saving and growth. There are several reasons for this. Perhaps the most important is that capital gains were already tax-favored in three ways: first, through the deferral of the taxation of gains; second, through a lower maximum rate, that is, 28 percent; third, through the step-up in basis of gains at death.

These three provisions mean that the effective capital gains tax rate is much lower than the rate of tax on ordinary income, so that any reductions in the capital gains tax rate would also be attenuated in their effects.

The second point is that if one starts from this relatively low impact of a reduction in the capital gains tax rate on the incentive to save and adds to it the fact that a retroactive capital gains tax cut also brings with it a very large windfall that encourages people to consume, this will certainly reduce the additional saving being encouraged and may well increase consumption. That is, a broad-based, retroactive capital gains tax cut, while perhaps intended to be an encouragement to saving, might well encourage consumption instead.

My next point is that indexing is a good idea. I will leave to others, the issue of complexity because I do not feel that that is my greatest area of expertise.

But I mention in my testimony, and I will second what Chairman Volcker said in his comments, that indexing should not be targeted exclusively at capital gains. Other forms of capital income are also taxed in nominal, rather than real, terms.

To the extent that capital gains already receive favorable taxation, the bite of inflation is greater for other types of income, such as ordinary interest income, than it is for capital gains.

So indexing may be a laudable objective, but indexing capital gains only, taking account in addition to issues of tax arbitrage that it might encourage because of borrowing not being indexed, is not necessarily the first place to go.

As to targeted capital gains, there are two types of proposals under consideration now. One has to do with venture capital and small business. Here the issue is whether the provisions that were introduced in 1993 to provide a 50 percent exclusion for qualifying new equity in smaller businesses is appropriate, whether it is enough, whether it has worked well. I would want to see the evidence on how well that provision has worked before expanding it or changing it.

As far as home sales go, very few capital gains on home sales are taxed now, through the rollover provision, the $125,000 exclusion, and the step-up on basis of death. I do not favor giving additional incentives to home ownership, given that owner-occupied housing already receives favorable treatment.

On the other hand, this is a terrible provision as it stands now, where we require people to keep records throughout their lives each time they sell a home, and then tell them that maybe they will have to pay taxes and maybe they will not, but they have got to keep all the records anyway. Evidence suggests that many of them do not because it is so difficult to comply with this provision.

If we are not collecting very much revenue from it and it is a very complicated provision, then maybe, not as a good tax policy but simply as a technical correction, we should undertake such a change. It is hard to get excited about, but it might be the right thing to do.

Finally, in thinking about capital formation and the need to encourage more saving, we should remember that capital gains tax cuts are not the only, and certainly not the best, way of approaching that. Moving to a consumption-based tax has been mentioned earlier. I have testified before this committee in recent years on one such proposal, the flat tax.

While I am not a wholehearted, unqualified supporter of moving to a flat tax because I think the transition issues are very complicated, I certainly think that a consumption-based tax would be a far better way of encouraging saving and decreasing consumption than a capital gains tax cut would.

Do not be confused by language. A capital gains tax cut does not represent a move toward consumption taxation. It has some characteristics in common with a move toward consumption taxation, but in other respects, particularly the delivering of windfall to existing assets, it is very different from a consumption tax and, therefore, might encourage consumption rather than encouraging saving at all. Thank you.

The CHAIRMAN. Thank you, Dr. Auerbach.

[The prepared statement of Dr. Auerbach appears in the appendix.]

The CHAIRMAN. Mr. Bloomfield.

STATEMENT OF MARK A. BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC; ACCOMPANIED BY MARGO THORNING, PH.D., SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC

Mr. BLOOMFIELD. Mr. Chairman, for the record, my name is Mark Bloomfield. I am president of the American Council for Capital Formation, and I am accompanied by Dr. Margo Thorning, our senior vice president and chief economist. Mr. Chairman, we are very grateful for the opportunity to present testimony before this committee today.

I would like to make three basic points today. First, let me set the predicate for a well-crafted capital gains tax cut. No. 1, trends in U.S. capital formation are not encouraging. Slow growth in the United States over the past two decades can be partially attributed to low levels of investment.

A recent international comparison by the World Bank suggests that countries with high levels of investment grow faster than countries with relatively low levels of investment. The United States, for example, was in the bottom quarter of these 16 countries surveyed in both the levels of investment and average real GNP growth.

No. 2, tax policy has an important impact on capital formation and economic growth. To those who would like to encourage individuals and businesses to save and invest, stimulate economic growth, and create new and better jobs, capital gains and other forms of savings should not be taxed at all.

This view was held by top economists in the past and by many mainstream economists today. That is why I share Chairman Volcker's call for moving toward a consumption tax. Capital gains tax cuts are an important short-term step toward that long-term goal. That is why my sense, reading Alan Auerbach's testimony, is that he would also like to reduce the taxes on saving and investment.

Second, let me briefly respond to the committee's four questions that you asked of us today. No. 1, the macroeconomic impact of capital gains tax reductions. According to authoritative economic studies, substantial reductions in capital gains taxes for individuals and corporations would increase jobs and economic growth, encourage entrepreneurship, promote U.S. saving and investment, and raise Federal tax receipts.

No. 2, indexing capital assets for inflation. Indexing would provide an exact adjustment for the effects of inflation, provide an incentive for entrepreneurship, help protect small investors and home owners, and reduce the cost of capital. However, it would make the current tax system more complex.

Sliding scale capital gains reduction, the third question. A sliding scale for capital gains would help increase the after-tax rate of return on investment, reduce the cost of capital somewhat, and help offset the impact of inflation on capital gains. However, it would have a smaller impact on capital costs than would a single rate for capital gains.

No. 4, broad-based versus targeted capital gains reductions. A broad-based capital gains tax reduction would have a more power-

ful impact on the cost of capital and on the efficiency with which capital markets operate than would a targeted approach.

Third, Mr. Chairman, let me conclude with a case for a soundly structured, broad-based capital gains tax cut. No. 1, by reducing the cost of capital it would promote the type of productive business investment that fosters growth in output in high-paying jobs. I think this is illustrated by Dr. Sinai's analysis today.

No. 2, by increasing the mobility of capital it would help assure that scarce saving is used in the most productive manner. No. 3, by raising capital values it would help support values in capital asset markets in general, and the stock market in particular.

No. 4, by increasing the availability in lowering the cost of capital it would aid entrepreneurs, as Jack Kemp says so well, in their vital efforts to keep the United States ahead in technological advances and translate those advances into products and services that people need and want. And by reducing taxes on saving it would treat fairly those thrifty Americans who must bear a heavier tax burden than the profligate.

Finally, because of the combined impacts of a lock-in, Senator Mack, and the macroeconomic impact, a broad-based capital gains tax cut is likely to increase Federal revenues over the long run.

Again, thank you for the opportunity to be with you here today.

[The prepared statement of Mr. Bloomfield appears in the appendix.]

The CHAIRMAN. Well, gentlemen, thank you for your testimony. You all agreed that we need to do more to increase this country's savings rate. The disagreement is whether a capital gains cut would accomplish that.

Let me ask you, instead of a capital gains rate, what are your thoughts about allowing taxpayers to move money from one investment to another without paying tax? Tax would be collected when the investor fails to roll it over into another investment. I would like to ask each one of you what your reaction is. Any one volunteer as a first? Dr. Auerbach.

Dr. AUERBACH. I guess I just volunteered. Well, if this provision would apply to any capital asset my first reaction is you would not collect a lot of capital gains tax.

One problem I would be concerned with, I guess I am concerned with already, is the tax arbitrage aspects of capital gains taxation, the fact that people are already seeking to engage in short sales on their transactions not to pay capital gains taxes.

I would have to think through all of the implications of that. It sounds like a plausible argument, something that might be a way of reducing consumption. But I would like to give it more thought before I give you a definitive answer.

The CHAIRMAN. If you do examine it further, I would appreciate your advice.

Dr. AUERBACH. Yes, I will. I will do that.

The CHAIRMAN. Mr. Bloomfield.

Mr. BLOOMFIELD. Senator Roth, in Alan Auerbach's 1995 testimony, one of the criticisms he made about a capital gains tax reduction is that people would consume that money as opposed to investing it. I think in the broader context of fundamental tax re-

form, obviously, which you have spoken about and legislated for years, I favor fundamental tax reform.

In the context of a capital gains tax cut, I would prefer a rate reduction to a rollover. I think it would be more efficient. I also do not think that most of that revenue that is generated would be consumed. I think most of it would very likely be reinvested.

The CHAIRMAN. Thank you.

Dr. Sinai.

Dr. SINAI. If we really want to enhance saving we would have to go to a different system of taxation which would involve—some people would call—radical tax reform, which appears to me to be more than we are set to deal with at this stage in the political climate. So, second to that, capital gains tax reduction looks very good at this time.

This particular notion, I do not really see how that would raise the savings rate. Those who roll over assets are high savers anyway, since higher income families hold the vast proportion of the assets that would be in that category. I do not see that we would really provide an incentive to raise savings through that kind of plan.

Also, I cannot see that there would be any significant macroeconomic effect of that, whereas with capital gains tax reduction it is very clear to me that there are significant effects on the economy which, in turn, induce a lot of other effects, including some additional savings across all income groups. So it has a better chance of raising the savings rate than my very quick reaction to that notion that you expressed.

The CHAIRMAN. Indexing. I would ask the panel again, according to Joint Taxation, a person who invested in the stock market in 1989 and sold the stock for a gain in 1994 had about 50 percent of his gain consist of inflation. So this person is paying a 56 percent tax rate, or twice the actual capital gains rate as his real economic gain.

I think that is unfair. I also understand how indexing leads to complexity. Do any of you have any suggestions on how we could make an indexing proposal less complicated?

Dr. SINAI. If I might react to that. In this day and age with so much availability of data, computers that do calculations, it would seem to me we could do something like choose a price index for each asset, whether it be real estate, art, stocks, a reasonable price index, and use that in indexing. It would be a fairly mechanical kind of operation as opposed to involving a lot of people dealing with it in a hand-generated way.

Mr. BLOOMFIELD. Mr. Chairman, can I make two comments in response to your question. The situation is even worse than that. When CBO looked at capital gains receipts in 1995, they were in the range of $47 billion. That is nominal. When you adjusted for inflation according to CBO, you ended up paying capital gains on a substantial loss. So it really is an unfair tax and does not make economic sense.

The next question, of course, is why do we not just address capital gains only with indexing. Of the four economic arguments for capital gains, capital costs, the mobility of capital, inflationary gains, and entrepreneurship, it obviously addresses one. So, I

would favor indexing in conjunction with something else. With regard to the technical problems, I think my co-panelists have addressed that.

Dr. AUERBACH. I have not heard from anyone the justification for indexing capital gains specifically rather than all capital assets, and I would be interested in hearing it because I do not think there is a really good argument for it.

There may be arguments for lowering capital gains taxes. I am not enthusiastic about them, but I understand that they exist. But why one would choose to index one particular type of capital income and leave all other types of capital income which are even more subject to the ravages of inflation alone, I do not understand.

Dr. SINAI. I think we actually all favor that, in principle. The difficulty is, if you try to do all of what you say, nothing will get done.

Dr. AUERBACH. But you are choosing the asset which is least subject to the extra tax caused by inflation to index first.

Dr. SINAI. Sure, because the benefits of doing that are quite high. The question is what you can do in the real world as opposed to what you might want to do in a theoretical world.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. Thank the panel members for being with us again.

One of the frustrating things, I guess, is the fact that there is no unanimous recommendation on what the effect of a capital gains tax cut would do to the economy. We have the static and dynamic scoring arguments. We have some economists at the point that it would lose revenues, others tell us that, no, it is going to increase revenues.

So it is pretty clear that we are not going to definitely, once and for all, come to a conclusion that is unanimous as to what a capital gains tax reduction would do in the next 5 years or in the future. There is disagreement across the board.

I hear today that it may be even difficult to tell what a capital gains tax cut has done to the economy after the fact. So we cannot determine what it would do before we enact it, then we are not able to determine what the effect was after we enact it.

I mean, how are we ever going to be able to determine whether it was good public policy or not? Is it that difficult for economists to look after the fact, after we have had a capital gains reduction, say, in half after 5 years, to say, all right, here was the effect of this capital gains tax cut?

I ask that question because of my sort of trigger mechanism that I have been talking about. I mean, let us go ahead and enact it. We do not know what it is going to do, but let us enact it with a safeguard that says, if it costs the economy money we will have an automatic triggered in increase in the top rate, for instance, to pay for the loss of revenues to the country.

But then I am told, well, we may not even be able to figure it out then. So, I mean, how lacking in economic analysis are we that we cannot even tell what it would do in the future, nor can we tell what it did after the fact.

Dr. AUERBACH. Here is the problem. A capital gains tax cut, even a large capital gains tax cut, is going to have a small effect on the economy relative to other things that are going on at the same

time. Look at the fluctuations in long-term interest rates over the last few years. Look at changes in the unemployment rate, changes in GDP growth. These are huge by comparison to the small changes that we are talking about here. No one suggests that they are associated with or caused by the changes in tax policy that we have had over the last few years.

The problem is separating the effects. We can look at individuals studies of behavior with respect to capital gains. We can say this is how individuals behave. We can add it up and get a prediction of how the economy would respond to a change.

But, in terms of actually validating that or contradicting it using aggregate evidence, we would need to have such a long time series of data that none of us would be here when we finally had an answer. That is just the sad fact of econometric methodology and there is absolutely nothing that can be done about it.

Mr. BLOOMFIELD. Senator Breaux, to steal from one of Senator Moynihan's earlier books, *Maximum Feasible Misunderstanding*, there is certainly a lot about this subject. But people make judgments. Thank goodness we do not run U.S. economic models only through econometric models. It seems to me that you have a lot of evidence before you on which you can make a judgment. First, let me respond specifically to your proposal. As you recall, we have discussed it several times in the past.

There are technical problems, but obviously one can address technical problems. How large a tax increase would this require? Estimates on capital gains tax receipts, they are there. It is not only capital gains tax receipts, but as Allen Sinai and David Weiss at DRI indicates, the impact of capital gains is through a larger GNP, which does not only result in increased capital gains tax receipts.

But there are some judgments that you can make on the economic impact and on the revenue impact. The revenue impact, as Mr. Kies has explained so many times, has four elements. One is easy, which is the rate reduction. That loses money. The second thing is also not that complicated, although there are different disagreements about the amount, and that is the unlocking, which raises you some money.

The third part, which was alluded to earlier, is the reclassification of income from capital gains into ordinary income. That can be estimated, too. But, quite frankly, I would suggest that Dr. Auerbach and others who would disagree with the evidence on capital gains go head to head with Allen Sinai, who has looked at the two positive elements, and that is the increase in asset values.

If you reduce the capital gains tax, the pre-tax rate of return becomes a lot greater after tax with lower capital gains taxes that increase asset value, and obviously can result in higher tax rates.

Then finally, something on which I would suggest that opponents go head-on-head, is what the impact is on GNP.

Senator MOYNIHAN. Higher tax revenues.

Mr. BLOOMFIELD. I am talking about the four elements of tax revenue. Those are elements that can be discussed. You make judgments about it. Separately you make judgments about the economic impact.

Senator BREAUX. Dr. Sinai.

Dr. SINAI. Well, I think the econometric work can actually give you a message on history. I think our work and the work of DRI would say that, historically, the effects have been of the nature that I described. There might be some quarrel about the magnitudes.

It is difficult for these futuristic kinds of investments to be made with econometric models because the structure of the economy can change during that period and there is a lot of uncertainty about that. But you can, in terms of your question, rely that you get some good approximations of history. The message, I think, is very clear. As to your particular suggestion/proposal, I think it is a creative and positive idea.

Of course, I am from the private sector, but it is the same kind of a reaction I have on the indexing side, that the way computers and data are these days, that as hard as things look in terms of measurement, I am very skeptical that they are very good people—and they are very good people who work in government—cannot deal with that measurement and give you a running tally on the capital gains side as to how we are doing.

Then the next question is, do you raise taxes on upper income people to deal with it if you are running a loss, or do you cut some spending, in the context of making sure the budget is balanced, which is very, very important.

The CHAIRMAN. Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you, Mr. Chairman. Mr. Bloomfield, it is good to see you again. Dr. Sinai, Dr. Auerbach.

My mantra in all of this discussion is: Simplify the Tax Code. Let me say it again: Simplify the Tax Code. We absolutely, positively have to do something about tax simplification. The Code right now is this Rube Goldberg, and everybody knows it.

I do not know. I think it was you, Senator Moynihan, who had a quote I wish I could find again, about some of the best minds in the law now are finding themselves wending their way through the intricacies of the Tax Code. Someone said it at one of these hearings, but it is certainly true and it just is a waste, that the Code is so complex.

In regard to this proposal, again, taking for a moment the consensus that there seems to be, or kind of consensus, around the capital gains issue, I am very much concerned about the transition issues, about the complexity issues, and about whether or not compliance will be impaired in any way by virtue of such shift as these proposals suggest.

Now, inasmuch as we are, as a friend of mine once said, the CDLS—that is, the Committee To Draw the Line Somewhere—that is our job, to draw the line somewhere. Have you any guidance for us regarding the transition issues and whether or not we can avoid adding even more complexity to the Tax Code by virtue of this initiative?

Dr. SINAI. If I could, because I think this is the last thing I can say to you today. But with the main goal that you have, which as a taxpayer I certainly share, and looking at all taxpayers, the problem is, how do you get it done? To try to do what you say could take 2 or 3 years, and then nothing else gets done. So part of poli-

tics is, something needs to be done, what can we do now. I would offer that on capital gains tax reduction.

The only other guide on transition and the complexity, the only answer I have is the one I have said before. I really do not believe it is as difficult as people make it out to be in this day and age of computers and very, very bright staff people, and I would suggest using price indices, coming to an agreement on a price index for art, for real estate, for farmland. There are such things out there.

The CPI, I guess, I would not like because it is biased up in terms of what to use for capital gains tax reduction. But I think you can get a collective judgment from technical experts on it as to which index to use in which category, and then turn the computers on and let them do the work.

Senator MOSELEY-BRAUN. Dr. Auerbach.

Dr. AUERBACH. Well, I do not know how to make your life easy, but I think one way to do it would be to not try to have separate price indices for every asset. The purpose of indexing is to keep people from paying taxes on increases in asset values that do not represent increases in purchasing power.

Purchasing power is measured by the CPI or some other overall index, and really should not have anything to do with what has been happening to prices in the art market or the real estate market.

So to start with, you would want to index using the single price index, or perhaps a price index based on people in different circumstances, but certainly not relating to the assets that they purchased. I do not think that is a particular problem, choosing the price index.

Other transition issues, and for that matter longer-run issues of complexity such as the tax arbitrage that is encouraged when capital gains are taxed at a very different rate than other income, are problems. They are not transition problems, they are permanent problems, but they are problems worth thinking about as you change the capital gains tax.

The CHAIRMAN. Dr. Sinai, we understand that you have a commitment.

Dr. SINAI. Yes. Thank you very much. I want to thank my colleagues and the Senators.

The CHAIRMAN. We appreciate your being here.

Senator MOYNIHAN. Thank you for coming.

Mr. BLOOMFIELD. Senator Moseley-Braun, I guess I would make three suggestions to your comment. No. 1, I think the chances of reclassification, trying to reclassify your income from ordinary income to capital gains, are less today than they have been in the past because of some of the changes in the tax sheltering, Senator Moynihan, in 1986, passive losses, and so on, and so forth. So you will not have that problem.

No. 2, I would suggest that if you do a capital gains tax cut to keep it simple, that it be broad-based and you not try to target it here or target it there. But there is this conflict between fairness, simplicity and an economically sound tax bill. When I was here last 2 years ago we talked about spousal IRAs. I strongly favor them, but some people might suggest it is another complication.

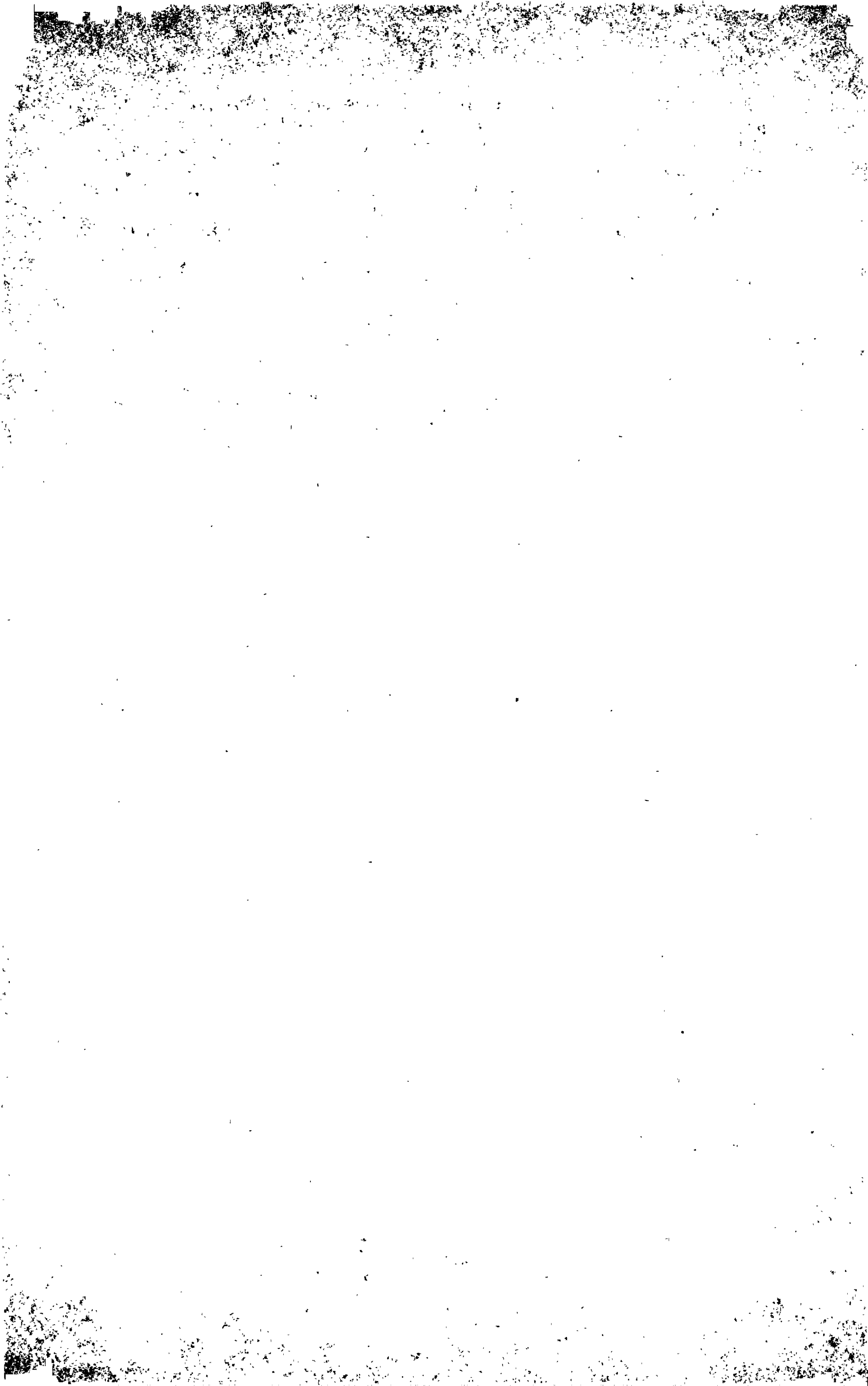
The CHAIRMAN. Thank you.
Senator Moynihan.
Senator MOYNIHAN. I just want to thank you, Mr. Chairman, for this enormously helpful hearing. You cannot imagine how helpful you are to us. You come in here and teach us and put up with us.
The CHAIRMAN. It is not easy.
Senator MOYNIHAN. It is not easy.
Just one general question. Am I right in thinking that the index number theory has made some very considerable advances in recent years and we are getting a hold on it that was rather tentative, say, 30 years ago. Dr. Auerbach?
Dr. AUERBACH. Well, I am not sure it is simply the theory. The theory has been developing over the years. I think it is as much the application.
Senator MOYNIHAN. All right.
Dr. AUERBACH. The fact is that we can do a better job of measuring increases in the cost of living than we did in the past.
Senator MOYNIHAN. Right. And you were talking about indexing art. You can imagine how to do that now. I mean, I can remember a time—perhaps age is showing—when the Bureau of Labor Statistics would announce the monthly unemployment rate, and instantly the AFL–CIO would say it is too low, and the Chamber of Commerce would say it is too high, and nobody believed it.
We had very elaborate committee structures to figure this out, because sampling was new. I think our first unemployment rate was 1948. We used to take the unemployment rate with the Census. We took it in April 1930 and April 1940, and there was no Depression. But there are advances in theory and practice which make things possible that previously were not. Would you like to comment, Mr. Bloomfield?
Mr. BLOOMFIELD. Yes. I would agree. I do not know if you remember Jim Wexler, when he was here.
Senator MOYNIHAN. Yes, sir.
Mr. BLOOMFIELD. Jim Wexler and Mr. Archer obviously crafted a wonderful indexing proposal for capital gains. I do not know if you remember Eddie Cohen. Eddie Cohen, one of our best lawyers who wanted everything perfect, had some concerns about whether it would work or not. Of course, the answer is, you do your best bet, and then later on you fix it.
So, obviously you have to draw lines, as the Senator was saying. But I think it is fundamentally a policy decision about whether you want to go that route on capital gains and/or address the concerns that many raise about just indexing that part of capital assets and only those capital assets.
Senator MOYNIHAN. We can agree, can we not, that setting an index number is not setting an atomic weight or the speed of light, you do it once and it is done. I mean, it is a judgment within a range of high probabilities.
Mr. BLOOMFIELD. Senator, can I just add one thing. I read about your comments on IRAs that got some press in various places. The only thing I would suggest is that a capital gains tax cut really is a free lunch.
Senator MOYNIHAN. All right.

Mr. BLOOMFIELD. You do not increase the deficit. It has some marginal positive impacts. For example, under DRI you would have $50 billion more in GDP in the year 2002, and I would take a finders fee and collect that, gladly.

Senator MOYNIHAN. I think that is a nice note on which to end. Thank you both, gentlemen, very much.

The CHAIRMAN. Yes. We appreciate your very helpful testimony. The committee is in recess.

[Whereupon, at 11:47 a.m., the hearing was concluded.]



APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Alan J. Auerbach

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University of California, Berkeley

March 13, 1997

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to give my views about the probable effects of reducing the capital gains tax. At present, there are many proposals under consideration that would alter the tax treatment of capital gains. Some of the proposed changes target particular kinds of capital, such as those that provide more favorable treatment of gains and losses on owner-occupied housing or small-business equity investment. Other changes would apply to capital assets more generally, increasing the exclusion of gains, indexing gains for inflation, or both. In my testimony, I will touch on each of the different approaches and consider their relative merits, focusing on provisions that affect individual taxpayers.

At the outset, it is important to point out that capital gains already receive favorable tax treatment under a variety of provisions. First, gains generally are taxed only upon realization, which provides a deferral advantage. Second, gains on capital assets escape taxation permanently at death -- a benefit not provided other assets with deferred tax liabilities, such as Individual Retirement Accounts. Third, long-term gains are taxed at a maximum rate of 28 percent, which is substantially

below the marginal income tax rates to which they would be subject as ordinary income. Fourth, gains on owner-occupied housing may be rolled over if a house of at least equal value is purchased within two years, and receive a one-time exclusion of up to 125 thousand dollars once an owner reaches age 55. Fifth, since 1993, qualifying gains on small business equity receive a 50 percent exclusion.

Thus, the question is not whether capital gains *should* receive favorable tax treatment -- they already do. Rather, we must ask whether this treatment should be more favorable than it is now. More importantly, we must ask whether a piecemeal approach to lowering capital income taxes, whether through broad-based capital gains tax reductions or targeted reductions for housing or small businesses, is better than a more comprehensive change, such as a shift from income taxation to consumption taxation as the primary source of federal revenue.

My general conclusion is that capital gains tax reductions, particularly those that are broad-based and retroactive (rather than prospective) are a poor tool for achieving what I take to be their main goal, encouraging saving and capital formation. Let me stress that my difficulty is not with the goal of encouraging saving; there is good reason to be concerned about the very low U.S. national saving rate. The problem is that capital gains tax reductions will not induce significantly more saving. There is *no* empirical evidence that saving would increase, and compelling theoretical support for the belief that capital gains tax reductions might reduce saving and increase consumption.

Broad-Based Capital Gains Tax Reductions

There are several arguments offered for broad-based reductions in capital gains but, as I will explain, I find them generally unconvincing.

Revenue Effects

A capital gains tax reduction would lessen the distortion of the "lock-in" effect that discourages investors from realizing their capital gains. As a result, it would lead to more frequent turnover of capital assets and hence more capital gains being taxed. Some argue that the increased tax base would more than offset the reduced tax rate, leading to increased revenue. Unfortunately, there is little empirical support for this argument.

While there is convincing evidence that investors time their capital gains realizations to take advantage of lower tax rates -- as they did at the end of 1986 to avoid the impending tax increase -- there is no evidence that realizations increase permanently by enough to raise revenues in the long run. Indeed, as I have illustrated in previous research, such a long-run increase in realizations would require an implausible speeding up of transactions and reduction in assets passed through estates.[1] The most recent studies of investor behavior confirm that, while realizations are extremely sensitive to temporary tax rate variations, they are far less responsive to more permanent ones -- not nearly responsive enough to raise revenues.[2] Hence, cuts in capital gains taxes do lower tax revenue, and must produce other social benefits to offset the revenue loss.

Increased Capital Formation

Proponents argue that capital gains tax reductions will lead to more capital formation and, as a result, generate further revenue gains as well as more saving. However, while reductions in

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[1]Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," National Tax Journal 42, September 1989, 391-401.

[2]Leonard E. Burman and William C. Randolph, "Measuring Permanent Responses to Capital-Gains Tax Changes in Panel Data," American Economic Review 84, September 1994, 794-809.

capital gains taxes (or other taxes on capital income) lower the cost of capital, thereby encouraging saving -- through what economists call the "substitution effect" -- they affect saving in a second way as well. By raising the after-tax income of households -- through what is known as the "income effect" -- capital income tax reductions encourage consumption. Saving will increase only if the first effect outweighs the former. A retroactive capital gains tax reduction, like the one being proposed, provides large additional windfalls to the owners of existing assets. Such windfalls are an additional spur toward increased consumption and reduced saving.

At best, the impact of a capital gains tax reduction on the incentive to save will be relatively small. There are several factors that attenuate its effect. First, since capital gains already receive favorable tax treatment (they are taxed only upon realization at a maximum of 28 percent and are not taxed if transferred through an estate), the effect of a new rate reduction would be muted. Given my past estimates of the advantages of deferral and basis step-up at death[3], the current 28 percent maximum rate translates into an effective rate of about 10 percent. Based on the same assumption, the introduction of a 50 percent exclusion would reduce this to about 7 percent, yielding a roughly 3 percentage point reduction in the effective tax rate on capital gains. Capital gains taxes primarily affect the cost of equity-financed investment, to the extent that equity returns are received in the form of capital gains and are received by taxable investors. As a rough estimate, if 1) two-thirds of all finance is through equity, 2) half of all equity returns are in the form of capital gains, and 3) three-fourths of all equity is held in taxable form (rather than through pension funds and other tax-exempt entities), then the effective tax rate reduction is itself reduced by a factor of three-fourths,

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[3]Alan J. Auerbach, "Capital Gains Taxation and Tax Reform," Op. Cit.

to about .8 percentage points. For a nominal, before-tax rate of return of 10 percent, this would provide an increase of at most 8 basis points in the rate of return to saving, if none of the benefit of the tax reduction were passed on to businesses in the form of a lower before-tax return. To the extent that the before-tax return fell, the increase in the after-tax rate of return would be even smaller.

Even if savers did receive the full benefit of the tax reduction and increased their saving in response, the resulting increase in output over time would be quite modest. As the appendix to this testimony shows, the increase in output after five years might be perhaps 1.4 billion dollars -- a rise in GDP of .02 percent. The logic is straightforward: a small increase in the after-tax rate of return leads to a small increase in saving, and an even smaller increase in output. Based on this calculation, I believe that a reduction in the capital gains tax would not increase output more than a modest amount. In fact, the calculation probably overstates the output increase that actually would occur, for two reasons.

First, any increase in saving that does occur will be attenuated by the presence of foreign investors who do not benefit from a reduction in capital gains taxes. Additional saving by domestic investors, to the extent that it drives down the available rate of return to foreign investors, will "crowd out" foreign sources of funds for domestic capital investment. The more open is the U.S. economy, the less impact a tax incentive based on the domestic supply of saving will have on the level of domestic investment.

Second, and perhaps even more important, domestic saving is likely to increase by even less than the small amount indicated above, and perhaps even decline. In addition to its increase in the incentive to save, a retroactive tax cut on prior appreciation of existing assets bestows a windfall that will increase consumption. Roughly speaking, the size of this windfall equals the reduction in the

effective capital gains rate, again about 3 percentage points, times the total current value of unrealized gains held by taxable domestic investors. The extra consumption this windfall generates will offset the small reduction in consumer spending potentially induced by the rise in the after-tax rate of return. Also, the elimination of the lock-in effect may in itself reduce personal saving, as those investors whose wealth is tied up in appreciated assets will suffer a smaller penalty from selling those assets for the purpose of consumption.[4]

Thus, as currently structured, the capital gains tax reform would increase capital formation and output by at most a very small amount, and even has the potential to increase consumption and reduce saving. This unfavorable outcome could be mitigated somewhat by reducing the windfall to existing assets. One move in this direction would be to require sale or constructive realization of existing assets in order to qualify for any indexing or rate reduction. This provision would have the additional benefit of increasing realizations and tax revenues in the short run.

Promoting Venture Capital Investment

An argument often made in favor of reductions in capital gains taxes is that they are needed to promote investment in risky enterprises and new businesses that yield much of their return in the form of capital gains. However, venture capital represents a minute fraction of the assets that would typically qualify for long-term capital gains tax treatment. Thus, the venture capital argument does not apply to broad-based changes in capital gains taxation. Moreover, a provision targeted precisely toward this objective is already in force: the Omnibus Budget Reconciliation Act of 1993 introduced

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[4]See Alan J. Auerbach, "On the Design and Reform of Capital Gains Taxation," American Economic Review 82, May 1992, 263-267.

a 50 percent exclusion for newly issued equity in small businesses. Adjustments to the 1993 provisions to increase their scope and coverage might deserve consideration, pending an evaluation of the impact of the 1993 changes themselves.

Insulating Gains from Inflation

The tax system generally measures income on a nominal basis, ignoring the fact that some returns merely compensate asset owners for a decline in the real value of their assets due to inflation. This distorts the measurement of income and raises the effective tax rate on asset returns. While a capital gains exclusion has sometimes been justified to compensate for this overtaxation, this is not the best way to alleviate the distortion of nominal taxation. A simple exclusion cannot account for differences among assets in the extent to which inflation has contributed to gains, even if the rate of exclusion is allowed to vary with respect to holding period. Further, if one did attempt to base the level of exclusion on holding period to compensate for inflation, then (for a constant rate of return and a constant inflation rate) the appropriate exclusion would *fall* with the length of holding period, in contrast to various proposals that would increase the exclusion with holding-period length.

While basis indexing is the right way to protect capital gains from inflation, there is no reason to single out this one form of capital income when indexing. Since capital gains already receive favorable tax treatment, the inflation tax weighs less heavily on them than on the return to fully taxed capital income such as payments on interest-bearing assets. Failure to index interest not only leaves out an important class of assets, but also keeps in place the *benefits* that inflation provides to interest deductions. Given that borrowers are likely to be in higher tax brackets than lenders, this means that, under the indexing provisions, borrowing to invest in capital assets will

actually be encouraged by higher inflation. While indexing is desirable, I see no justification for limiting it to capital gains, particularly when capital gains are already tax-favored and about to become more so. We should remember that, like an exclusion, indexing acts to reduce the portion of nominal capital gains subject to tax.

Capital Gains on Owner-Occupied Housing

Owner-occupied housing already receives very favorable tax treatment relative to other capital investments. Homeowners are exempt from all tax on the imputed rent from their dwellings, even though they can deduct mortgage interest and property taxes. Only a few percent of capital gains realized on the sales of homes are ever taxed, as a result of the rollover and one-time exclusion provisons already discussed. At first blush, then, it makes little sense to argue for further tax benefits for housing. Certainly, encouraging investment in housing won't help reallocate capital to socially more productive assets. But, with so little revenue at stake, the benefits of eliminating the distortions of current law might justify the policy nonetheless.

At present, a homeowner is supposed to file a special form each time a house is sold, and, in principle, keep records from each house sale in order to justify the basis being carried over from one house to the next. But given that few gains on housing ultimately are taxed (because of the rollover and one-time exclusion and also the general step-up in basis at death), we could save taxpayers considerable compliance costs with relatively little revenue loss. Such a change is better thought of as a technical correction to the tax system than as a significant change in policy.

Another proposed change in the tax treatment of housing makes less sense, in the current environment. Given that such a small share of housing capital gains are subject to tax, it is hard to

support an argument for allowing an immediate deduction for capital losses on housing without also moving to more complete taxation of housing capital gains.

Can't We Do Better?

The analysis above suggests that a broad-based, retroactive reduction in capital gains taxes is a poor policy tool for stimulating economic growth. Indeed, I have argued that such a policy might encourage consumption rather than saving. There are two directions in which one could move to improve the proposed change in policy. One would be to modify the capital gains reduction so that it performs better. The other would be to turn to alternatives.

If the choice is among competing capital gains proposals, then a first step to provide a stronger incentive to save is to eliminate the large windfalls associated with retroactive capital gains reductions. There is no justification for providing such windfalls. Targeting venture capital or a more specific class of investments might represent as second step, although one would have to make the case that the targeted provisions introduced in 1993 are inadequate. Beyond these two modifications, eliminating the current practice of taxing gains only upon realization and not at all if transferred through an estate could sharply reduce the lock-in effect that represents one of the significant problems with the current treatment of capital gains.

An alternative approach to encouraging saving, of course, would be to shift the tax base from income to consumption. I have testified before this committee on the subject of one such approach, the Flat Tax.[5] While there are considerable transition problems to be overcome in moving

[5] "Flat Taxes: Some Economic Considerations," Testimony before the Committee on Finance, April 5, 1995.

successfully to a consumption tax, such a policy could encourage saving and has the potential to eliminate many of the difficulties of the current tax system, as typified by the treatment of capital gains.

Appendix: The Possible Output Effects of Capital Gains Tax Reductions

Suppose a capital gains tax reduction raises the rate of return to saving by 8 basis points. For a real, after-tax return of 4 percent, this amounts to a 2 percent increase in the after-tax return to saving, which will raise output to the extent that it leads to more capital accumulation.

For an elasticity of net private saving with respect to the after-tax return equal to .4, a value generally viewed by economists as at the very high end of plausible estimates, a 2 percent increase in the real return to saving translates into a .8 percent increase in private saving, or roughly 3.6 billion dollars a year. After five years of such investment, the capital stock would be higher by about 18 billion dollars. For a real, before-tax return of 8 percent, this would increase GDP after five years by about 1.4 billion dollars -- roughly .02 percent of GDP.

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AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Mark Bloomfield, President
American Council for Capital Formation
before the Committee on Finance of the United States Senate
March 13, 1997

Executive Summary

1. **OVERVIEW.** We commend the emphasis Chairman Roth has placed on the impact of capital gains taxation on the cost of capital, saving and investment, and economic growth. A capital gains tax cut will, if enacted, help reduce the burden on capital formation imposed by current U.S. tax policy.

2. **TRENDS IN U.S. CAPITAL FORMATION.** Slow growth in the United States over the past two decades can be partly attributed to low levels of investment. A recent international comparison by the World Bank suggests that countries with high levels of investment grow faster than countries with relatively low levels of investment.

3. **TAX POLICY AND ECONOMIC GROWTH.** To those who favor a truly "level playing field" over time to encourage individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and by many mainstream economists today.

4. **CAPITAL GAINS ISSUES RAISED BY THE FINANCE COMMITTEE.**

- Macroeconomic Impact of Capital Gains Tax Reductions: According to authoritative economic studies, substantial reductions in capital gains taxes for individuals and corporations would increase jobs and economic growth, encourage entrepreneurship, promote U.S. saving and investment, and raise federal tax receipts.
- Indexing Capital Assets for Inflation: Indexing would provide an exact adjustment for the effects of inflation, provide an incentive for entrepreneurship, help protect small investors and homeowners, and reduce the cost of capital. However, it would make the current tax system more complex.
- Sliding Scale Capital Gains Tax Reduction: A sliding scale for capital gains would help increase the after-tax rate of return on investment, reduce the cost of capital somewhat, and help offset the impact of inflation on capital gains. However, it would have a smaller impact on capital costs than would a single rate for capital gains.
- Broad-Based Capital Gains Tax Reductions: A broad-based capital gains tax reduction would have a more powerful impact on the cost of capital and on the efficiency with which capital markets operate than would a targeted approach.

5. **CONCLUSION.** A soundly structured, broad-based cut in tax rates on capital gains would significantly benefit all Americans. By reducing the cost of capital, it would promote the type of productive business investment that fosters growth in output and high-paying jobs. By increasing the mobility of capital, it would help assure that scarce saving is used in the most productive manner. By raising capital values, it would help support values in capital asset markets in general and the stock market in particular. By increasing the availability and lowering the cost of capital, it would aid entrepreneurs in their vital efforts to keep the United States ahead in technological advances and translate those advances into products and services that people need and want. By reducing taxes on their savings, it would treat fairly those thrifty Americans who must bear a heavier tax burden than the profligate. And, because of the combined impacts of unlocking and macroeconomic feedback, a broad-based capital gains tax cut is likely to increase federal revenues.

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March 13, 1997

Introduction

My name is Mark Bloomfield. I am president of the American Council for Capital Formation (ACCF). I am accompanied by Dr. Margo Thorning, our senior vice president and chief economist.

The ACCF represents a broad cross section of the American business community, including the manufacturing and financial sectors, Fortune 500 companies and smaller firms, investors, and associations from all sectors of the economy. Our distinguished board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders, and public finance experts.

The American Council for Capital Formation has led the private-sector "Capital Gains Coalition" since 1978, when the first major post-World War II capital gains tax cut was enacted. The Coalition brings together in support of capital gains tax relief diverse participants from all sectors of the business community—venture capital, growth companies, timber, farmers, ranchers, small business, real estate, securities firms, and the banking and insurance industries.

This testimony begins with a discussion of trends in U.S. capital formation and productivity growth, and the impact of tax policy on economic growth. Then we specifically address the issues raised by this Committee:

- The macroeconomic effects of capital gains tax reductions;
- The effect of indexing capital assets for inflation;
- The sliding scale approach to capital gains tax rate reduction; and
- Broad-based versus targeted capital gains tax reductions.

We conclude our testimony by setting forth three criteria that a good capital gains tax cut should meet: it should make economic sense; it should be fair; and it should be fiscally responsible.

We commend the emphasis that Chairman Roth has placed on the impact of capital gains taxation on the cost of capital, saving and investment, and economic growth. A capital gains tax cut will, if enacted, help reduce the burdens on capital formation imposed by current U.S. tax policy. That tax policy must be revised if real wages for U.S. workers are to increase, living

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standards are to advance at a faster pace, and the United States is to maintain the economic strength necessary to sustain its leading role in world affairs.

Trends in U.S. Capital Formation, Productivity Increases, and Economic Growth

Slow growth in the United States over the past twenty years can be partly attributed to low levels of investment. A recent international comparison by the World Bank suggests that countries with high levels of investment experience faster growth than countries with relatively low levels of investment. This relationship is clearly demonstrated in Table 1 and Figure 1. International comparisons aside, even more disturbing is the fact that net annual business investment in this country has in recent years fallen to only half the level of the 1960s and 1970s. As shown in Table 2, that rate dropped from an average of 8.9 percent of GDP in the 1960s and 1970s to 4.8 percent in the 1990s.

Harvard Professor Dale W. Jorgenson, one of the nation's foremost public finance economists, emphasizes the overwhelming importance of investment in plant and equipment for economic growth in his recent volume, *Productivity—Postwar U.S. Economic Growth*. Professor Jorgenson's study analyzes economic growth between peaks in the business cycle over the 1948-79 period. Allocating increases in output to three sources—growth in the capital stock, labor supply, and multifactor productivity—he found that increases in the capital stock had the strongest impact on growth in output.

Studies by University of California Professor J. Bradford De Long and Deputy Secretary of the Treasury Lawrence H. Summers also conclude that investment in equipment is perhaps the single most important factor in economic growth and development. Their research provides strong evidence that, for a broad cross section of nations, every one percent of GDP invested in equipment is associated with an increase in the GDP growth rate itself of one-third of one percent, a very substantial social rate of return.

Tax Policy and Economic Growth

To those who favor a truly "level playing field" over time to encourage individual and business decisions to save and invest, stimulate economic growth, and create new and better jobs, capital gains (and other forms of saving) should not be taxed at all. This view was held by top economists in the past and is held by many mainstream economists today.

This is primarily because the income tax hits saving more than once—first when income is earned and again when interest and dividends on the investment financed by saving are received, or when capital gains from the investment are realized. The playing field is tilted away from saving and investment because the individual or company that saves and invests pays more taxes over time than if all income were consumed and no saving took place. Taxes on income that is saved raise the capital cost of new productive investment for both individuals and corporations, thus dampening such investment. As a result, future growth in output and living standards is impaired.

A consumption-based tax system, under which all saving and investment would be exempt from tax, would be more favorable toward capital formation and economic growth than is our current income tax system, according to analyses by top public finance scholars over the past decade and a half. Studies by Stanford University's John Shoven and Lawrence Goulder, Harvard's Dale Jorgenson, the University of Texas' Don Fullerton, and Joel Prakken of Macroeconomic Advisers have used macroeconomic models that incorporate "feedback" and dynamic effects in simulating the impact of adopting a consumption tax as a full or partial replacement for the income tax. These studies, which use different types of general equilibrium models, conclude that U.S. economic growth would be enhanced if we relied more on consumption taxes, or replaced the income tax with a fundamental tax restructuring plan similar to those proposed by several prominent members of the U.S. Senate and House of Representatives in recent years.

In addition, at a recent forum on dynamic revenue estimating sponsored by the Joint Committee on Taxation, the majority of the economic modelers concluded that if the United States switched from the existing income tax to a broad-based consumption tax, the rate of economic growth would increase significantly.

Macroeconomic Impact of Capital Gains Tax Reductions

In their search for methods of stimulating saving, investment, and economic growth, policymakers should give strong consideration to lightening the tax burden on investment through a significant capital gains tax reduction.

Low capital gains taxes not only treat savers more fairly but also help hold down capital costs. Public finance economists refer to the tax on capital gains as a tax on retained income. It is retained income that funds a large part of business investment. The higher the capital gains tax, the more difficult it is for management to retain earnings (rather than pay out dividends) for real investment in productive projects.

Although the short-term outlook for the U.S. economy is favorable, worries about the future appear to be multiplying. For example, many public finance experts such as Professor John Shoven conclude that this country's long-term strength and economic stability depend on increasing saving and investment to ensure that the retirement of the baby boom generation does not sink the economy into a sea of red ink. A cut in the capital gains tax to a top marginal rate of 15 to 20 percent would by no means act as an economic panacea. However, it would surely help encourage saving, help maintain the values of capital assets (e.g. real estate and stocks), promote investment by both mature and new businesses, and more fairly tax individual savings.

Substantial reductions in capital gains taxes for individuals and corporations would have important economy-wide consequences:

- **Increase Jobs and Economic Growth**

Dr. Allen Sinai, president and chief global economist at Primark Decision Economics and a highly respected economic forecaster, will provide the results of his new capital gains tax analysis in his testimony today. I expect that his new study will demonstrate, as did earlier research, the highly beneficial impact of a significant capital gains tax rate reduction for the economy.

In addition, a new study by the prominent economic analysis firm DRI/McGraw-Hill (DRI) concludes that S. 66, a broad-based capital gains tax proposal introduced by Senators Hatch, Grassley, Breaux, and Lieberman, would have a beneficial impact on the U.S. economy. S. 66 would provide a 50 percent exclusion for individuals, a 25 percent corporate capital gains tax rate, capital loss treatment for the sale of a residence, and a targeted incentive for investment in certain small businesses. DRI concludes that S. 66 would reduce the cost of capital (defined as the pretax return required by investors) by three percent and increase investment, GDP, and productivity growth (see Table 3).

Reduced capital costs lower the "hurdle rate" for new business investment and induce increases in the rate of growth of capital formation, investment, productivity, GDP, and employment. Lower capital gains taxes support the value of equities as well as other capital assets. A capital gains tax reduction would also tend to shift the financing of business activity from debt to equity, and induce portfolio allocations by households toward equity to take account of changes in expected after-tax returns on stocks and bonds.

- **Benefit Middle-Class Taxpayers**

Investments in capital assets are widely held by the middle class. According to data compiled by the Investment Company Institute, almost 60 percent of households with income of $50,000 or less own mutual funds. A 1996 Congressional Budget Office (CBO) draft report also documents the widespread ownership of capital assets among middle-income taxpayers. According to the CBO report, in 1989 31 percent of families whose incomes were under $20,000 held capital assets (not including personal residences) and 54 percent with income between $20,000 and $50,000 held capital assets.

Middle- and low-income taxpayers also hold a significant share of the total dollar value of capital assets, even when personal residences are excluded. The CBO study shows that 30 percent of the dollar value of such assets (excluding housing) was held by families with incomes of $50,000 or less in 1989.

- **Encourage Entrepreneurship**

Capital gains taxation has a particularly powerful impact on this nation's entrepreneurs. These individuals are a major driving force for technological breakthroughs, new start-up companies, and the creation of high-paying jobs. Starting new businesses involves not only

entrepreneurs but also informal investors, venture capital pools, and a healthy public market. All taxable participants are sensitive to after-tax rates of return, which is why the level of capital gains taxation is so important.

Foremost is the entrepreneur. If the tax on potential capital gains is a higher rate, either the pool of qualified entrepreneurs will decline or taxable investors will have to accept a lower rate of return. In either case, the implications for the U.S. economy are clearly negative. To be successful, the entrepreneur needs capital. Fledgling start-ups depend heavily on equity financing from family, friends, and other informal sources. Professors William Wetzel and John Freear of the University of New Hampshire, in a survey of 284 new companies undertaken in the late 1980s, found taxable individuals to be the major source of funds for those raising $500,000 or less at a time. The point to be stressed is that individuals providing start-up capital for these new companies pay capital gains taxes and are sensitive to the capital gains tax rate.

Small businesses and entrepreneurs face higher capital costs than Fortune 500 companies. For them, a significant capital gains tax differential can make a big difference in their decisions affecting jobs and growth.

- **Raise Tax Receipts**

Critics of lower capital gains taxes argue that such cuts will reduce federal revenues and thus add to the budget deficit, absorb national saving, and raise interest rates and capital costs. Both economic analysis and experience effectively refute this view.

Scholars have researched and debated two elements affecting capital gains tax revenues, the "unlocking" of unrealized gains and the macroeconomic impact of a low tax on capital gains.

Revenue estimates used in congressional and Treasury Department analyses ignore macroeconomic impacts but do incorporate an "unlocking" or "behavioral" response on the part of taxpayers to changes in capital gains tax rates. Estimates of unlocking are extremely sensitive to assumptions about the elasticity of taxpayer response. Very minor differences in assumptions can result in large differences in expected revenues.

In the late 1980s, experts at the prestigious National Bureau of Economic Research (NBER) examined the question of the revenue-maximizing capital gains tax rate: At what point is there sufficient "unlocking" to compensate for the "static" revenue loss resulting from a reduction in the tax? The NBER study by former Harvard Professor Lawrence Lindsey (a recently retired member of the Board of Governors of the Federal Reserve), which was based on academic models of the responsiveness of taxpayers to changes in the capital gains tax rates, found that the revenue-maximizing rate ranged between 9 and 21 percent. The NBER study did not take into account the additional revenue stemming from the positive macro consequences of increased employment and growth which result from a significant reduction in capital gains tax rates.

Although government revenue estimates do not factor in the macroeconomic consequences

of lower capital gains tax rates on U.S. capital costs, investment, and economic growth, previous research indicates these effects can have a favorable impact on overall tax revenues. In addition, the new dynamic analysis by DRI shows that the government would gain revenue from the capital gains tax reductions in S. 66 (see Table 3).

Actual experience also indicates that lower capital gains taxes have a positive impact on federal revenues. The most impressive evidence involves the period from 1978 to 1985. During those years the top marginal federal tax rate on capital gains was cut almost in half—from 35 percent to 20 percent—but total individual capital gains tax receipts nearly tripled, from $9.1 billion to $26.5 billion annually.

- **Promote U.S. Saving and Investment**

Our international competitors recognize the contribution a lower capital gains tax rate can make in promoting capital formation, entrepreneurship, and new job creation. The United States, on the other hand, taxes capital gains more harshly than almost any other industrial nation. A survey by the OECD of twelve industrialized countries shows that the U.S. capital gains tax rate on long-term gains on portfolio securities exceeds that of all countries except Australia and the United Kingdom, and these two countries index the cost basis of an asset (see Table 4). Germany, Japan, and South Korea exempt or tax only lightly capital gains on portfolio stock. Not only do virtually all industrialized as well as developing countries tax individual capital gains at lower rates than the United States, they also accord more favorable treatment to corporate capital gains (see Figure 2).

It is important to note that most of the countries shown in Table 1 have had higher rates of investment as a percentage of GDP than the United States over the past two decades. This fact may in part reflect the encouragement of saving and investment due to their lower capital gains tax rates.

Other Capital Gains Tax Policy Issues

- **Indexing Capital Assets for Inflation**

Some of the capital gains reform bills introduced in the 105th Congress index the cost basis of assets for inflation. For example, if an asset were purchased five years ago for $1,000, and prices increased by 25 percent since then, the purchasing power of the original $1,000 is equivalent to $1,250 in current dollars. Indexing would adjust the basis upward by 25 percent to $1,250, and any gain or loss would be reckoned relative to the inflated basis. As a CBO report notes, the benefits of indexing include:

- Providing an exact adjustment for the effects of inflation;
- Providing an incentive for entrepreneurship and risk-taking (in part by sheltering investors from the risk of inflation);
- Helping to protect small investors and homeowners;

- **Reducing the cost of capital and the double tax on corporate equity and encouraging dividend distributions.**

These advantages make indexing of capital gains a worthwhile goal. However, it should be noted that indexing would also make the current tax system more complex. In addition, indexing alone would not reduce the cost of capital as significantly as would a substantial reduction in capital gains tax rates.

- **Sliding Scale Capital Gains Tax Reduction**

Some of the capital gains tax reform proposals reduce the tax rate for individuals according to the length of time the asset is held. This type of reform would help increase the after-tax rate of return on investment, reduce the cost of capital to some extent, and help offset the impact of inflation on capital gains. However, the sliding scale concept has a much smaller impact on capital costs than would a single tax rate for capital gains (with the current law one-year holding period) because the full rate reduction under a sliding scale would be delayed until some point in the future. In addition, there is a real question as to whether the after-tax rate of return on long-term investments should exceed that of short-term investments, many of which produce relatively high social rates of return.

- **Broad-Based Versus Targeted Capital Gains Tax Reductions**

A broad-based capital gains tax cut that includes all capital assets will have a more powerful impact on the cost of capital and on the efficiency with which capital markets operate than would a targeted approach. Although it would have beneficial effects, a targeted approach, whether limited to assets of small firms or to taxpayers in certain income classes, would not produce the significant macroeconomic impacts of a broad-based capital gains tax reduction shown in the DRI study and is unfair to holders of ineligible assets. With its lagging investment and slow productivity growth, the United States should adopt a capital gains tax reduction that will have the greatest impact in terms of unlocking old capital and stimulating new investment.

Conclusion

A soundly structured, broad-based cut in tax rates on capital gains would significantly benefit all Americans. By reducing the cost of capital, it would promote the type of productive business investment that fosters growth in output and high-paying jobs. By increasing the mobility of capital, it would help assure that scarce saving is used in the most productive manner. By raising capital values, it would help support values in capital asset markets in general and the stock market in particular. By increasing the availability and lowering the cost of risk capital, it would aid entrepreneurs in their vital efforts to keep the United States ahead in technological advances and translate these technological advances into products and services that people need and want. By reducing taxes on their savings, it would treat fairly those thrifty Americans who must bear a heavier tax burden than the profligate. And, because of the combined impacts of unlocking and macroeconomic feedback, a broad-based capital gains tax cut could increase federal revenues.

Mr. Chairman, the case for an early broad-based cut in capital gains tax rates is exceedingly strong. We urge this Committee and both Houses of Congress to enact such legislation at the earliest feasible time.

Table 1 Investment and Saving as a Percent of GNP and Real GNP Growth, 1974–1993

Country	Gross Domestic Saving	Gross Domestic Investment	Average Annual Real GNP Growth
South Korea	30.7	32.0	11.4
Singapore	40.0	41.8	7.6
Thailand	27.3	31.2	7.5
Hong Kong	30.4	28.6	7.3
Malaysia	34.9	31.7	6.8
Japan	32.3	30.9	3.6
Norway	30.0	27.7	3.5
Switzerland	24.9	24.0	3.1
Australia	23.2	24.3	2.7
Canada	23.5	22.7	2.7
Germany	23.7	21.0	2.6
United States	17.5	18.8	2.3
France	22.1	22.0	2.0
United Kingdom	17.4	18.1	1.6
Denmark	20.7	19.5	1.6

Source: The World Bank, *World Tables 1995* (Baltimore: The Johns Hopkins University Press).

Table 2 Flow of U.S. Net Saving and Investment (percent of GDP in current $; national account basis)

	Average 1960–1980	Average 1981–1985	Average 1986–1990	Average 1991–1996***
Net Private Domestic Saving	8.1%	7.3%	5.3%	5.3%
State and Local Government Surpluses	2.1%	1.9%	1.8%	1.4%
Subtotal of Private and State Saving	10.2%	9.2%	7.1%	6.7%
Less: Federal Budget Deficit	-0.8%	-3.8%	-2.8%	-3.1%
Net Domestic Saving Available for Private Investment	9.3%	5.4%	4.3%	3.6%
Net Inflow of Foreign Saving*	-0.4%	1.2%	2.4%	1.3%
Net Private Domestic Investment	8.9%	6.7%	6.7%	4.8%
Gross Private Domestic Investment	16.0%	16.9%	15.4%	13.7%
Nonresidential Fixed Investment	10.4%	12.2%	10.5%	9.6%
Producers' Durable Equipment	6.6%	7.4%	6.9%	6.8%
Industrial Equipment	1.9%	1.8%	1.6%	1.6%
Producers' Durable Equipment Less Info. Processing and Related Equipment	5.2%	5.0%	4.6%	4.5%
Personal Saving	5.4%	5.7%	3.8%	3.6%
Net Business Saving**	2.7%	1.6%	1.5%	1.7%

*In the 1960–80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.
**Net Business Saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.
***Includes only first, second, and third quarter figures for 1996.

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts.
Update prepared by American Council for Capital Formation Center for Policy Research, February 1997.

Table 3 Cumulative Impact of Tax Reductions in S. 66

	Total 1998–2007
Real GDP (billions of $)	$120
Real capital spending (billions of $)	
Total equipment	$27
Total fixed investment	$36
Capital stock (% difference)	1.1
Output per hour (% difference) (productivity increase)	0.4
Cost of capital (% difference) (pretax return required by an investor)	-3.0
Total federal tax receipts (billions of current $)	$12.0

Source: DRI/McGraw-Hill, March 1997

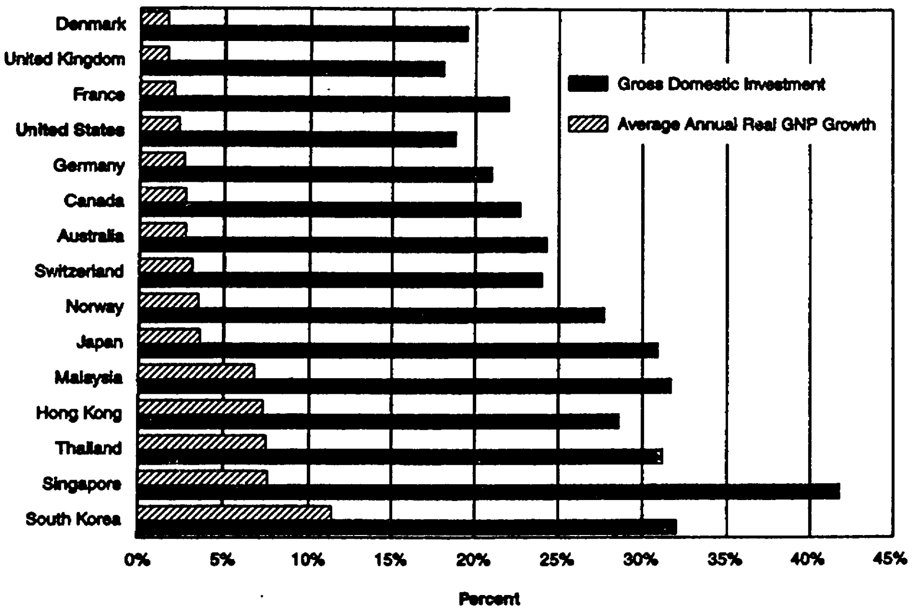
Table 4 International Comparison of Capital Gains Taxes and Personal Saving Rates

Country	Capital Gains Maximum Individual Tax Rate[1]		Personal Saving Rate[2]
	Short-term	Long-term	1975-1994
United States	39.6%	28%	6.4%
Japan	1% of sale price or 20% of net gain	1% of sale price or 20% of net gain	17.0%
Australia	48.3%	48.3%; asset cost is indexed	8.4%
Belgium	Exempt	Exempt	18.0%
Canada	23.80%	23.80%	11.9%
France	18.1%	18.1%	15.3%
Germany	53.0%	Exempt	12.6%
Hong Kong	Exempt	Exempt	N/A
Italy	25.0%	25.0%	20.7%
Netherlands	Exempt	Exempt	2.4%
Sweden	25.0%	25.0%	2.7%
United Kingdom	40%; asset cost is indexed	40%; asset cost is indexed	10.3%

1 Reflects top marginal rates on portfolio securities gains.
2 Organization for Economic Cooperation and Development. Net household saving as a percent of disposable income. *OECD Economic Outlook 57*, June 1995, Annex Table 26, p. A-29.

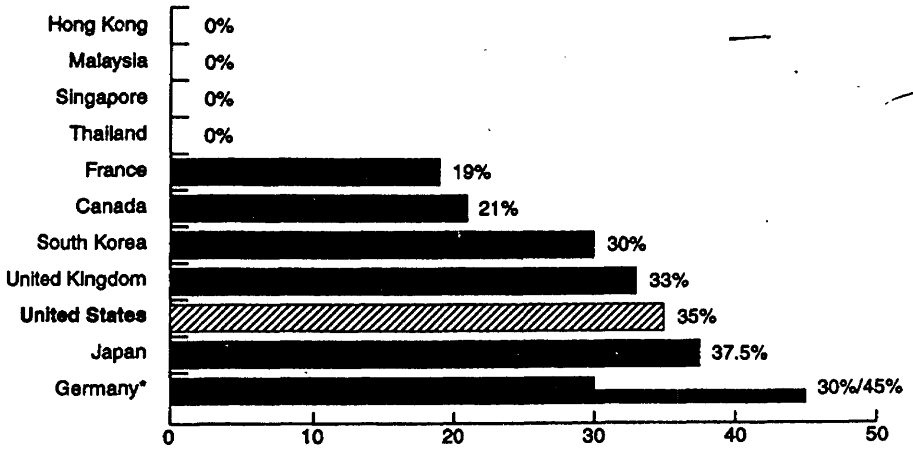
Prepared by the ACCF Center for Policy Research.

Figure 1 Investment as a Percent of GNP and Real GNP Growth, 1974–1993



Source: The World Bank, *World Tables 1995* (Baltimore: The Johns Hopkins University Press).

Figure 2 Corporate Capital Gains Tax Rates, 1996



Note: Gains are for portfolio securities.

* For Germany, the 30 percent rate applies to gains distributed to stockholders; the 45 percent rate applies to undistributed gains. In the United Kingdom, assets are indexed for inflation.

Source: Price Waterhouse, *Corporate Taxes: A Worldwide Summary*, 1996 edition.

PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

I am a proud original cosponsor of the Senate's bi-partisan Capital Gains tax bill introduced by my friends, Senator Hatch, Senator Breaux, and Senator Lieberman. Its principal provision is a 50% reduction in the effective rate of taxation of capital gains across the board. You will remember that Congress passed this provision in 1995. But it was subsequently vetoed by the President. I think the Senate must again act in a bi-partisan manner to provide capital gains tax relief. It is vital to my state of Iowa.

A disproportionate amount of farmland is held by older landowners. Studies in my state of Iowa show that 42% of farmland is held by persons over 65 years old.

Last year, Iowa State University conducted its annual farm life survey. It found that in the next 5 years, 21 percent of Iowa farmers are planning to retire. This high rate of those exiting farming raises important questions about who will be the next generations of Iowa Farmers.

Some of those farmers who retire will want to hold onto the land and maybe rent it out. Many others want to sell the land, move to town, and be fully retired. However, the capital gains tax has locked them on the farm. A 65 year old farm couple may have bought their farm over 45 years ago. This means that they have a basis for capital gains from 1952 as low as $200 per acre. Average farm prices in Iowa today are closer to $2,000 per acre. This looks 'like a capital gain of $1800, but it is not. Most of the $1,800 gain is 45 years of inflation. Therefore, a 50% reduction, as in our bill, is barely fair. Federal Reserve Chairman Alan Greenspan recently said that the optimal capital gains tax rate is zero percent. I am inclined to agree. But I think that bi-partisan legislation is a good down payment on fairness.

Now, there will be some people who will hesitate at the price of capital gains tax fairness. And make no mistake, I support a balanced budget.

However, I also think that it is unfair to penalize the most frugal of American families. Congress is at fault for being wasteful, and for running up the national debt. It is not the taxpayers' fault. Taxpayers need and deserve relief. By keeping their tax burden too high, we're in effect blaming them for our mismanagement. They should not have to bear the responsibility for our lack of responsibility.

STATEMENT OF SENATOR ORRIN G. HATCH
before the
Senate Committee on Finance
March 13, 1997

HEARING ON CAPITAL GAINS TAXATION

Mr. Chairman, I am very pleased that you are holding this hearing today. I have long been an advocate for reforming the tax treatment on capital gains. I am pleased to be joined by Senator Lieberman as well as our colleagues on this committee, Senators Grassley, Breaux, D'Amato in introducing legislation to cut the capital gains tax in half.

During the last Congress, Senator Lieberman and I offered a bipartisan capital gains tax reduction bill. The Hatch/Lieberman bill, S. 959, contained a 50 percent deduction for capital gains as well as an enhanced incentive for investments in newly issued stock of small corporations. This measure was supported by 45 senators, and we were pleased that its provisions were included in the Balanced Budget Act of 1995 that passed the House and Senate during the last Congress.

This year our bill, S. 66, is substantially the same. Our bill combines two important elements of capital gains relief -- a broad based tax cut and a targeted incentive to give an extra push for newly formed or expanding small businesses. Our bill would allow individual taxpayers to deduct 50 percent of any net capital gain. This means that the top capital gains tax rate for individuals would be 19.8 percent. Also, it grants a 25 percent maximum capital gains tax rate for corporations. Our bill also includes an important provision that would allow homeowners who sell their personal residences at a loss to take a capital gains deduction.

In addition to the broad-based provisions listed above, our bill also includes some extra capital gains incentives targeted to individuals and corporations who are willing to invest in small businesses. We see this add-on as an inducement for investors to provide the capital needed to help small businesses get established and to expand. Nearly 75 percent of our job growth comes from small businesses.

In particular, these special incentives should really make a difference in the electronics, biotechnology, and other high tech industries that are so important to our economy and to our future. The software and medical device industries in Utah are perfect examples of how these industries have transformed our economy. While these small business provisions are not limited to high tech companies by any means, these are the types of businesses that are most likely to use them because it is so hard to attract capital for these higher risk ventures. A capital gains tax cut will give investors an incentive to fund the high risk research companies of tomorrow.

Mr. Chairman, our economy is becoming more connected to the global marketplace every day. And, it is vital for us to realize that capital flows across national boundaries very rapidly. Therefore, we need to be concerned with how our trading partners tax capital and investment income.

Unfortunately, the U.S. has the highest tax rate on individual capital gains of all of the G-7 nations, except the U.K. And, even in the U.K., individuals can take advantage of indexing to alleviate capital gains caused solely by inflation. For example, Germany totally exempts long-term capital gains on securities. In Japan, investors pay the lesser of 1 percent of the sales price or 20 percent of the net gain. I think it is no coincidence, Mr. Chairman, that Germany's saving rate is twice ours, and Japan's is three times as high as ours. In order to stay competitive in the world, it is vital that our tax laws provide the proper incentive to attract the capital we need here in the U.S. Why should U.S. taxpayers be at a disadvantage to our competitors?

Mr. Chairman, we are aware that some of the opponents of capital gains tax reductions have asserted that such changes would inordinately benefit the wealthy, leaving little or no tax relief for the lower and middle income classes. Nothing could be further from the truth. In fact, capital gains taxation affects every homeowner, every employee who participates in a stock purchase plan, or every senior citizen who relies on income from mutual funds for their basic needs during retirement. A capital gains tax cut is for everyone.

It is interesting to note how the current treatment of capital gains only gives preferential treatment to those taxpayers whose incomes lie in the highest tax brackets. Under the Capital Formation Act of 1997, the benefits will tilt decidedly toward the middle-income taxpayer. A married couple with $30,000 in taxable income who sells a capital asset would, under our bill, pay only a 7.5 percent tax on the capital gain. Further, this bill would slash the taxes retired seniors pay when they sell the assets they have accumulated for income during retirement.

Mr. Chairman, I also believe there is a misperception about the term "capital asset." We tend to think of capital assets as something only wealthy persons have. In fact, a capital asset is a home, a piece of land, a savings bond, some stock your grandmother gave you, a mutual fund share, your farm, your 1964 Mustang convertible, or any number of things that have monetary worth. It is misleading to imply that only "the wealthy" would benefit from this bill.

I want to elaborate on this point. Current law already provides a differential between ordinary income tax rates and capital gains tax rates for upper income taxpayers. The wealthiest among us pay up to 39.6 percent on ordinary income but only 28 percent on capital gains. Certainly, income tax rates are too high. However, for middle-income taxpayers in the 28 percent income tax bracket, there is no difference between their capital gains tax rate and their ordinary income tax rate. Thus, current law provides no tax incentive for middle income taxpayers to invest in assets that may have capital gains. Our bill would correct this problem and give the largest percentage rate reduction to the lowest income taxpayers. For example, the rate for high income earners would change from 28 percent to 19.8 percent -- a 8.2 percentage point reduction. Whereas, a middle income taxpayer -- who is getting no benefit under current law -- would be taxed at 14 percent -- a 14 percentage point reduction.

Frankly, passing a reduction in the capital gains tax couldn't come at a better time than now. Congress is in the midst of formulating a plan to balance the federal budget. The elements of this plan will have consequences far beyond this year or even beyond 2002 when we hope to achieve our balanced budget goal. Crucial to the achievement of a balanced budget is the underlying growth and strength of our economy. Small changes in the behavior of the economy

can make or break our ability to put our fiscal house in order. Thus, especially now, we can ill afford to have our economy slow down and create an increased fear of future job insecurity. Both Republicans and Democrats alike can agree that the creation of new and secure jobs is imperative for a vibrant and growing economy.

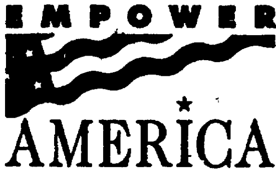
This is where a reduction of the capital gains rate can be so important. By stimulating the economy and spurring job creation, a cut in the capital gains rate can help increase private sector investment to replace any reduction in government spending. This will make for a more efficient tax system and a more efficient economy.

Furthermore, many Americans have expressed concern about the wisdom of a tax reduction while we are trying to balance the budget. However, this bill is a change that will help us balance the budget. The evidence clearly shows that a cut in the capital gains tax rate will increase, not decrease, revenue to the Treasury. During the period from 1978 to 1985, the tax rate on capital gains was cut from almost 50 percent to 20 percent. Over this same period, however, tax receipts increased from $9.1 billion to $26.5 billion. The opposite occurred after the 1986 Tax Reform Act raised the capital gains tax rate. The higher rate resulted in less revenue.

Mr. Chairman, the capital gains tax is really a tax on realizing the American dream. For those Americans who have planted seeds in small or large companies, family farms, or other investments, and who have been fortunate enough and worked hard enough to see them grow, the capital gains tax is a tax on success. It is an additional tax on the reward for taking risks. The American dream is not dead; it's just that we have been taxing it away.

The benefits of a broad-based capital gains tax cut speak for themselves. The prominent economic analysis firm DRI/McGraw-Hill studied the effects of a 50 percent reduction in the capital gains tax. They conclude that our bill would increase GDP by 1.4 percent, increase fixed investment by 5.1, create an average of 150,000 additional jobs per year, reduce the cost of capital by 8 percent, and increase federal tax revenues by almost $12 billion.

I believe a capital gains tax cut offers a solid plan to help us achieve our goal of a brighter future for our children and grandchildren. When it comes down to it, jobs, economic growth, and entrepreneurship are not partisan issues. They are American issues.



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TESTIMONY BEFORE THE U. S. SENATE COMMITTEE ON FINANCE

THE TAX TREATMENT OF CAPITAL GAINS

BY JACK KEMP

MARCH 13, 1997

Contributions are not tax deductible for Federal or State Income Tax purposes

TESTIMONY BEFORE THE U.S. SENATE COMMITTEE ON FINANCE THE TAX TREATMENT OF CAPITAL GAINS MARCH 13, 1997 BY JACK KEMP

Thank you, Mr. Chairman for inviting me to testify today on the tax treatment of capital gains and losses. A tax on capital gains is economically unsound and imposes unnecessary and unacceptable burdens on the economy and on individual taxpayers. The federal tax on capital gains is a paramount example of what in general is wrong with our current tax system.

THE PROBLEM WITH THE CURRENT TAX SYSTEM

The preeminent question legislators must answer in levying an income tax is how income is to be defined. There are two basic, internally consistent ways to define income over a given accounting period: 1) money earned but not saved plus net capital accumulation (the "accretion" or Haig-Simons definition of income), and 2) money earned but not saved plus any reduction in existing savings (the "economic" or "yield" definition of income). Only the latter definition is economically sound. The former mistakenly treats the value of expected *future* income (capital) as *current* income and counts it twice—both currently and then again in the future.

By double counting, the accretion definition of the income-tax base necessarily leads to the double taxation of money used for saving and investment. The economic-income or yield-income definition of the tax base does not. Hence, for purposes of taxation, only economic income is compatible with maximizing long-run economic performance since use of the accretion income-tax base penalizes saving and investment relative to consumption. Under an economic-income definition of the tax base, capital gains are not considered "income" but rather capital accumulation and thus would not be taxed as current income.

The current federal tax code begins with the accretion definition of income but it does not in the end rely on an unadulterated accretion-income tax base. Recognizing the economic inefficiency produced by double taxing saving and investment, Congress has deviated from a pure Haig-Simon definition of the income tax base. Throughout most of the income tax's history, for instance, Congress has taxed capital gains at a preferential rate (usually by subjecting only a fraction of capital gains to taxation under the income tax rate) in an *ad hoc*

effort to mitigate somewhat the deleterious economic effects of double taxation. Likewise, Congress has periodically adopted devices such as an investment tax credit or variations of accelerated depreciation as cumbersome attempts to lighten multiple taxation of investment. Since 1986, however, Congress has eliminated many of these provisions. For example, the 1986 Tax Reform Act eliminated the capital gains exclusion and now taxes capital gains as any other income. Yet, even in this rare obeisance to the pure accretion-income concept, Congress still felt it necessary to cap the capital gains tax rate at 28 percent.

Ad hoc adjustments to the accretion definition of income, while legitimate and necessary for the health of the economy, have had two unfortunate side effects. First, while such adjustments may mitigate one type of distortion in the tax code, they frequently create inconsistencies in the definition of the tax base that give rise to new distortions. By their very nature, *ad hoc* adjustments are cumbersome and inefficient.

For example, if capital gains are granted a preferential rate compared to other types of income, taxpayers have an incentive to reclassify income for tax purposes to pass it off as capital gains. In my opinion, taxpayers' ability to actually accomplish such a reclassification of income is vastly overstated by the opponents of capital gains tax cuts. The real question for legislators is the relative magnitude of this potential distortion comparted to the current penalty on saving and investment. I believe the record is clear that any distortion that might be caused by a preferential rate is by far the lesser evil.

Second, *ad hoc* deviations from the pure accretion definition of income for legitimate economic purposes invites politicians to use the tax code as a political trading ground for all manner of politically motivated tax preferences that have no legitimate economic rationale (what economists refer to as "rent seeking"). One of the biggest problems with the current tax code is the high multiple tax rates that are necessitated by the plethora of illegitimate tax breaks created for no other reason than to subsidize politically favored activities, penalize politically incorrect behavior and redistribute income.

The National Commission on Economic Growth and Tax Reform, which I was privileged to chair, found that our current income tax system is economically destructive, impossibly complex and overly intrusive. High marginal tax rates weaken the link between effort and reward, depress productivity and kill jobs. Multiple layers of taxation on work, saving and investment dry up new capital, retard entrepreneurial activity and stifle creation of new businesses. Is it any wonder? Income is taxed once as wages and salaries. Then if it is invested, it is taxed twice as income at the corporate level; a third time if dividends are paid out; a fourth time when the asset is disposed of and a capital gain declared; and a fifth time at death under the estate tax.

THE FUTILITY OF PARTIAL TAX REFORM

Attempting to alleviate distortion and multiple taxation of income under the current code only invites a political firestorm. The problem is that tax code has served for too long as a major political market place. Politicians now find it difficult to distinguish between economically legitimate, albeit complicated and clumsy, deviations from a pure accretion-income concept and unjustified, special-interest tax breaks. In a spasm of reform, Congress is likely to do great economic damage in the name of "simplification" and "loophole closing." In the heat of political competition among interest groups, provisions that have been placed in the tax code explicitly to mitigate multiple taxation of saving and investment may become tainted. "Reformers" characterize these provisions in derogatory terms (such as "corporate pork"), and Congress unwisely eliminates them from the code.

This happend in 1986. Not only did Congress raise the cost of capital by increasing the capital gains tax, it also did so by extending asset lives while simultaneously repealing the investment tax credit; devastated the real estate market by enacting new real estate provisions that abruptly collapsed real estate values; weakened American firms' international competitiveness with the adoption of new foreign tax provisions; and adopted an alternative minimum tax that only magnifies and exacerbates the worst anti-growth aspects of the current tax code—all in the name of "base broadening," "loophole closing," and "fairness."

In the President's budget this year, he has proposed some $80 billion in tax increases, largely by changing provisions of the tax code that he characterizes as subject to "abuse" by rich people. In fact many of the provisions he targets comprise perfectly legitimate deviations from a pure accretion method of taxing income that are in the code to alleviate some of the anti-growth characteristics of a pure Haig-Simons income tax.

In large part Mr. Chairman, we are here today at the end of another "tax reform" cycle, deliberating about how to fix the damage Congress created the last time it "fixed" the code. Which brings me to a major thesis of my testimony this morning. **The current tax code is irredeemably flawed. It is unfixable. We should throw it out and start over from scratch.**

The single biggest step we could take toward a revival of economic growth in America would be to completely overhaul the tax code to make it fairer, flatter, simpler and eliminate the double, triple and quadruple taxation of saving and investment income. I would urge going farther and eliminating the quintuple taxation of income, which occurs at death, by repealing the estate and gift tax altogether. Recent empirical analyses of the dead-weight burden of the current tax code reveal that fundamental overhaul of the tax system could raise long-term growth by one full percentage point or more.

REPLACING THE CURRENT TAX CODE

There are numerous plans under consideration that would completely overhaul the tax system. Most of the plans under discussion—illustrated by the proposals of House Majority Leader Dick Armey, Ways and Means Chairman Bill Archer, Congressmen Schaefer and Tauzin, Senators Dominici and Lugar—reject the Haig-Simons, accretion definition of income and adopt instead an economic- or yield-income definition of the tax base. Consequently, any of these plans would eliminate the multiple taxation of income and have the great virtue of dramatically increasing the incentives to work, save and invest.

In common parlance, economic or yield income can be thought of as the money people use for consumption over the accounting period. Therefore, it is not unusual to hear people describe tax systems that rely on this definition of the income tax base as "consumption-base taxes." In fact, the three primary candidates currently under consideration as replacements for the current federal income tax—variations of the Hall-Rabushka Flat Tax, the Bradford Consumed Income Tax and a Retail Sales Tax—all rely with minor modifications on such a "consumption base." Any of the three would be a vast improvement over the current system and far preferable to a "reform" in the opposite direction that would take the current code closer to a pure Hair-Simon (accretion) income tax.

Let me give the Committee a sense of the degree to which any of these plans would improve economic performance. History informs us that reductions in marginal tax rates on income from wages and capital translate directly into lower costs of doing business. In the early 1960s, President Kennedy's tax cuts reduced the marginal cost of expanding output by 4.5 percent. Twenty years later, the Reagan tax cuts lowered it by 3.2 percent. In both cases, the economy responded with a substantial increase in output capacity.

After the Kennedy tax cuts, real GDP growth was more than double the 2.5 percent average of the 1950s for a substantial period of time. Likewise, average annual growth in the 7 years after President Reagan's tax cuts took effect more than doubled that of the preceding 9 years. Each of the major tax overhaul plans now on the table has the potential to lower marginal business costs by 10 percent to 15 percent — two to three times the effects of the Kennedy and Reagan cuts.

The stakes are enormous, and therefore I look forward during the next couple of years to exploring with this committee how we should proceed to write a new tax code for the 21st Century. I would like to begin right now. I wish President Clinton would jump in and help us in this endeavor, and I know that the Republican Congressional Leadership has written him a letter urging him to do just that.

I hope the President rises to their challenge to send the Congress his best shot at overhauling the tax system. Frankly though, I doubt that the President is prepared to make the

kind of comprehensive overhaul to the tax system that you, Mr. Chairman, and I know are necessary.

Although 1997 may not be the year we remake the federal tax system, there is no reason we cannot make progress this year. Leading the list of "doable" tax cuts this year should be at least major reform of both the capital gains tax and the estate and gift tax if not outright repeal of both. I also hope you are able to expand IRAs this year as well. I will elaborate specifically on capital gains but first please allow me to digress momentarily to talk about the politics of tax cuts this year.

THE POLITICS OF TAX CUTS *CIRCA* 1997

There appears to be a growing consensus that some kind of capital gains tax cut and change in the death tax on inheritances is doable this year. The challenge is to make sure that what is doable is worth doing. In my opinion, any capital gains tax cut worth doing must be broad based. The reason is simple. The point of making incremental changes to an irredeemably flawed tax code is to begin the journey toward fundamental overhaul of the system in the hopes of gaining momentum. Targeted tax cuts are counterproductive since they only serve to increase vested interests in maintaining the tax system as a means of political subsidy, punishment and redistribution.

Second, a capital gains tax cut this year must not take back in technical changes (such as the President's proposal to require the use of average-cost basis or burdensome depreciation recapture provisions) what it gives in rate reductions. It should not exclude or discriminate among asset classes such as real estate or assets held by corporations. It should not lengthen holding periods or make the rate reduction conditional on the length of time an asset is held, which would seriously attenuate any beneficial economic impact of cutting the tax. It must fix the Alternative Minimum Tax problem that stands to obliterate any beneficial results of cutting the tax for many taxpayers. Finally, any capital gains tax cut must also provide for inflation indexing—prospective indexing of all future gains at a minimum but I also believe gains temporarily should be indexed retrospectively to the date of the asset's acquisition.

Mr. Chairman, you asked specifically whether I would favor some kind of sliding-scale rate reduction tied to the length of time an asset is held. For the reasons specified above, the answer if no. The only conceivable reason to increase holding periods would be out of a belief, unfounded in my mind, that people will not of their own volition invest sufficiently in long-term investments. It honestly alludes me who is better positioned to determine how long to hold an asset than the investor himself. But, even if one grants the premise that the tax code should take some positive step to encourage long-term investing, which I do not, there is a simple and effective way to do so without an intrusive sliding scale: Index all capital gains for inflation, which will remove the single biggest obstacle to investors holding assets long-term.

Before I proceed Mr. Chairman, let me offer a suggestion on how to think about incremental changes to the tax code in 1997. The tax system has become so internally inconsistent and jerry rigged that any incremental change to the code will create distortions of its own and create ripple effects that seem problematic. For example, virtually any suggested change in the taxation of capital gains will generate some problem in the abstract.

As long as the top income tax rate remains in the neighborhood of 40 percent, for instance, any substantial reduction in the capital gains rate could theoretically be argued to encourage reclassification of income and "sheltering" behavior. But my response to this kind of criticism is, "yes indeed, it is not tidy. And that's the result of having to operate within the confines of a very untidy tax code." The solution to this particular problem is not, in my opinion, to keep the capital gains tax rate high but rather to lower all tax rates, the sooner the better. The fastest way to get about the business of reducing all tax rates is to begin where we know it will have a powerful and demonstrable beneficial economic effect, with the capital gains tax.

Finally, the scuttlebutt around town is that advocates of estate tax reform are prepared to abandon a capital gains tax cut if necessary to achieve significant reform of the death tax. I hope these rumors are false. It is unnecessary, indeed counterproductive, to abandon a worthwhile cut in the capital gains tax under the misguided impression that watering down capital gains tax reform somehow leaves money on the table to "pay for" reform of the death tax. Not only are capital gains tax cuts and repeal of the estate tax not mutually exclusive or antagonistic, repeal or significant reform of the estate tax may well depend on cutting and indexing capital gains taxes.

THE CASE FOR REPEALING THE CAPITAL GAINS TAX

Federal Reserve Chairman Alan Greenspan—a man not known for sounding "irrationally exuberant"—makes the case for repealing the capital gains tax. In testimony before the Senate Budget Committee in January, he said: "The appropriate capital gains tax rate is zero." He went on to say—before a group of hard-nosed budgeteers mind you—"The net effect of reducing the capital gains tax, as it impacts total revenue—corporate income taxes, individual income taxes, and such—could very well be a positive. I view the capital gains tax as a poor means of raising revenue . . . and I certainly do not think it effectively functions for any other purpose."

The Fed Chairman then hastened to make the even more critical point that he does not believe "the issue of capital gains taxation is a revenue question. . . . it is an issue of the extent to which it affects entrepreneurial activity." If we are interested in improving economic growth, Chairman Greenspan said, the real question is one of how to increase "productivity-increasing investments" which we should be seeking to "foster as best we can."

The smartest thing President Clinton did during his first term was to heed Chairman Greenspan's advice on inflation and the dollar. I hope the President continues this practice during his second term and takes Alan Greenspan's advice on taxes. I think he will if Congress puts its full legislative weight behind Greenspan's advice. Therefore, I urge the Congress to be bold and show true leadership by repealing both the capital gains tax and the death tax on inheritances.

If the President resists outright repeal of the capital gains tax, Congress should do the next-best thing and send the President a bill cutting the rate and allowing investors to unlock their current investments and roll them over into new investments without facing capital gains taxes. The President already has embraced a near-universal rollover provision for personal residences. In my humble opinion, he would be well advised to extend his universal rollover concept to apply to all assets not just homes. If Congress and the President insist on maintaining a capital gains tax, investors should only have to pay it once—when they finally cash out their investment and consume it—not every time they simply move their investment funds from one asset to another.

The Case For Cutting The Capital Gains Tax In Half And Indexing It For Inflation

If the votes are not there for complete repeal of the capital gains tax or universal rollover, Congress at a minimum should cut the capital gains tax rate in half—to 14 percent for those in the highest tax brackets and to 7.5 percent for those in the 15 percent tax bracket—and to zero for urban enterprise zones such as the District of Columbia; index all future capital gains for inflation; and for two years, index back to the date of acquisition of the asset those capital gains that already have been accrued.

Anyone who does not avail themselves of the opportunity during the grace period to pay the accrued taxes should have to pay taxes when they finally sell the asset on all inflationary gains accrued between now and date the asset was acquired. (In order to avoid upsetting portfolios, owners should not actually have to sell their assets to take advantage of the retroactive indexing provision. All they should have to do is declare the new, inflation-indexed basis—"mark to market"—and pay the taxes due on the accrued gains sometime during the two-year window.)

If Congress were to adopt these reforms to the capital gains tax it would then be able to repeal the death tax outright because the additional revenue generated by reforming the capital gains tax would more than replace the death-tax revenues.

These reforms would liquefy capital markets with a flood of investment, unlocking an estimated $5 trillion in capital gains (about three-fourths of which are purely inflationary gains). Owners of these assets currently are sitting on them because they refuse to sell the assets and

face the exorbitant and confiscatory inflation tax which amounts to about one trillion dollars—an average tax rate of about 80 percent on the real, inflation-adjusted gains. The situation is even worse for corporate stock. In the mid 1980s, the Treasury Department acknowledged that total inflation swollen, nominal capital gains on corporate stock exceeded real, inflation-adjusted gains. In other words, the average real capital gains tax on unrealized capital gains from corporate stock was greater than 100 percent.

Most Democrats and Republicans agree that taxing inflated gains is unfair but neither party seems to appreciate the extent to which it is also self-defeating. Both parties are trapped by their delusion that the trillion-dollar, inflation-swollen bonanza of accrued capital gains taxes eventually will materialize as revenue. It won't. It is a trillion dollar will-o'-the-wisp. People simply refuse to pay the high toll—sometimes a toll of more than 100 percent—to go through the tax gate so they sit on assets that they really would rather liquidate and reinvest in other types of assets.

While every special interest in Washington, and all the budget balancers, keep their eyes fixed on the trillion dollars of accrued capital gains taxes, they not only miss the great economic potential that could be unleashed by removing the inflation tax, they also deny governments at all levels an immediate increase in revenue—both capital gains tax revenues and, as Mr. Greenspan pointed out, revenues from all other sources as well. **Unlocking of the magnitude one might expect from cutting the rate in half and temporarily indexing gains for inflation back to the date of the asset's acquisition would increase federal revenues by an estimated $150 billion.**

The Federal Treasury is not the only public treasury that would benefit; so would the states and just at a critical time. Last year, Congress and the President took the first tangible step toward a devolution of power and responsibilities to the states by enacting the historic welfare-reform legislation. Real capital gains tax reform would help make welfare reform work by generating economic expansion that will bolster states' capacity to take on these added responsibilities and guarantee the creation of more jobs, which ultimately is the real solution.

RETROSPECTIVE INDEXING OF CAPITAL GAINS PROVIDES OPPORTUNITY TO REPEAL THE DEATH TAX ON INHERITANCES

The death tax on inheritances raises very little revenue for the federal government and in fact probably costs the government and the taxpayers more in administrative and compliance fees than it raises in revenue. In reality, Congress should just repeal the tax and not worry about the consequences of so-called "lost revenue."

I recognize, however, that for this year at least Congress remains stuck with a dysfunctional tax-scoring system that prevents you from looking at secondary consequences of tax policy. Whatever else you do therefore, please change this system before the 105th

Congress comes to an end. But that is the subject for another occasion. I reluctantly accept that you remain stuck with this totally irrational system for this year's tax bill. Therefore, it is important that capital gains tax reform and repeal of the death tax on inheritances be considered in tandem, as compliments, not as antagonists.

For many asset owners under current law, the decision of when to realize capital gains becomes intimately intertwined in the estate-planning process. Today, if asset owners hold onto their assets until they die, they avoid paying capital gains taxes. Their heirs, however, must pay the death tax based on the current market value of the assets, which forces some heirs to sell off all or part of their inheritance just to pay the death tax. When the heirs sell the assets, they calculate their capital gains based on the market price of the asset at the time it was inherited, not the original acquisition price. This arrangement leads many asset owners to hold onto assets longer than they desire just to avoid the inflation tax, possibly even preventing some of them from selling or marking their assets to market during a retrospective indexing grace period. At the same time, this arrangement forces many heirs to sell their inherited assets sooner than they desire.

The simple solution to these problems is to eliminate the death tax on inheritances altogether along with its attendant step-up-in-basis provision. The $17 billion annual revenue loss would more than be made up for in additional revenues from freeing up locked-in gains and revenues from other taxes generated by future economic growth.

UNFOUNDED CRITICISMS OF CAPITAL GAINS TAX CUTS

Unnecessary. I was amazed several weeks ago to see the President's budget chief quoted in *The Wall Street* Journal saying that with the stock market already at record levels "it's hard to see what the problem is to which the solution is to cut the capital-gains tax." I wonder if the OMB Director has looked recently up the street a few blocks from the White House where a major commercial district of the Nation's Capital is crumbling from lack of entrepreneurial effort. I wonder if he has looked beyond the President's feel-good campaign rhetoric to the empirical record of the 1990s which tells the story: Since the end of the 1990-91 recession, the American economy has experienced the slowest economic expansion in more than a century, growing a mere 2.3 percent a year as compared to a 4.4 percent average annual growth rate during the preceding five economic expansions.

The problem is simply stated: If we have any hope of reversing the slowdown in productivity growth that afflicts our economy and revitalizing our urban areas, it can only come about by expanding capital stock we put at the disposal of our workers and the increasing the flow of capital available to those at the bottom of the economic pyramid. I can't believe that this President would concur with the implications of his budget director's comments that somehow we have enough or even too much capital at work in our economy.

Ineffective and Counterproductive. Another frequent criticism heard against cutting the capital gains tax is that it won't do anything to increase investment or even that it will cause the stock market to decline. Just a week ago on national television, Secretary Rubin fell into this fallacy again when he claimed a capital gains tax cut "would probably have very little effect on the savings rate" and therefore "will contribute very little to economic growth."

To the contrary, any cut in the capital gains tax rate will immediately raise the real after-tax rate of return to capital, thereby raising the value of existing assets and thus the stock market. While the official, incorrectly measured "saving rate" may not rise, people's wealth will, and it is rising wealth and greater incentives to put that wealth at risk that matters if there is to be more investment. If we assume a stable price/earnings ratio in after-tax terms to the shareholder, a three percent inflation rate and a continuation of investors' historical requirement that they receive a 3 percent real yield after all taxes, it is possible to estimate what the effect of cutting and indexing the capital gains tax would be on asset values and the stock market.

Under these reasonable assumptions, if the capital gains tax rate on all assets were cut from 28 percent to 14 percent and all future gains were indexed for inflation, one could expect assets to appreciate on the order of 19 percent to 20 percent which should reflect itself in more than 1300 points on the Dow Jones Industrial Average. The DJIA, now at 7000, is already discounting a capital gains tax cut but passage of this proposal made retroactive to the first of the year still should mean a Dow approaching 8000.

The mistake made by those who predict a decline in the stock market and no effect on economic growth is that they forget that for every seller with new incentives, there is also a buyer with new incentives. It is true that people who own assets at the time of the tax rate reduction will suddenly see the after-tax value of those assets increase and thus could be willing to sell the asset for less than the pre-tax-cut price. But for every seller now willing to take less, who may offer the market down, there are potential buyers willing to pay more than the current market price and bid the market up because the after-tax value of the asset is now also worth more to them than before the capital gains tax cut occurred.

But Mr. Chairman, the point of eliminating or cutting the capital gains tax is not to raise stock prices. More important than the appreciation of existing assets that are held at the peak of the economic pyramid is the increased capital flow that suddenly will occur at the bottom of the pyramid. An entire universe of new and expanded enterprises, which formally were not economically viable because they failed to yield a sufficient after-tax return to entice investors to put their money at risk, suddenly will be able to generate adequate after-tax return to attract investors. Like more wild catters lured into the drilling fields by higher oil prices, the higher after-tax rate of return on capital will draw more investment capital into the market, more enterprises will be undertaken, more jobs created and faster overall economic growth will be the result. And, ownership will be expanded at the base of the pyramid.

Revenue Loser. This brings me back to the biggest fallacy regarding capital gains which is that repealing the tax or cutting the rate and indexing it for inflation will "lose revenue." Let me relate an anecdote to the Committee that sums up the box we have gotten ourselves into with respect to revenue estimating.

During the last Congress, after the Joint Committee on Taxation (JCT) pronounced that the Contract-With-America capital gains tax cut proposal would lose substantial amounts of revenue, a number of House Members, including Majority Leader Dick Armey, Congressman Jim Saxton and Senator Connie Mack, were so perplexed by the estimate that they inquired of the JCT how the staff kept coming up with such large revenue loss estimates. In response, the JCT gave selected Members of Congress a private briefing on how its staff arrived at their revenue estimates. After the briefing, Dick Armey commented, "I know I have just been snowed but I don't have a clue how."

There is probably not a one of us here this morning who understands the inner workings of the Joint Tax Committee's little black revenue-estimating box sufficiently to criticize it. Thus, it is easy for us to be "snowed" if we do not get outside the confines of the box. Fortunately, we retain our common sense, and the JCT revenue estimates on capital gains taxes simply do not pass the common sense test. Let me explain why.

The capital gains tax currently brings in about $30 billion a year, roughly. In fiscal year 1996, federal receipts from all revenue sources excluding capital gains taxes amounted to $1.42 trillion, approximately 19 percent of our gross domestic product (GDP) of $7.49 trillion. Therefore, if Congress were to repeal the capital gains tax completely, GDP would have to increase by only about $158 billion (19% of $158 billion equals $30 billion), or 2 percent, to leave the federal government with the same amount of revenue it raised with the tax on the books.

The Joint Tax Committee assumes absolutely no increase in economic output will result from eliminating the capital gains tax. Everything we know about economics tells us that is an outlandish assumption. If the capital gains tax were repealed, the value of assets would increase by almost one-quarter. Investment would rise. Output would increase.

How much of an increase in output is likely? Is a 2 percent increase plausible? It certainly is. Numerous highly respected private economists have estimated that merely reducing the capital gains tax rate from 28 to about 19 percent without indexing for inflation would raise the level of total GDP anywhere from 1.5 percent to 2.3 percent.

Ultimately, the best test of what will happen if we cut capital gains taxes is the historical record itself. Consider what happened when the capital gains tax rate was cut in 1978 by almost 45 percent, from 35 percent to 20 percent. Total individual capital gains tax receipts nearly tripled from $9.1 billion in 1978 to $26.5 billion in 1985. Conversely, when the capital gains

tax was raised to its current level in 1986, Congress was assured that capital gains realizations and revenues would increase substantially. Instead, they fell.

Administrative Complexity. Finally, one hears a great deal of concern from the Treasury Department that indexing capital gains for inflation would be "convoluted." Deputy Treasury Secretary Lawrence Summers says Mr. Clinton's Treasury Department has "been implacably opposed to indexing on the grounds of administrative feasibility and complexity." Whenever this Administration—the same Administration that dreamed up the world's most convoluted and complex national health care scheme—gets misty eyed over "administrative complexity," you know for a certainty that they are shedding crocodile tears.

The reality is, asset owners already must maintain all of the records they need to do the indexing calculations. Don't forget, under the unindexed capital gains tax and depreciation rules, people must keep track of the date they acquired and the price they paid for every single share of stock, every building, every piece of machinery, every head of cattle and every parcel of real estate. The only additional piece of information they need to index their gains is the inflation factor which the IRS could easily provide taxpayers in a table going back as far as necessary.

Besides, indexing one's capital gains for inflation is totally voluntary. If any taxpayer, Assistant Secretary Summers for instance, finds it too onerous a task to adjust his capital gains for inflation, he may simply report his unindexed gains and pay the higher tax. What is the problem? There is none.

The best proof that America can index capital gains is the fact that Great Britain does so without difficulty. In fact Mr. Chairman if I may, I would like to submit for the hearing record a simple taxpayers'-information guide put out by the Inland Revenue Service of the United Kingdom and a sample of the inflation-factor table provided to English taxpayers.

CONCLUSION

For too long, too many investors on Wall Street and too many politicians at both ends of Pennsylvania Avenue have labored under the myth that the economy cannot grow faster than about 2.5 percent a year without producing inflation. They thought they heard the Chairman of the Federal Reserve Board confirm this myth every time he repeated the Fed's refusal to use loose monetary policy to artificially stimulate the economy above its current 2.5 percent pace. Listen again!

Mr. Greenspan has never said the economy cannot grow faster than 2.5 percent a year without creating inflation, nor does he threaten to snuff out growth above 2.5 percent if it is sustainable growth resulting from policy changes, such as capital gains tax cuts, that improve the economy's long-run growth capacity. Today's 2.5 percent ceiling on growth is artificial, created

by oppressive tax, spending and regulatory policies. What the Fed Chairman has been attempting to get across to Congress and the President is that it is up to them, not him, to raise long-run growth. The Fed cannot use monetary policy to stimulate faster growth without igniting inflation. But that does not mean Congress and the President cannot. You can. You must.

Chairman Greenspan made it clear before the Senate Budget Committee in January that he would be perfectly happy to see Congress adopt policies such as capital gains tax reform, that will increase "productivity-increasing investments," that in turn spur entrepreneurial activity and faster growth. In his parting remarks to the Committee, he said, "The last thing we [the Fed] want to do is to inhibit economic growth." The only thing inhibiting growth now are policies such as excessively high capital gains taxes that are perfectly within the ability of Congress and the President to correct.

I urge Congress to act with dispatch to pass a broad-based capital gains tax cut with indexing this year. And if you find yourself in a blizzard of revenue estimates that defy common sense, reject them. Rely on your common sense and experience. Had Congress not abandoned experience and common sense in 1986 when it raised the capital gains tax, we would be a lot better off today economically and considerably closer to a balanced budget.

Thank you, Mr. Chairman.

RETAIL PRICES INDEX : FIGURES FROM MARCH 1982

	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
JAN		82.61	86.84	91.20	96.25	100.0	103.3	111.0	119.5	130.2	135.6	137.9	141.3	146.0	150.2
FEB		82.97	87.20	91.94	96.60	100.4	103.7	111.8	120.2	130.9	136.3	138.8	142.1	146.9	150.9
MAR	79.44	83.12	87.48	92.80	96.73	100.6	104.1	112.3	121.4	131.4	136.7	139.3	142.5	147.5	151.5
APR	81.04	84.28	88.64	94.78	97.67	101.8	105.8	114.3	125.1	133.1	138.8	140.6	144.2	149.0	152.6
MAY	81.62	84.64	88.97	95.21	97.85	101.9	106.2	115.0	126.2	133.5	139.3	141.1	144.7	149.6	152.9
JUN	81.85	84.84	89.20	95.41	97.79	101.9	106.6	115.4	126.7	134.1	139.3	141.0	144.7	149.8	153.0
JUL	81.88	85.30	89.10	95.23	97.52	101.8	106.7	115.5	126.8	133.8	138.8	140.7	144.0	149.1	152.4
AUG	81.90	85.68	89.94	95.49	97.82	102.1	107.9	115.8	128.1	134.1	138.9	141.3	144.7	149.9	153.1
SEP	81.85	86.06	90.11	95.44	98.30	102.4	108.4	116.6	129.3	134.6	139.4	141.9	145.0	150.6	153.8
OCT	82.26	86.36	90.67	95.59	98.45	102.9	109.5	117.5	130.3	135.1	139.9	141.8	145.2	149.8	
NOV	82.66	86.67	90.95	95.92	99.29	103.4	110.0	118.5	130.0	135.6	139.7	141.6	145.3	149.8	
DEC	82.51	86.89	90.87	96.05	99.62	103.3	110.3	118.8	129.9	135.7	139.2	141.9	146.0	150.7	

ASSET ACQUIRED:- MARCH 1983
COST:- £5000
ASSET SOLD:- JAN 1995

TO CALCULATE THE INDEXATION ALLOWANCE USE THE FOLLOWING FORMULA (R.U. TO 3 DECIMAL PLACES)

$$\frac{\text{RPI for month of disposal} - \text{RPI for month of acquisition (or March 82)**}}{\text{RPI for month of acquisition (or March 82)**}} \times \text{COST}$$

ie, $\frac{146.0 - 83.12}{83.12} = 0.757 \times £5000 = £3785$ (Indexation Allowance to be subtracted from gain)

**Acquisition date or March 1982, whichever is the later (unless pre 1982 date elected).

Inland Revenue

Capital Gains Tax

An Introduction

These notes are for guidance only and reflect the tax position at the time of writing. They do not affect any right of appeal.

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March 1996

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We produce a wide range of free leaflets each designed to explain a different aspect of the tax system in plain English. Some you might find useful are listed below.

- CGT4 - Capital gains tax. Owner-occupied houses
- CGT6 - Retirement relief on disposal of a business
- CGT11 - Capital gains tax and small businesses
- CGT16 - Capital gains tax. Indexation allowance. Disposals after 5 April 1988
- IR37 - Appeals against tax
- IR45 - What to do about tax when someone dies

Our leaflet IR120 'You and the Inland Revenue' tells you more about the standard of service you can expect from us. It also tells you the steps you can take if you want to make any comments on the service you receive, or complain about the way your tax affairs have been handled.

Our IR List 'Catalogue of leaflets and booklets' gives further information about our publications, most of which you can get from any Tax Enquiry Centre or Tax Office. Addresses are in your local phone book under 'Inland Revenue'. Most offices are open to the public from 9.30am to 4pm, Monday to Friday, and some are also open outside these hours.

Your local library or Citizens' Advice Bureau may also have copies of our leaflets.

In addition, we have produced the following leaflets on Self Assessment.

- SA/BK1 - Self Assessment - A general guide
- SA/BK2 - Self Assessment - A guide for the self-employed
- SA/BK3 - Self Assessment - A guide to keeping records for the self-employed
- SA/BK4 - Self Assessment - A general guide to keeping records

You can order leaflets about Self Assessment from our special Self Assessment response line. Ring 0345 16 15 14.

This leaflet sets out the basic rules of capital gains tax (CGT) for individuals.

It does not cover the more complex situations. If you need further information ask your Tax Office.

What is capital gains tax?

CGT is payable when you make a chargeable gain. A chargeable gain arises when something you own (an asset)

- is given away, exchanged, sold or disposed of (see page 2 'What is a disposal?') in any other way, and
- its value has increased since you acquired it.

CGT is not charged on the asset itself, but on its gain in value. Chargeable gains can be made on many things, for example stocks and shares, land, and business assets. If you receive less for an asset when you dispose of it than it cost you to acquire it, the loss can usually be set against gains in the same tax year (which begins on 6 April and ends on 5 April in the following year). If losses are more than gains of the same year, the excess can be set against gains of later years. (See page 12 'How are losses dealt with?'.)

Usually, the gain is the difference between the sale price and the cost of the asset, after deduction of allowable expenditure and of an amount to take account of inflation. However, assets do not always have a buying or selling

price. For example, you may inherit assets or the owner of an asset may give it away. If so, we take into account the market value of the asset at the time of acquisition or disposal. The market value is also generally used instead of any sale price when assets pass between you and a connected person. (See page 13 'How is an asset valued'.)

If someone dies and leaves assets, there is no charge on any gains up to the date of death. Our leaflet IR45 - 'What to do about tax when someone dies' gives more details.

Who is liable to pay CGT?

Anyone who is resident or ordinarily resident in the United Kingdom for tax purposes has to pay tax on chargeable gains in excess of the annual exempt amount (see page 11), wherever the assets are situated.

What is a disposal?

Liability to CGT may arise on gains from disposals of assets and on certain capital receipts.

You make a disposal of an asset whenever the ownership of part or all of an asset is transferred to another person (except on death). This includes sales, exchanges, or gifts of assets.

There is also a disposal when you receive a payment relating to the asset, for example, when insurance proceeds are received following the loss of an asset. Sums which are chargeable to income tax are not also chargeable to CGT.

Do I always have to pay CGT if I give an asset away?

The transfer of an asset to your husband or wife will not be taxable immediately if you are living together (see page 14, 'Husbands and wives').

In most other circumstances, CGT will be charged immediately where an asset is given away.

However, in certain circumstances a CGT charge may be deferred or 'held-over' until the person receiving the asset disposes of it. Ask your Tax Office for more details.

Is CGT payable on the disposal of all assets?

Some disposals of assets and other receipts are disregarded for CGT purposes, including

- private motor vehicles
- personal effects and goods each worth £6,000 or less when you disposed of them
- Savings Certificates, Premium Bonds and British Savings Bonds
- certain shares in Venture Capital Trust companies and shares issued after 18 March 1986 on which Business Expansion Scheme Relief has been given and has not been withdrawn
- gains made within a Personal Equity Plan (PEP)
- bonuses from Tax Exempt Special Savings Accounts (TESSAs)

- UK Government stocks (gilts)
- foreign currency for your own, or your family's, personal use
- life assurance policies and deferred annuity contracts unless purchased from a third party
- National Lottery prizes and betting winnings
- SAYE (Save-As-You-Earn) terminal bonuses
- personal injury compensation
- private homes, subject to certain conditions set out in our leaflet CGT4 'Capital gains tax. Owner-occupied houses'.

What expenditure can I set against a gain?

The following expenditure may be set against the amount received or the value of an asset on disposal in calculating the gain or loss, but this does not include any expenditure which may be taken into account in computing your income.

- **The cost of acquisition**

This is the amount which you, or someone acting on your behalf, gave wholly and exclusively for the acquisition of the asset. In some cases, the true value of the asset may be substituted for the amount actually paid. It also includes the incidental costs of acquiring the asset (see page 5).

In the case of an asset which was not acquired but created (for example, copyright or the goodwill of a business built up from nothing) any expenditure which you incurred wholly and

exclusively in creating or providing the asset is treated as the cost of acquisition of that asset.

Where you owned the asset on 31 March 1982 the value of the asset on that date is usually taken as the cost of acquisition (see page 8).

- **Additional expenditure**

This is expenditure which you, or someone acting on your behalf, incurred wholly and exclusively for the purpose of enhancing the value of the asset. The expenditure must be still reflected in the state or nature of the asset at the time of disposal. This does not include expenditure on normal maintenance or repairs.

Ask your Tax Office for details.

- **The incidental cost of acquiring or disposing of the asset**

Such expenditure has to satisfy two tests before it is allowable,

- it has to be wholly and exclusively incurred for acquisition or disposal of the asset

  and

- it must take the form of fees, commission or remuneration paid for professional services

  or

- it must represent the cost of transfer or conveyance.

Advertising costs to find a buyer or seller are allowable and so are costs of any valuation or apportionment needed to calculate the capital gain or loss on a disposal.

- **Wasting assets**

Special rules govern allowable expenditure on disposal of wasting assets, that is assets with a predictable life of less than 50 years. Ask your Tax Office for details.

- **Part disposals**

If you dispose of only part of an asset, only part of the expenditure incurred on that asset can be set against the amount received for the disposal.

Example 1

An asset cost £30,000 and some years later a part of that asset was sold for £12,000 when the market value of the remainder of the asset was £36,000.

The gain on the part disposal (ignoring incidental costs and indexation allowance - see 'calculating gains and losses' on page 7) is worked out as follows.

Disposal proceeds	£12,000
cost of asset $\times \frac{A}{A+B}$	
(A = sale price of part sold) (B = market value of remainder)	
that is - £30,000 x $\frac{£12,000}{£48,000}$	£7,500
Chargeable gain	**£4,500**

The balance of the cost £22,500 (£30,000 - £7,500) is carried forward against any future disposal of the remainder of that asset.

Calculating gains and losses

In general, only gains or losses since 31 March 1982 are taken into account. There is also an adjustment for inflation called indexation allowance. This adjustment is made using the Retail Prices Index (RPI) published each month by the Central Statistical Office. The Inland Revenue issues a monthly Press Release giving details. Your Tax Office can give you the information.

You work out the gain or loss by deducting the cost, any allowable expenditure, and then the indexation allowance from the net sale proceeds.

Indexation allowance cannot be used to create or increase a loss if the disposal is made on or after 30 November 1993 (but there was a transitional allowance for 1993-94 and 1994-95 - see page12).

If there is a gain after deducting costs from the net sale proceeds, but a loss after deducting costs and indexation allowance you are treated as making neither a gain nor a loss.

Assets acquired after 31 March 1982

If the asset disposed of was acquired after 31 March 1982 indexation allowance is based on the increase in the RPI between the dates of acquisition and disposal.

Example 2

Asset acquired 4 July 1983 for	£10,000
Asset disposed of on 6 January 1995 for	£16,000

The gain is calculated as follows

Disposal proceeds	£16,000
Less acquisition cost	£10,000
Unindexed gain	£6,000
Less indexation allowance	
(£10,000 x 0.712) restricted to	£6,000*
Chargeable Gain	NIL

* *The figure of 0.712 is obtained from the Inland Revenue Press Release. The total indexation allowance of £7,120 (£10,000 x 0.712) is restricted to the amount, £6,000, which gives no gain or loss.*

Assets acquired before 1 April 1982

If the asset disposed of was acquired before 1 April 1982, its cost is taken as its market value at 31 March 1982. Indexation allowance is based on the increase in the RPI between that date and the date of disposal.

The meaning of 'market value' is explained in 'How is an asset valued?' (page 13).

Example 3

Asset acquired 31 March 1980 for	£10,000
Market value 31 March 1982	£20,000
Asset disposed of on 31 July 1991 for	£60,000

The gain is calculated as follows

Disposal proceeds	£60,000
Less acquisition cost (taken as 31 March 1982 market value)	£20,000
Unindexed gain	£40,000
Less indexation allowance	
March 1982 to July 1991	
£20,000 x 0.684* =	£13,680
Chargeable gain	£26,320

* *This figure is obtained from the Inland Revenue Press Release.*

There are special rules to ensure

- that the indexation allowance is calculated on the original acquisition cost, if this is to your advantage

  and

- that the gain or loss since 1982 is not greater than the gain or loss over the whole period you have owned the asset.

Example 4

Asset acquired 31 March 1980 for	£10,000
Market value 31 March 1982	£5,000
Asset disposed of on 31 July 1991 for	£40,000

The gain is calculated as follows

Disposal proceeds	£40,000
Less acquisition cost (original cost as this is greater than 31 March 1982 market value)	£10,000
Unindexed gain	£30,000
Less indexation allowance March 1982 to July 1991 £10,000 x 0.684* =	£6,840
Chargeable gain	£23,160

- *This figure is obtained from the Inland Revenue Press Release*

You can elect for these special rules not to apply and if you do there is then no need to calculate the gain or loss over the whole period of ownership. You only calculate the gain from 31 March 1982.

If you do make such an election it cannot be withdrawn and will normally apply to all assets which you owned on 31 March 1982.

The election must be made in writing within two years of the end of the tax year in which you first disposed of an asset held on 31 March 1982. (For disposals after 5 April 1996 see page 16.)

Net gains or losses

If you have made more than one disposal during the tax year, all your gains and losses are added together to arrive at your net gains or losses.

Annual exempt amount

The annual exempt amount (£6,000 for 1995-96) is set against any net gains.

If the exempt amount exceeds the net gains, no CGT is payable. If the net gains exceed the exempt amount any losses brought forward from an earlier year can be set against the gains above the exempt amount. If the losses brought forward are not enough to cover these gains there will be a charge to CGT.

Ask your Tax Office for our IR (Insert) which gives the current annual exempt amount.

How is CGT worked out?

Assessments are made for a tax year beginning 6 April on the total gains in the year after deducting losses in that year and any unallowed losses of earlier years.

The net gains are treated as the 'top slice' of income and charged to CGT at income tax rates.

Unused income tax reliefs and allowances cannot be set against chargeable gains (but see page 13 'Income losses').

Example 5

Tax year 1995-96: threshold for higher rate tax	£24,300
Individual's taxable income (after reliefs and allowances)	£15,000
Chargeable gains (after annual exempt amount)	£20,000

The CGT is worked out as follows

£9,300 x 25% (unused basic rate band)	£2,325
£10,700 x 40% (higher rate)	£4,280
CGT	£6,605

These rules are modified if you have dividend income. Ask your Tax Office for details.

How are losses dealt with?

The computation of allowable losses follows that of chargeable gains.

Indexation allowance cannot be used to create or increase a loss if the disposal is made on or after 30 November 1993. There was a transitional allowance for disposals made between 30 November 1993 and 5 April 1995. Ask your Tax Office for details.

Relief for losses is given first against any gains of the same tax year.

Any net losses of the year may be carried forward and set against gains of later years. Losses may not be carried back and set against gains of earlier years except for net losses incurred by an individual in the year of death.

Certain allowable losses arising on the disposal of shares in an unquoted trading company may

be set against your income. Ask your Tax Office for details. Otherwise allowable losses cannot be set against other profits or income.

Income losses

For 1991-92 and later years income tax trading losses which cannot be absorbed by other income may be set against chargeable gains. Ask your Tax Office for details.

How is an asset valued?

In certain circumstances an asset is treated as having been disposed of (and acquired by its new owner or re-acquired by the original owner) at its market value at the date of disposal.

The 'market value' is generally used instead of any sale price when assets pass between you and a connected person. Examples of connected persons are

- your relatives or your husband's or wife's relatives
- your business partners and their relatives, including husbands and wives
- any company that you control, either alone or with connected persons.

There are special rules for transactions between partners which involve business assets. Ask your Tax Office for details.

The 'market value' may also be required in other circumstances, for example where an asset acquired before 1 April 1982 is sold.

For all of these purposes 'market value' means the price which the asset might reasonably be expected to fetch on a sale in the open market. In the case of shares or securities quoted on the London Stock Exchange, for example, the market value is taken to be the lower of

- a figure one-quarter up from the lower of the two prices in the quotation for the relevant day, and
- the figure half-way between the highest and the lowest prices of recorded bargains for that day.

If you inherited the asset and inheritance tax was chargeable on the death in question, then you are treated as having acquired the asset at the same value as was used in calculating the inheritance tax. Our leaflet IR45 'What to do about tax when someone dies' gives more details.

Husbands and wives

For the tax year 1990-91 and later years a husband and wife are taxed separately on their gains and losses. Each has his or her own annual exempt amount and the rate of tax charged relates only to his or her own income.

The transfer of an asset between husband and wife is not taxable immediately if they are living together. Any gain or loss is deferred until the asset is disposed of by the partner who receives it. He or she is normally treated as having acquired it for the original cost to the transferring partner, plus indexation allowance up to the date of transfer.

Special rules apply where the asset was acquired by the transferring partner before 1 April 1982. Ask your Tax Office for more details.

What about my business assets?

Special relief may be available on business assets when you retire from your business or when you replace them.

See our leaflets CGT6 'Retirement relief on disposal of a business' and CGT11 'Capital gains tax and small businesses'.

Reporting gains

If you receive a Tax Return you must complete the section asking for details of gains and losses. You may become liable to interest and penalties if you do not submit your return within 30 days of the date on which it was issued or, if later, by 31 October following the end of the tax year in which the gain arose.

If you do not receive a Tax Return for a tax year, and have not already been asked for details of your gains and losses in that year, you must report them to your Tax Office if the gains exceed the annual exempt amount. In this case, if you do not report gains within twelve months of the end of the tax year in which they arose you may become liable to interest and penalties.

You must tell the Tax Office about changes which could affect your tax position. If you do not, you may pay more than you should or find that you owe tax.

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Claims and elections: disposals after 5 April 1996

Proposals were included in the Finance Bill following the Budget on 28 November 1995 which affect disposals made after 5 April 1996, that is in the tax year 1996-97 and later years. The time allowed in which to make some claims and elections is reduced from two years to one year and ten months. Such claims and elections will have to be made by 31 January which is one year and ten months after the end of the year of assessment in which you made the relevant disposal.

So, for disposals made in 1996-97 the claim or election must be made by 31 January 1999.

These notes do not cover every point but any Tax Office or Tax Enquiry Centre will be pleased to help you. They can also give you any of the other leaflets mentioned. You may also consult the Inland Revenue Capital Gains Manual at these offices.

Their address is in your local phone book under 'Inland Revenue'. Most offices are open to the public from 9.30am to 4pm Monday to Friday, and some are also open outside these hours.

Statement of Senator Connie Mack

I commend the Chairman for holding today's Senate Finance hearing on the tax treatment of capital gains. For many years now, there has been a large and growing consensus among economists, lawmakers, and taxpayers that our tax system has become a tremendous obstacle to economic growth and our standard of living. Therefore, I'm glad to see bipartisan support for balancing the budget while also providing needed tax relief--including capital gains tax changes. If the "era of big government" is over than the era of big tax burdens must be reversed as well.

Our current tax system punishes saving and investing and is unfit to carry us into the 21st Century. By punishing investment and capital formation, we are jeopardizing a better future for ourselves, our children and grandchildren. Examining pro-growth tax policies could not be more timely or important to the welfare of all Americans. Despite slow and steady economic growth, the latest Census Bureau data reveal that real family income is lower today than in 1989. We can and must do better. Regardless of how high tax rates have been raised, the federal government has historically collected around 19 percent of GDP in revenue. What this tells us is we need to focus our energies on increasing economic growth, not tax rates.

If we are truly interested in improving economic growth and the standard of living of all Americans, we must stop punishing productivity-increasing investment. We know that the best way to ensure higher wages is to improve productivity. Therefore, we need capital to invest in the research, technologies and equipment that will make American workers the most productive and competitive in the world. The punitively high capital gains tax has diminished our chances of achieving our greatest growth potential. Also, in today's global economy, we must be sure our tax policies are competitive with other industrialized nations, which often have more favorable tax treatment of savings and investment.

The current capital gains tax represents punitive double taxation, and taxes illusory gains due simply to inflation. It is ironic that the Treasury Department just issued inflation-indexed bonds to protect investors from inflation but still levies an inflation tax on capital gains. This obvious policy conflict must be corrected by at least indexing capital gains for inflation. We must put an end to the practice of taxing people on "phantom income" due solely to inflation.

Cutting the capital gains tax rate and indexing it for inflation would promote, not punish, economic growth. That is why I am introducing a bill that would cut the capital gains tax rate, (especially for small businesses), index for inflation, and allow a capital loss deduction on a principal residence. In recent years, major tax hikes have taken their toll on economic growth and the American family. It's now time we begin rewarding saving, investing, and the entrepreneurial spirit that made this country the world's economic leader.

To ensure capital gains tax relief becomes a reality, the politically motivated "rich vs. poor" class warfare must stop, and the defenders of the status quo must make way for positive change. Capital gains are not just for the "rich." According to IRS tax return data, 56 percent of taxpayers reporting capital gains have incomes below $50,000 -- meaning more than 8 million households earning less than $50,000 would likely benefit from capital gains tax relief. More than 83 percent of capital gains are reported by households with less than $100,000 in income.

Simply stated, a large and growing number of ordinary middle-income Americans are directly or indirectly invested in the stock market. They invest directly by buying shares themselves or indirectly through savings in mutual funds, IRA accounts, or pension plans at work. The proportion of families who own stocks has increased dramatically from 32 percent in 1989 to 41 percent by 1995. Cutting capital gains taxes would encourage families to save even more and make it easier for them to buy a home, prepare for retirement, or pay for their childrens' education.

And let's not forget that capital gains taxes are largely a voluntary tax, since investors decide when they sell their assets. According to analysis by the Joint Economic Committee, there is more than $1.5 trillion in "locked-up" capital in our economy due to the steep capital gains tax rate. Investors should be allowed to freely move their money into new investments without paying punitive capital gains tax rates. Reducing the capital gains tax rate and indexing it for inflation will unleash greater investment opportunities, create jobs, boost growth and government revenue to the benefit of all income groups.

New entrepreneurial activity that boost economic growth takes money, and the demands for capital are the greatest they have been in decades. New technologies are opening the door to greater productivity gains and new products. We must ensure that the adequate savings and investment needed to fuel new technologies and productivity gains are available. A more productive workforce will increase incomes and our standard of living.

No doubt, the typical static income distribution and revenue models used to trumpet the so-called tax "winners" and "losers" will be used in an attempt to scare us into preserving the status quo. However, to date these models do not encompass the real essence of capital gains tax relief--its potential to make everyone better off through economic growth and to increase incomes across all classes.

I believe providing capital gains tax relief is one of the best pro-growth measures we can give to the American family this year. It would make the U.S. more competitive by reducing capital costs, prevent the unfair taxation of inflationary gains, increase the mobility of investments, and foster greater savings and entrepreneurship.

Capital Gains Tax Reduction and the Economy

by Allen Sinai*

After six years of an extraordinary business upturn and now an economy near full employment, extending and preserving the expansion without accelerating price inflation has become the major challenge for economic policy.

Against this backdrop, changes in tax policies that increase saving, induce productive investment and capital formation, raise productivity growth, increase the labor force and jobs, and raise potential output should be considered. Given the need to balance the federal budget and eventually run a surplus in times of prosperity, any new tax reductions must be balanced against the costs in lost revenues and of offsetting reductions in outlays, with the best tax reductions those that produce the biggest "bang-for-a-buck" in supply-side potential at the lowest cost. Whatever net reduction in tax receipts might occur from any tax reduction must be offset by outlay reductions in order to maintain a balanced budget. Tax policies that stimulate consumption rather than saving or investment, with little significant payoff in potential growth and large costs in lost tax receipts, are not appropriate at near full employment unless equivalent outlay reductions can be found. The political and economic costs of such outlay reductions can be prohibitive.

Once again this year, capital gains tax reduction has become central in the debate over tax policy. Since the preferential rate on capital gains was eliminated in 1986 and despite the restoration of some differential with ordinary income tax rates through the income tax increases of 1990 and 1993, the question of reducing capital gains taxes keeps recurring.

Of the various criteria for judging capital gains tax reductions—fairness or equity; distortions in relative prices or tax efficiency; the cost of capital; international competitiveness; too heavy taxation of capital in a growing economy; and the effects on growth and economic performance—the one relating to growth and economic performance has received relatively little attention.

Most studies of capital gains tax reduction have been microeconomic in nature, with few performed on the full scale of macroeconomic effects. Most have focused on small segments of the economy, issues related to revenues from "unlocking," questions narrowly related to finance, or topics dealing with the specific details of capital gains. Only a few have tried to assess the overall macroeconomic effects of capital gains tax reduction, although the intuition and framework of many would suggest that lower capital gains taxes should stimulate the economy, jobs, capital formation, new ventures, and raise the maximum sustainable rate of economic growth.

This statement discusses the macroeconomic effects of capital gains tax reduction, reporting on computer simulations with a large-scale macroeconometric model of the U.S. that places heavy emphasis on finance and interactions with the real economy, certain supply-side effects from changes in taxation, as well as incorporating expectational effects on financial markets from various policies and changes in the economy.[1]

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[1] The model used is the Sinai-Boston Model of the U.S. Economy. Previous studies on capital gains tax reduction were "Capital Gains and U.S. Economic Performance," Economic Advisors, Inc., Economic Studies Series, No. 37, October 1990 and "Saving and Investment in a Full Employment Economy: the *Contract With America* Tax Reductions," Committee on Ways and Means, U.S. House of Representatives, Hearings on Tax Provisions from the *Contract With America*, January 24, 1995. The best documentation of the Model can be found in A. Sinai, "Financial and Real Business Cycles," Eastern Economic Journal, Vol. 18, No. 1, Winter 1992, pp. 1-54.

Capital Gains Tax Reduction and the Economy

Over the years, various programs to reduce capital gains taxes have been proposed.

Currently, ongoing research is being undertaken to examine the macroeconomic effects of current capital gains tax proposals, including reductions in effective capital gains tax rates for individuals and corporations, indexing capital gains for inflation and more specific, targeted capital gains tax reduction proposals.

By-and-large, work with a full system model of the U.S. economy, which includes numerous channels by which capital gains taxes affect financial markets, the cost of capital, economic activity, entrepreneurship, supply-side potential and feedback on tax receipts from changes in economic activity and the stock market, produces the following.[2]

Capital gains tax reduction increases savings, capital spending and capital formation, economic growth, jobs, productivity and potential output. The increases relative to what might have happened otherwise are definitely significant, but small to modest in magnitudes. The costs of the capital gains tax reduction, in terms of lost revenues, vary depending on whether the calculated revenue loss is static or ex-ante, i.e., the initial cost of the tax reduction; include macroeconomic feedback on tax receipts at federal, state and local government levels; include realizations as a consequence of changes in economic activity, the stock market and new capital gains; or take account of "unlocking" previously unrealized capital gains because of the change in capital gains taxation.

Capital gains tax reduction is unique among tax policies in its financial market effects and generation of capital gains, which, in turn, can provide additional tax receipts at the new lower capital gains rate, along with additional funds from unlocking to be spent or saved by individuals and corporations.

All taxes that stimulate economic activity produce additional tax receipts in response; none can induce additional tax receipts from higher economic activity that will fully pay for the original tax cut. However, because of direct effects on equity market prices and new tax receipts from the unlocking of unrealized capital gains, capital gains tax reduction has the greatest chance of minimizing the loss of tax receipts that arises when a tax reduction is put into place.

Capital Gains Tax Reduction: Some Preliminary Quantitative Results from Current Proposals

Tables 1-3 show some estimates of the macroeconomic effects from capital gains tax reductions for individuals and corporations—a program of a 50% exclusion of long-term capital gains for individuals and a 25% capital gains tax rate on the long-term capital gains of corporations. These results are preliminary and subject to change in subsequent work, but provide the general thrust of the macroeconomic effects that have been determined in ongoing research.

The reduction in capital gains taxes raises the aftertax return on equity to shareholders and reduces the aftertax weighted average cost of debt and equity, leading to a somewhat higher stock market as individuals shift investments toward equities, increased household net worth or wealth, increased consumption, greater business capital outlays on equipment and plant, and higher real GDP. New business incorporations rise as well, a supply-side entrepreneurship effect. Jobs are increased, along with earnings and corporate profits, leading to increased consumption and greater economic activity. The increased activity induces more spending on consumption and investment, increases expected future earnings growth and stock market valuations, reducing further the cost of capital, inducing more entrepreneurial effort, spending, orders, production, jobs and business activity.

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[2] Of course, it must be noted that econometric model simulations are "what if" quantitative analyses conditional upon the underlying assumptions on the structure of the economy as modeled. Any particular result as reported is only one in a distribution of possible outcomes for a given policy change, a center of the distribution of those outcomes, but not to be taken literally as a single figure certain expectation. Econometric models represent history, providing no more nor less than has been captured in historical data and the processes that underlie the phenomena incorporated in the economy and the model at that time. Changes in policies, fiscal or monetary, can impact on the economy's structure, setting up forces that make for a new structure compared with the old, making the results obtained in simulation only approximations.

In the case of capital gains taxation, numerous changes have occurred over the postwar period so should be represented reasonably well in the historical data. To the extent that markets rationally discount future events, the model used reflects this phenomenon, one of the only large-scale models that attempts to use model-consistent expectations in its analyses, i.e., the projections of the model itself as inputs into financial market reactions, through a quick discounting of future events which is the nature of markets and asset prices.

The increased economic activity induces additional tax receipts at the federal and state levels, from individuals and corporations, on income, sales, excise and social security, to an extent offsetting the "static" or "ex-ante" cost of the capital gains tax reduction. Over time, the increased jobs exceed any rises in the labor force, bringing about a lower unemployment rate. There is little change in price inflation, given the modest nature of the increase in aggregate demand and some rise in productivity growth and in potential GDP.

The simulation reported in Table 1 shows a rise in real GDP, compared with the Baseline, of 0.5% at its peak, an increase of 0.1 percentage points per year in real economic growth, and a long-run decline in the unemployment rate of 0.1 percentage points. The increase of jobs peaks at around 400,000 three to four years after the tax change before diminishing somewhat to a permanent 200,000.

National savings rises with capital gains tax reduction, a consequence of increased personal and business savings and a rise in the personal savings rate (Table 1).

In part, the greater savings is generated by the increased income of a stronger economy in response to the reductions in the capital gains tax, but also is due to the increased flows-of-funds from higher capital gains realizations, especially at the individual level, some of which go back to government at the new lower capital gains tax rate but most of which are available for spending or saving by individuals and, for corporations, on new investment or in cash flow. The additional savings generated by increased realizations, both "unlocked" and because of a higher equity market, are assumed to be mostly saved rather than spent, in a pattern different from the consumption and saving out of current disposable income.[3]

Capital spending also is higher, the result of a lower rental price of capital, increased economic activity, and a shift toward capital formation from current outlays because of increased entrepreneurship activity.

Although the magnitudes of change are not large, they are significant. And, from a microeconomic point of view, an average of $33 billion per year of increased real GDP, 400,000 new jobs after three or four years, 0.1 percentage points higher average hourly compensation, and greater new business incorporations averaging 3,000 per year would be notable.

The rise in saving that occurs helps keep interest rates from rising in the face of the increased economic activity, in turn promoting some capital formation as well. And, the 0.1 percentage point rise in productivity growth and somewhat higher potential GDP provides supply-side help to the economy, even though the magnitudes are relatively small.

The ex-ante, or static, revenue loss calculated from the program totals nearly $150 billion over the next six years. Increased realizations, as estimated by Primark Decision Economics (PDE), and macroeconomic activity feedback effects on taxes reduce the net cost of the capital gains tax reduction to only $8.4 billion by 2002 compared to the Baseline and total $56 billion for the six-year period.

Depending on the unlocking that occurs at the new lower capital gains tax rates and increased realizations that generate new tax receipts at the lower capital gains tax rate, the overall full ex-post cost of the capital gains tax reduction could be very small, or even positive. Previous estimates by the JCT and OTA are used in Table 3 to provide a rough approximation.[4]

What safely can be indicated is that capital gains tax reductions will be substantially less costly than the initial estimated revenue loss because of macroeconomic feedback, increased realizations, and unlocking of unrealized capital gains, the latter a unique feature of this particular tax.

More than any other tax policy, capital gains tax reduction has the best chance at minimizing the loss in tax receipts, net, relative to the gains in economic activity, entrepreneurship, productivity and potential output.

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[3] The long-run (three-to-four year) marginal propensity to consume (MPC) for permanent disposable income in the Model is 0.8; for funds realized on capital gains, 0.25 is assumed. Since the marginal propensity to save (MPS) is higher for high income earners and most realized capital gains accrue to high income families, this assumption seems justified. Capital gains realizations also may be viewed as windfall gains, where the MPC would be different from the MPC out of permanent income.

[4] New estimates of unlocking on current proposals and more recent data on unrealized capital gains subject to realization have not been performed.

Some Further Observations

The program analyzed, which is indicative of most capital gains tax reduction proposals, should raise the personal savings rate, in part because of increased income from greater economic activity but also the additional savings realized from increased capital gains realizations on the lower capital gains tax. Some of the increased realizations would be in response to a higher stock market; some should occur from the unlocking of previously unrealized capital gains, taxed at a lower capital gains tax rate. The increased realizations generate additional tax receipts at the federal and state levels because of higher income, greater sales and more earnings subject to social security. But, not all of the funds realized from the increased realizations are siphoned to government. Most become available for spending or saving by individuals and corporations. The additional funds that are saved tend to be reinvested in the equity or other financial markets, may be used for purchases of big-ticket items, and also can help reduce indebtedness. For corporations, the increased cash flow that comes from higher realizations also are spent or saved, on capital goods or in hiring, saved in the form of debt reduction, used in strategic business initiatives or invested in financial assets.

The results shown in Table 1 indicate an average 0.1 percentage point rise in the personal savings rate over a six-year period, much higher in Years I and II when capital gains realizations are the highest and lower thereafter.

Capital spending in equipment and plant is enhanced through a lower weighted average cost of debt and equity, in turn a reduction in the rental price of capital, which, along with increased output and enhanced cash flow, leads to new capital formation. The lower cost of capital, or discount rate, raises fundamental valuations of equities.

The jobs created in the process, increased income and higher household wealth stimulate consumption spending and economic activity benefits from it, the increase in savings, and more capital spending. Capital gains tax reduction also stimulates entrepreneurial effort through increased new business incorporations, adding to productivity growth and the potential output of the economy. Increases in the labor force and the stock of capital also raise potential output.

The broad-based effects of reducing effective capital gains taxation thus are many, including the balance sheets of households, business and the government sectors, and generally is widespread across the economy in its effects.

More targeted capital gains relief, for example an increase in the capital gains allowed on home sales or a change in the rule requiring the purchase of higher-priced homes within 18 months of the sale of an existing home, also should stimulate economic activity in similar ways to broad-based capital gains relief, but nowhere near as much in magnitude and scope.

Capital gains relief for home-selling and home-buying would certainly increase housing activity, the turnover of sales, probably raise the price of homes, therefore increasing household net worth and consumption.

But, much less benefit would accrue to savings, in general, capital formation, productivity and the maximum sustainable rate of economic growth. Entrepreneurship, except in the housing and real estate area, would not benefit from such a measure.

Other proposals on capital gains tax reduction should qualitatively show similar results to those analyzed in this statement.

A capital gains rate which slides lower as the holding period of the asset lengthens would likely stimulate savings, capital spending, jobs and the economy, but be spread out much more over time and be much smaller in magnitude. The cost of such a program would be smaller than that of the broad-based capital gains tax reduction indicated, however.

Indexing capital gains for inflation is desirable in any situation because of the stimulative effect on the economy and enhanced economic performance, but also to remove a distortion in relative prices of equity and debt, along with the higher cost of saving and capital formation in current time given the effective inflation-adjusted cost of capital.

In any circumstance, because of the distortions in relative prices currently and over time in the taxation of the inflation component of capital gains, indexing capital gains for inflation would be desirable.

Although potentially difficult in administration, inflation adjustment to the basis of assets for purposes of determining gain or loss on the disposition of assets should be legislated.

Conclusions

Broad-based capital gains tax reduction should be undertaken.

Based on large-scale macroeconometric model simulation of a 50% exclusion on long-term capital gains for individuals and a lower 25% long-term capital gains tax rate for corporations, the Sinai-Boston Model indicates a higher national and personal savings rate, increased investment in equipment and plant, higher economic growth and levels of economic activity, increased jobs, and a lower unemployment rate.

Of the criteria for judging tax reductions, reduction of effective capital gains tax rates for individuals and corporations is desirable on almost all—on the basis of distortions and relative price tax efficiency, on the basis of reductions in the cost of capital, on the basis of leveling the playing field on international competitiveness; on the basis of too heavy, in some cases triple, taxation of capital in the U.S. economy; and on the basis of the effects of capital gains tax reduction on economic growth and economic performance. Only on the dimension of fairness or equity can a persuasive case be made for not reducing capital gains taxes.

Capital gains tax reduction would stimulate both the supply- and demand-sides of the economy at relatively little cost in lost tax receipts. Depending on unlocking, the net loss on tax receipts, especially in early years, would be minimal, and could even be positive, requiring smaller offsetting reductions of government outlays to balance the federal government budget. Such a policy is desirable for an economy like the United States that is near full employment and where the main policy challenge is to extend and preserve the expansion without an increase in price inflation.

The tax policies that should be undertaken ought to have the greatest chance of raising the maximum sustainable rate of economic growth through increased saving, capital formation, productivity, and jobs. At a time when achieving a balanced budget is an absolute necessity, any tax reduction should be of minimal cost in lost tax receipts and the required offsetting reductions in outlays, carrying with it maximum benefit on potential supply.

Capital gains tax reduction has all of these features, uniquely exhibiting an additional possible feedback of tax receipts and additional saving because of the unrealized capital gains that would be realized on a reduction in the effective capital gains tax rate.

There is little disagreement on the notion of increased capital gains realizations from a reduction in the capital gains tax; any disagreements are mainly over the magnitudes, time form of response, and permanence of the increased realizations relative to a situation without any capital gains tax reduction.

In any case, according to quantitative research with the Sinai-Boston Model of the U.S. Economy, capital gains tax reduction would provide stimulus to economic activity, savings, capital formation, jobs growth, entrepreneurial activity, productivity and potential output, helping to balance aggregate demand and aggregate supply in an economy that is near full employment.

On these grounds and others, it is time for Congress to enact the broad-based capital gains tax reduction that now is very appropriate for the U.S. economy.

Table 1
Macroeconomic Effects of a Capital Gains Tax Cut*
30% Exclusion for Long-term Capital Gains - Individuals
29% Rate for Long-term Capital Gains - Corporations
(Changes from Baseline, Fiscal Years)

	1997	1998	1999	2000	2001	2002	Avg. Per Yr.
Real GDP - Level							
(Bils. 92 $'s)	14.6	26.0	36.0	38.3	41.3	42.8	33.2
(Pct. Chg.)	0.2	0.4	0.5	0.5	0.5	0.5	0.4
Real GDP-Growth (Pctg. Pts.)	0.2	0.2	0.1	0.0	0.0	0.0	0.1
Business Capital Spending							
Total (Bils. 92 $'s)	2.7	9.0	13.6	15.2	16.3	17.3	12.4
(Pct. Chg.)	0.3	1.1	1.5	1.6	1.6	1.6	1.3
Plt. (Bils. 92 $'s)	1.0	4.0	5.4	5.5	5.4	5.3	4.4
(Pct. Chg.)	0.5	2.0	2.6	2.5	2.3	2.2	2.0
Equip. (Bils. 92 $'s)	1.6	4.7	7.8	9.4	10.7	11.9	7.7
(Pct. Chg.)	0.3	0.7	1.1	1.3	1.4	1.5	1.0
Capital Formation - Stocks							
Plt. (Bils. 92 $'s)	0.4	3.2	8.0	12.9	17.5	21.7	10.6
(Pct. Chg.)	0.0	0.1	0.3	0.4	0.6	0.7	0.4
Equip. (Bils. 92 $'s)	0.7	4.0	9.8	16.8	24.0	31.3	14.4
(Pct. Chg.)	0.0	0.1	0.3	0.5	0.7	0.8	0.4
Consumption							
(Bils. 92 $'s)	15.3	31.1	45.0	51.3	54.5	56.2	42.2
(Pct. Chg.)	0.3	0.6	0.9	1.0	1.0	1.1	0.8
Real Net Exports							
(Bils. 92 $'s)	-4.62	-17.6	-26.6	-31.4	-32.2	-33.0	-24.2
Inflation - GDP Deflator							
(Pctg. Pts.)	0.0	0.1	0.1	0.1	0.0	0.0	0.0
Hourly Compensation							
(Pctg. Pts.)	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Employment and Unemployment							
Payroll (Mils.)	0.096	0.349	0.428	0.396	0.300	0.201	0.295
Unemp. Rate (%)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
New Business Incorporations							
(Thous.)	1.9	3.1	3.0	3.1	3.2	3.4	3.0
Productivity Growth (Pctg. Pts.)	0.1	-0.1	0.1	0.0	0.1	0.1	0.1
Potential GDP							
(Bils. 92 $'s)	0.5	3.9	8.7	13.4	17.4	21.2	10.8
(Pct. Chg.)	0.0	0.1	0.1	0.2	0.2	0.3	0.1
Interest Rates (%)							
90-day T-Bill	0.05	0.10	0.14	0.15	0.16	0.16	0.13
30-year Treas.	-0.05	-0.06	0.01	0.06	0.07	0.07	0.02
AAA-Equiv. Corp. New Issue	-0.07	-0.09	-0.02	0.05	0.07	0.07	0.00
Aftertax Return on Equity	0.65	0.86	0.85	0.84	0.84	0.83	0.81
Cost of Capital (%)							
Pretax Equity	-0.45	-0.60	-0.59	-0.59	-0.57	-0.56	-0.56
(Pct. Chg.)	-3.4	-4.6	-4.6	-4.5	-4.4	-4.4	-4.3
Aftertax Wtd. Avg. Cost - Debt & Equity	-0.16	-0.19	-0.17	-0.15	-0.12	-0.11	-0.15
(Pct. Chg.)	-0.2	-2.2	-2.0	-1.7	-1.4	-1.3	-1.5
S&P500							
(Pct. Chg.)	1.7	0.6	0.9	0.5	-0.2	-0.6	0.5
Exch. Rate							
(Pct. Chg.)	0.2	0.6	0.6	0.3	0.0	-0.1	0.3

Table 1 (Continued)

	1997	1998	1999	2000	2001	2002	Avg. Per Yr
Household Net Worth							
(Bils. $'s)	80.0	343.9	565.1	708.2	798.4	879.0	562.4
(Pct. Chg.)	0.3	1.2	1.8	2.2	2.3	2.5	1.7
Fed. Bdgt. Def. (NIPA)							
(Bils. $'s)	-8.6	-11.9	-9.7	-10.5	-12.3	-14.1	-11.2
Personal Savings							
(Bils. $'s)	28.4	24.0	13.9	5.5	-0.5	-5.7	10.9
Business Savings							
(Bils. $'s)	21.1	25.9	25.1	25.0	24.6	25.2	24.5
National Savings							
(Bils. $'s)	42.3	40.7	32.6	23.5	15.5	9.2	27.3
Personal Savings Rate							
(Pct.)	0.4	0.3	0.1	0.0	-0.1	-0.2	0.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1997. Preliminary, subject to change, not final.

Table 2
National Savings*
50% Exclusion for Long-term Capital Gains - Individuals
25% Rate for Long-term Capital Gains - Corporations
(Changes from Baseline, Fiscal Years)

	1997	1998	1999	2000	2001	2002	Avg. Per Yr.
National Saving	42.3	40.7	32.6	23.5	15.5	9.2	27.3
Personal Saving	28.4	24.0	13.9	5.5	-0.5	-5.7	10.9
Business Saving	21.1	25.9	25.1	25.0	24.6	25.2	24.5
Government Surplus or Deficit (-) (NIPA)	-7.2	-9.3	-6.3	-7.0	-8.6	-10.3	-8.1
Federal	-8.6	-11.9	-9.7	-10.5	-12.3	-14.1	-11.2
State and Local	1.4	2.7	3.4	3.6	3.6	3.7	3.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1997. Preliminary, subject to change, not final.

Table 3
Federal Tax Receipts*
50% Exclusion for Long-term Capital Gains - Individuals
25% Rate for Long-term Capital Gains - Corporations
(Changes from Baseline, Fiscal Years)

	1997	1998	1999	2000	2001	2002	Cum. 1997-2002
Total Receipts	-8.8	-12.4	-9.4	-8.7	-8.5	-8.4	-56.1
Personal	-6.8	-9.2	-8.2	-7.6	-7.3	-7.2	-46.4
Ordinary	0.7	2.2	3.3	3.9	4.3	4.6	19.0
Capital Gains	-7.5	-11.4	-11.5	-11.6	-11.7	-11.8	-65.4
Corporate	-3.0	-6.2	-5.7	-6.2	-6.6	-6.8	-34.4
Ordinary	1.1	1.7	2.3	2.5	2.8	3.3	13.7
Capital Gains	-4.1	-7.9	-7.9	-8.6	-9.4	-10.1	-48.0
Excise	0.2	0.4	0.5	0.6	0.6	0.6	2.9
Social Insurance	0.8	2.7	3.9	4.5	4.8	4.9	21.7
Ex-Ante (Static) Revenue Loss	-18.3	-25.1	-25.2	-25.8	-26.3	-27.0	-147.5
Personal**	-11.7	-15.3	-15.8	-15.9	-16.1	-16.2	-91.1
Corporate**	-6.6	-9.8	-9.4	-9.8	-10.2	-10.8	-56.4
Economic Feedback Effect (Increased Tax Receipts from Macroeconomic Feedback - PDE)	2.2	7.5	10.9	12.5	13.6	14.5	61.2
Ex-Post (Dynamic) Revenue Loss With Macro Feedback	-16.1	-17.6	-14.3	-13.2	-12.7	-12.4	-86.3
Ex-Post (Dynamic) Revenue Loss With Increased Realizations (PDE) and Macro Feedback	-8.8	-12.4	-9.4	-8.7	-8.5	-8.4	-56.1
With "Unlocking" Estimates and Macro Feedback, Excludes Increased Realizations (PDE)							
Personal							
JCT (1)	-13.1	1.3	0.1	1.7	0.7	1.0	-8.3
OTA (1)	-13.3	1.7	4.1	3.8	[illegible]	4.2	4.4
Pers. and Corp. (Corp. Est., PDE)							
JCT (1)	-11.2	4.1	1.6	3.4	-1.0	-0.7	-3.8
OTA (1)	-11.4	4.5	5.6	5.5	2.2	2.5	8.9
With "Unlocking" Estimates, Macro Feedback And Increased Realizations (PDE)							
Personal							
JCT (1)	-5.8	6.5	5.0	6.2	[illegible]	5.0	21.9
OTA (1)	-6.0	6.9	9.0	8.3	8.1	8.2	34.6
Pers. and Corp. (Corp. Est., PDE)							
JCT (1)	-3.9	9.3	6.5	7.9	3.2	3.3	26.4
OTA (1)	-4.1	9.7	10.5	10.0	[illegible]	6.5	39.1

* Macroeconometric model simulation with the Sinai-Boston Model of the U.S. Economy. Policy changes effective January 1, 1997. Preliminary, subject to change, not final.
** PDE Estimate.
(1) JCT - Joint Committee on Taxation, 1990 estimate of Bush Administration capital gains proposal, no indexing.
OTA - Office of Tax Analysis, 1990 estimate of Bush Administration capital gains proposal, no indexing.

STATEMENT OF PAUL A. VOLCKER
before the
COMMITTEE ON FINANCE
of the
UNITED STATES SENATE
WASHINGTON, DC
MARCH 13, 1997

Mr. Chairman and Members of the Committee:

As I understand it, you have invited me today not as an expert on all the intricacies of capital gains taxation but as one who might reflect a "common sense" view from the perspective of appropriate public policy. No doubt, you will be reminded this morning that what is "common sense" may lie in the eye of the beholder. But it is also true that there is little generally accepted empirical (or even theoretical) "truth" in this area. Moreover, approaches that seem conceptually sound on economic grounds may clash with administrative realities and concepts of equity.

As you debate what to do, I do think it relevant to remind you of aspects of the economic background about which there can be little debate. The American economy is in one of its longest periods of expansion, with low unemployment and strong job creation; it is indeed performing better than any other major industrialized country. The stock market has been rising to the point that some question has been raised as to whether its exuberance might be irrational. Business innovation is flourishing. Venture capital is in strong supply, certainly more than in other countries. The adaptive and risk-taking instincts of our capital markets have become the envy of the world.

All that has happened while we have had among the highest capital gains tax rates in the world, effectively at 25 percent or more over most of the post-World War II period. Indeed, the 1986 Act, as it reduced marginal income tax rates, eliminated almost all special capital gains tax preferences. While the tax rate for long-term capital gains was capped (appropriately in my view) when marginal income tax rates were raised in the 1990's, the 28 percent Federal rate (with more added by important states) remains high by world standards.

I am not about to claim cause and effect -- that high capital gains taxes are responsible for the good economic and financial performance. But it is demonstrable that

capital gains taxation has not dragged economic activity or financial market performance below their <u>current</u> potential.

Surely, there is no general case for fiscal stimulus right now; quite the contrary is true. And in the particular area of capital gains taxation, the issue doesn't strike me as pressing.

The question is the longer run. Productivity gains have slowed appreciably in the last quarter century. As a nation, that is a major concern that needs to be addressed. We do need to consider carefully whether lower taxes on savings and investment in general, or on capital gains in particular, might make a significant contribution toward improving the performance over time. At the same time, questions of tax equity and administrative complexity and feasibility also arise.

A central element in our growth and productivity potential must be our rate of national savings, which in turn bears upon our ability as a nation to invest. In contrast to our performance in creating jobs and fostering consumption, the United States is at the bottom of the world league in savings. We sustain our investment -- which itself is relatively low -- only by heavy borrowing from abroad. A central priority for economic policy should be to increase domestic savings as a basic ingredient in investment and productivity.

The surest approach toward that result -- and an approach directly controllable by the Government -- is to balance the budget and to move beyond balance into a structural surplus. In other words, we should stop public borrowing, at the expense of future generations, and move to greater saving. Consequently, especially with the economy already close to or at its current potential, there should be a clear bias against proposals for tax changes that would reduce revenues.

The structure of taxation as well as its level can also bear on private behavior -- how much people and business enterprises choose to save and how much to consume from current income. There is general agreement, I think, that our present tax structure bears particularly hard on savings in general and on equity investment in particular. Those considerations point, it seems to me, to much more use of consumption taxes, and to reduced emphasis on personal and business income taxes, as we move toward budgetary balance and surplus. But where do capital gains taxes fit in?

Reduced capital gains taxes should influence the composition of private savings. Broadly, flows into equity -- common stock, real estate, and private businesses --

should be enhanced relative to interest-earning assets. However, the effect on total savings seems to me highly uncertain. Moreover, as a matter of relative priority, any effect should be judged in the light of other tax benefits afforded retirement savings and changes that might be made in that area.

So far as budget balance is concerned, scenarios can easily be envisaged in which a capital gains tax reduction, so long as the reduction is significant but not too large, would actually raise revenues for a year or two as existing investments are "unlocked". (That effect would, of course, be maximized if the reduction was thought to be temporary, but uncertainty about the sustainability of a reduction would surely undermine its economic effectiveness). Consequently, a reduction could help the immediate budgetary situation, but what will really count for total savings, and ultimately for investment, will be the medium and longer-run revenue effects.

In that perspective, it seems to me to require strained assumptions (no matter how "dynamic" you want to make them) to assume a sizable reduction in capital gains tax rates will generate a significant <u>sustained</u> increase in capital gains tax revenues. The more likely result over time from a reduction large enough to affect economic behavior would be some loss of such revenue. That would surely be the case with very large reductions; it would be certain if the rate approached or reached zero as some have proposed.

The potential effects of a capital gains tax reduction on productivity and long-term economic growth (and thus general tax revenues) will need to depend heavily on whether such a reduction will provide special stimulus to new ventures, innovation and risk-taking <u>and</u> that greater risk-taking will, at the margin, have an exceptionally large economic pay off. Instinctively, it is easy to be sympathetic to the view that some entrepreneurial activity would be encouraged. However, it also seems clear that the impact on the economy and productivity would be gradual and long-term. Many other factors -- notably the trend in total savings -- will probably swamp the effects.

Moreover, as I suggested earlier, venture capital seems in good supply today and apparently is more and more provided by non-taxable investors. Consequently, the favorable but limited impact on risk-capital and productivity would need to be balanced off against the cost -- budgetary and economic -- of a loss of revenue. There is another cost as well of a sizable cut in capital gains taxes: that is the rekindling of tax arbitrage and tax shelter activities that do not contribute to economic growth.

Considerations of that kind suggest the potential attractiveness of "targeted" capital gains tax reductions aimed particularly at venture capital and new enterprises. The trouble is such targeted reductions require rather arbitrary distinctions, add greatly to administrative complexity, and generate essentially unproductive efforts to artificially meet the favored tax criteria.

As a practical matter, I suspect that it would be difficult to confine "targeted" capital gains cuts to areas that objectively seem most promising from the standpoint of efficiency and productivity. Surely, the most popular target for favorable capital gain tax treatment is housing (and real estate generally), areas with large social and political appeal but with limited or non-existent rationale from the standpoint of economic efficiency.

On both economic and equity grounds, the clearest conceptual case for capital gains tax reform arises in the context of an inflationary economy. A rising price level over time means that taxation of nominal increases in capital value may cut into real gains to a much greater extent than intended. In extreme cases, real losses can be inflicted on the asset holder. For that reason, many economists argue that, logically, capital gains should be deflated by an acceptable price index before being taxed.

I am not among them. The temptation to seek insulation from the pernicious effects of inflation by indexing is, I suppose, natural. But limited indexing is itself distorting and if inflation persists will almost inevitably lead to demands to insulate other sectors. In the end the process is clumsy and self-defeating. The present controversy over how to accurately measure price increases is only a small, but nonetheless telling, part of the problem.

In the area of taxation, how can we reasonably insulate capital gains while we make no allowance for the inflationary component in interest? That is not simply a question of equity and avoiding economic distortion. There is a potential administrative nightmare in drawing up, and enforcing, rules against directly or indirectly borrowing (with interest fully tax deductible) to hold capital assets (with gains partly tax exempt).

The way to deal with the adverse impact of inflation on capital gains, as on so many other aspects of economic life, is to achieve and maintain reasonable price stability. As a nation, we have now gone a long ways in that direction after the unprecedented inflationary episode in the 1970's. Over almost all of our national history, inflation has not been a major problem in peace time. This is no time to sound a note of accommodation or retreat.

The suggestion has been made that capital gains tax rates be progressively reduced as the holding period is extended. As a practical matter, such an approach would relieve much of the concern about the erosion of real values by gradual inflation. At the same time, it would reward "patient" capital, arguably of particular significance for innovative entrepreneurs and new ventures.

Such an approach would raise additional issues of complexity and administration, requiring more record-keeping. Moreover, the distinction, from a conceptual standpoint, would create new arbitrary elements in decisions about when to buy and sell assets, distorting markets. Theoretically at least some of the sought-for benefits for productivity and efficiency would be offset.

My own instinct is that "fine tuning" downward adjustments year-by-year may create more complications than benefits. Nonetheless, I would welcome careful exploration and debate about the potential advantages of a staged reduction beyond the one-year point in present law, say after a five year holding period.

Such an approach would presumably be welcomed by home owners, real estate investors, family businesses and farmers. Presumably such a change would be less costly than a large general reduction in the capital gains rate. Moreover, it would relieve the pernicious "lock-in" effects of the favorable treatment of capital gains at death.

To summarize, a near-term reduction in the capital gains tax rate from present levels does not strike me as a pressing matter, especially given the current performance of the economy and the medium and longer-term budgetary prospects. Looking further ahead, I do believe we have long taxed savings and investment too heavily. Mainly for that reason, but also because of the adverse effects of even gradual inflation, the practical decision to cap capital gains taxes below high top-bracket income tax rates strikes me as sensible. However, a very large across the board reduction in capital gains taxes poses serious problems of equity and complexity, of revenue loss and of distortion of decision-making. Efforts to compromise the issue by highly targeted reductions also pose enforcement and effectiveness problems.

If public policy is to make a serious effort to raise the level of savings and investment, and do so equitably, the priorities seem to me clear. We should move as fast as we can toward a surplus in the Federal budget. We should also move in the direction of a consumption tax, reducing the weight we place on both personal and corporate income taxes. In that context, the idea of a limited reduction in existing capital gains tax rates -- with particular emphasis on longer-term holdings -- could be explored. But I must conclude with a word of warning. To the extent the debate on capital gains taxation is permitted to detract attention from the larger budget and tax priorities I have emphasized, the result will be counter-productive.

COMMUNICATIONS

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association (ABA) is pleased to submit this statement for the record in connection with the March 13, 1997 hearing before the United States Senate, Committee on Finance, on the tax treatment of capital gains and losses.

The ABA brings together all elements of the banking community to best represent the interests of this rapidly changing industry. Its membership -- which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks and thrift -- makes ABA the largest banking trade association in the country.

At the outset, we would like to commend Chairman William Roth (R-DE) for introduction of the "American Family Tax Relief Act", S. 2, and Minority Leader Tom Daschle (D-SD) for introducing the "Targeted Investment Incentive and Economic Growth Act of 1997", S. 20, which would, *inter alia*, reduce capital gains taxes and provide incentive for corporate investment in entrepreneurial small business. We particularly commend Senators Orrin Hatch (R-UT), John Breaux (D-LA), Charles Grassely, (R-IA), and Joeseph Lieberman (D-CT) for introducing the "Capital Formation Act of 1997", S. 66, which would provide a broad-based capital gains tax cut along with much needed improvements to existing small business stock investment tax incentives.

BROAD-BASED CAPITAL GAINS

ABA is pleased that the subject of capital gains rate reduction has garnered bi-partisan support. We fully support the enactment of tax legislation which incorporates targeted investment incentives for small business along with a broad-based capital gains cut.

The current tax regime essentially discourages investment in the most efficient, highest return opportunities. A broad-based capital gains rate cut would reduce the cost of capital and encourage the use of equity financing, rather than debt, for business activities. It would benefit a wide variety of income groups and economic sectors, including retirees, middle income families, large and small investors, businesses, farmers, and entrepreneurs. According to the 1996 Congressional Budget Office report, in 1989, thirty-one percent of families with incomes under $20,000 owned capital assets, not including their personal residences. For families with incomes between $20,000 and $50,000 the figure was fifty-four percent. Also, according to the Investment Company Institute, approximately sixty-percent of households earning $50,000 or less own mutual fund investments.

Capital gains tax relief is necessary in order to increase capital formation, stimulate saving and investment, raise domestic wages, and to boost domestic economic growth. Accordingly, a broad-based tax cut would impact virtually every sector of the American economy.

VENTURE CAPITAL

Under the present law, venture capital investment of corporations is effectively taxed at three levels: (1) the earnings of the recipient of the capital are subject to the regular corporate income tax, (2) the gains earned by the venture capital subsidiary are subject to the corporate income tax, and (3) distributions to individual stockholders of the investing corporation or the bank holding company parent are once again taxed. Reducing the capital gains tax rate is expected to "unlock" capital assets, lower interest rates and spur the economy, resulting in raising

federal revenues. It would also encourage venture capital investments by financial institutions by lowering the excessively high cost of capital.

The banking industry is actively involved in the venture capital business and is a vital source of venture capital funding. Banks represent a stable source of venture capital that has provided a cushion during periods when other sources of capital have contracted. By obtaining funds from the parent holding company, banks provide consistent, long-term support for the venture firms. Bank venture capital subsidiaries are also less subject to the fluctuations of the availability of venture capital funds and may also diversify their portfolios across industries and geographic regions to reduce risk.

Many of the larger U.S. commercial banks have non-bank venture capital subsidiaries which obtain funding from a parent bank holding company. In recent years, commercial banks have provided between 6 and 13 percent of all new venture capital invested each year, amounting to more than $5 billion. Bank venture capital investments have created approximately 80,000 new jobs over the last ten years.

Generally, investment in the stock of young entrepreneurial firms is among the most productive of investments. According to the Small Business Administration, a new job is created for every $17,000 of venture capital invested. These high risk, innovative and usually highly technical enterprises often must rely on investor purchase of stock to finance their operations. Most venture companies have little or no operating history and virtually no sales. A very large percentage of them produce losses or fail. However, successful venture businesses are among the fastest growing domestic companies. A reduction in the rate of capital gains tax on corporate venture capital investments is not only appropriate but sorely needed to stimulate continued job growth and development.

CONCLUSION

In conclusion, we support legislative efforts to reduce the tax rate on capital gains. We believe that any capital gains tax cut should be fiscally responsible, should provide benefits to all sectors of the economy and should reduce capital costs, prevent taxation of inflationary gains, facilitate movement of capital and promote entrepreneurship. Although we support the Administration's proposal to eliminate taxation of capital gain on the sale of certain principal residences, we are disappointed that the proposal is limited in scope and does not provide for a broad-based capital gains tax cut. We urge you to include provisions to provide broad-based and targeted venture capital tax relief in the revenue reconciliation portion of the fiscal year 1998 budget.

Thank you, once again, for allowing us to submit this statement. We look forward to working with you on these and other important issues.

The American Bankers Association
March 13, 1997

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SENATE FINANCE COMMITTEE REGARDING CAPITAL GAINS TAX REFORM

March 13, 1997

Farm Bureau supports repeal of capital gains taxes. Until repeal is possible, Farm Bureau supports cutting the rate to no more than 15 percent. It is wrong to tax earnings twice. In addition, the tax interferes with the sale of farm assets and causes asset allocation decisions to be made for tax reasons rather than business reasons. The result is the inefficient allocation of scarce capital resources, less net income for farmers and reduced competitiveness in international markets.

Farmers need capital gains tax relief in order to ensure the cost and availability of investment capital. Access to affordable capital influences agriculture's ability to compete with overseas production. Most farmers and ranchers have limited sources of outside capital. It must come from internally-generated funds or from borrowing from financial institutions. The capital gains tax reduces the amount of money available for reinvestment by farmers and ranchers. Financial institutions look closely at financial performance, including the impact of the capital gains tax on the profit-making ability of a business.

Capital gains taxes affect the ability of new farmers and ranchers to enter the industry and expand their operations. While many think of the capital gains tax as a tax on the seller, in reality it is a penalty on the buyer. Older farmers and ranchers are often reluctant to sell assets because they do not want to pay the capital gains taxes. Buyers must pay a premium to acquire assets in order to cover the taxes assessed on the seller. These higher costs for asset acquisition negatively impact the ability of new and expanding farmers and ranchers to make a profit and compete in international markets.

Proceeds from the sale of many agricultural commodities including timber, Christmas trees, and breeding livestock such as dairy cows, horses, sheep, and hogs are subject to the capital gains tax. The extended production cycles of these commodities rightfully merits capital gains treatment but it is unfair to tax the proceeds from the sale of trees and breeding livestock at ordinary rates. Farmers and ranchers who produce slow maturing commodities must wait for years to recover their investment and do so at high risk. This is justification for a capital gains tax rate that is no more than 15 percent.

Farm Bureau supports adjusting capital gains for inflation so that only real gains in the value of assets would be taxed. Under current law, many farmers and ranchers pay an effective tax rate that is extreme and sometimes end up paying more in capital gains taxes than the increase in the real value of the assets. Farmers and ranchers are reluctant to sell land and farm assets and reinvest in other assets, even when that may make the best business sense. For assets held for long periods of time, adjusting their value for inflation is a matter of fairness.

Farmland provides a good example. Farmers and ranchers on average hold farmland for about 30 years. In 1966, farmland in Missouri was selling for an average of $142 per acre. In 1996, the average was $948. A farmer who bought 300 acres of land in 1966 for $42,600 and sold it in 1996 would have a taxable gain of $241,800 and owe $67,704 at a 28 percent tax rate. Average prices in the U.S. economy are now 4.26 times what they were 30 years ago. This means that the real increase of value on those 300 acres was $102,924, making the effective tax rate on the real capital gain 66 percent.

Farm Bureau supports allowing receipts from the sale of farm and ranch assets to be placed directly into a pre-tax individual retirement savings account (IRA). Withdrawals would be taxed at the regular applicable income tax rate. Farm and ranch assets accumulated over a lifetime are often the "retirement plan" for farmers and ranchers. Allowing these funds to be placed into a pre-tax account would treat farmers and ranchers in the same manner as other taxpayers who contribute to IRAs throughout their working life.

Farm Bureau also believes that the current once-in-a lifetime exclusion of $125,000 on the sale of a primary residence by a taxpayer over 55 years of age should be increased to $500,000 and expanded to include farms and ranches. The exclusion should not be limited to a single use by a taxpayer over age 55 and, if not used, should be added to an individual's estate tax exemption.

American farmers and ranchers are the most productive in the world, producing 16 percent of the world's food on just 7 percent of the land. Farm and ranch productivity allows U.S. citizens to spend only 9.3 percent of their income on food, the lowest percentage in the world.

Agriculture and related industries provide jobs for more than 21 million people. Nearly 3.5 million people operate farms or work on farms. Another 3.6 million produce the machinery and inputs used on the farm or process and market what farmers produce. More than 14 million work in wholesale or retail businesses helping get farm products from the farm to consumers.

In order for farmers to continue this high level of productivity, reform in capital gains tax laws is needed without delay. The results will benefit farmers, consumers and the economy.

Statement of the
National Council of Farmer Cooperatives

Submitted to the
Senate Committee on Finance
March 13, 1997

Mr. Chairman, Senator Moynihan, and Members of the Committee. We appreciate the opportunity to submit our statement to this Committee concerning the impact of capital gains and other taxes on farmers and cooperatives.

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses owned and controlled by farmers. Its membership includes nearly 80 major farmer marketing, supply and credit cooperatives, plus 31 state councils. NCFC members in turn, represent more than 4000 local farmer cooperatives across the nation, with a combined membership of nearly 1.6 million farmers.

These farmer owned-businesses handle almost every type of agricultural commodity produced in the U.S., market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. NCFC's mission is to develop and support national policies and programs which protect and promote the economic well-being of farmer cooperatives and their members.

Farmer Cooperatives Are an Important Self-Help Tool for Farmers -- and are extremely important to their well being and livelihood. Given the changes in the recent farm bill and continued budget pressures, it has become more important than ever for farmers to be able to join together in cooperative efforts:

- to better manage the risk inherent in agriculture;
- to achieve the necessary economies of scale;
- to capitalize on new market opportunities, including value-added; and
- compete more effectively in the global marketplace.

We believe, the elimination or, at least, a Reduction in the Current Capital Gains Tax would benefit farmers and cooperatives alike.

Farming is a capital-intensive business. The current tax policy in this country does not encourage the transfer of assets from one generation to another, or the intra-generational transfer of assets. This policy hinders cooperatives. The current capital gains tax structure serves as a disincentive to invest in many farmer-owned cooperatives.

Farmers are independent individuals who work hard to create their own opportunities and to create their own personal financial safety net. In order for farm families to become financially secure over the long haul and into their retirement years, it is necessary for farmers to make money while farming, and to set aside income or assets for future use. Changes to the current capital gains structure are needed so that farmers are not penalized because of their capital-intensive investments. The elimination or reduction in Capital Gains would address this issue, and would help attract needed capital, and encourage investment, to help farmers and their cooperative make the necessary improvements to meet environmental challenges, enhance their competitiveness and capitalize on new market opportunities.

Any gain from the transfer of the equity stock among producers in a cooperative is subject to capital gains tax. This tax is a substantial hinderance for farmers who would like to transfer their stock in a cooperative to a prospective member

of the cooperative. This hinders not only the farmer but also the cooperative, because it limits the cooperative's ability to create incentives which raise new capital through new membership in the cooperative. Again, for all these reasons, we urge Congress to eliminate or, at least, reduce the capital gains tax rate.

Furthermore, We Support Eliminating Alternative Minimum Tax (AMT) Liability for Farmers Who Use Deferred Payment Contracts. The Senate and the House recently introduced legislation to achieve this, (S. 181) and (H.R. 426). NCFC strongly supports this legislation and applauds the efforts of all the Senators and Representatives who have worked tirelessly and in a bipartisan manner in support of this legislation, especially the Members of this Committee.

In closing, we encourage the Senate Committee on Finance to recognize the self-help tool cooperatives provide farmers by endorsing tax changes that encourage and strengthen cooperative efforts. Cooperatives are extremely important to the well-being and livelihood of farmers across this country. NCFC urges this Committee to support proposals that aid farmers in joining together in cooperative efforts. In addition, NCFC supports many of the tax changes advocated before this Committee by the agricultural industry that would lessen the tax burden on farmers. These include reinstatement of income averaging, liberalization of estate tax laws, 100 percent deductibility of health insurance premiums, and creation of an environmental tax credit for farmers. Thank you, Mr. Chairman -- NCFC and its members look forward to working with Congress to achieve these objectives throughout the coming year.

STATEMENT
on the
TAX TREATMENT OF CAPITAL GAINS AND LOSSES
for submission to the
SENATE COMMITTEE ON FINANCE
for the
U.S. Chamber of Commerce
by
William T. Sinclaire
Senior Tax Counsel and Director of Tax Policy
March 13, 1997

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the tax treatment of capital gains and losses. The U.S. Chamber is the world's largest business federation, representing an underlying membership of more than three million businesses and organizations of every size, sector, and region. This breadth of membership places the U.S. Chamber in a unique position to speak for the business community.

Introduction

The U.S. Chamber believes that public policies should not only improve our current economic environment but also ensure our future prosperity. The key to a stronger economic future is simple to define, *i.e.*, a high rate of economic growth, but difficult to achieve. It is strong economic growth that will allow us to maintain our position of world leadership, increase our domestic standard of living, and meet the daunting demographic challenges that will begin to present themselves early in the next century.

But economic growth does not occur by accident. Just as our farmers do not rely on good luck for bountiful harvests, neither can we rely on chance or the momentum of the past to propel us in the future. The seeds of tomorrow's economic success must be planted today, and so, when evaluating economic policies, we must ask how they would cultivate long-term economic growth.

By definition, economic growth is simply the product of growth in the labor force (*i.e.*, the number of hours worked) and growth in productivity (*i.e.*, output per hour). With growth in hours worked largely determined by demographics, sensible economic policy must emphasize strong productivity growth.

This is a crucial issue because productivity growth has been languishing for the past quarter-century or so. After expanding at a healthy 2.7-percent rate during the 1960's, for example, productivity growth has slowed to an anemic one percent rate so far in the 1990's. With growth in hours worked hovering a little below 1.5-percent, long-term economic growth is thus limited to 2.5-percent – well below the average of the post-World War II era.

While measurement problems related to productivity have expanded with the growing share of the economy devoted to service-producers rather than goods-producers, the decline in economic growth over the same period confirms that we are suffering a decline in the underlying growth rate in productivity. The question then becomes: What can we do to raise productivity growth?

Like the farmer who sows the seed corn and cultivates the soil, households and businesses must also prepare for the future. Virtually all economists agree that this is done by saving and investing in capital – both human capital (education) and physical capital (plant and equipment). Thus the issue of long-term productivity growth and, in turn, economic growth becomes one of fostering additions to, and improvements in, capital. Consequently, the U.S. Chamber believes that today's economic policies must be targeted toward improving economic growth by fostering saving, investment, and capital formation. Only through such pro-growth policies can we lay the foundation of prosperity and security for our children into and beyond the 21st century.

To boost productivity, the federal government must end its misdirection of resources and curb its appetite for borrowing so that national savings and investment can be increased. This will yield stronger productivity growth, which in turn will propel the economy on a higher growth track. Besides balancing the budget, other policy elements that would aid long-term economic growth include overhauling our regulatory and tort systems, enhancing education and job training programs, reducing the tax burden, and reforming the tax code.

The Need for Capital Gains Tax Reform

Vibrant, healthy economies require resources to be allocated to their most efficient, or productive, uses, but high tax rates on capital gains impose a barrier to the efficient flow of capital. Lower capital gains taxes would spur investment activity, create jobs and expand the economy, which would benefit individuals of all income levels.

Many investors and businesses are unwilling or unable to sell their capital assets due to the high rate of tax that would be imposed on the "gain" of such assets – much of

which can be due to inflation, rather that real appreciation. This creates a "locking effect" of capital assets which prevents investors and businesses from allocating their resources to more productive capital or business ventures. Scarce capital, therefore, remains tied up in suboptimal uses, to the detriment of economic growth.

Bold capital gains reforms should be implemented to boost capital formation and mobility. These reforms include reducing capital gains rates on individuals and corporations, indexing the bases of capital assets for inflation, providing capital loss treatment for sales of principal residences and expanding the preferential capital gains treatment for small business stock.

Current Treatment of Capital Gains

Gain or loss reflected in the value of an asset is generally not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, the net capital gain is taxed as ordinary income, except that a net capital gain of a noncorporate taxpayer is subject to a maximum marginal tax rate of 28-percent. Capital losses are generally deductible in full against capital gains, and, in the case of noncorporate taxpayers, losses may be deducted against ordinary income up to a maximum of $3,000 per year. In addition, noncorporate taxpayers may carry forward capital losses in excess of the foregoing to future years indefinitely, but may not carry them back to prior years. Corporate taxpayers may generally carry back capital losses three years and forward five years.

A 50-percent exclusion of the gain from the sale of stock in certain small-business corporations is permitted. For a taxpayer to be eligible for the exclusion, the small-business stock must be held for at least five years and it must have been acquired at original issuance when the corporation had aggregate gross assets of not more than $50 million. In addition, the amount of gain eligible for the exclusion is limited to the greater of 10 times the taxpayer's basis in the stock or a $10 million gain from stock in the corporation.

Gain is not recognized on the sale of a principal residence if a new residence (at least equal in cost to the sales price of the old residence) is purchased and used by the taxpayer as his or her principal residence generally within two years before and two years after the date of sale of the old residence. The basis of the new residence is reduced by the amount of any gain not recognized (because of this rule) on the sale of the old residence. Furthermore, an individual, on a one-time basis, may exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer has attained age 55 before the sale, and has owned and used the property as his

or her principal residence for at least three of the five years preceding the sale. However, a loss on the sale or exchange of a principal residence is treated as a nondeductible personal loss.

Capital Gains Reform Proposals

There are several capital gains reform proposals introduced in the 105th Congress which the Chamber supports, including:

American Family Tax Relief Act (Title II of S. 2) – introduced by Senator Roth (R-DE) and others – would permit individuals to exclude 50-percent of their net capital gains from tax, subject corporations to a maximum capital gains tax rate of 28-percent, permit taxpayers other than C corporations to index certain capital assets for inflation, allow taxpayers to treat losses on the sales of principal residences as deductible capital losses, and modify the rules relating to sales of certain small-business stock.

Capital Formation Act of 1997 (S. 66) – introduced by Senators Hatch (R-UT), Lieberman (D-CT), Grassley (R-IA), and Breaux (D-LA) – would permit individuals to exclude 50-percent of their net capital gains from tax, subject corporations to a maximum capital gains rate of 25-percent, and modify the rules relating to sales of certain small business stock.

Capital Gains Reform Act of 1997 (S. 72) – introduced by Senator Kyl (R-AZ) – would provide individuals with a 70-percent capital gains exclusion, and a maximum capital gains tax rate of 22-percent for corporations.

There are other proposals which the Chamber believes move in the right direction but need to be expanded, including:

Presidents Clinton's Fiscal Year 1998 Budget Proposal – Under his budget proposal, a taxpayer would generally be able to exclude up to $250,000 ($500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence no more frequently than once every two years. (No other capital gains provisions were included in his budget package.)

Targeted Investment Incentive and Economic Growth Act of 1997 (S. 20) – introduced by Senator Daschle (D-SD) and others – would allow a taxpayer to roll over the gain on the sale of the stock of an eligible small-business investment, permit ordinary loss deductions for individuals up to $150,000 ($300,000 for joint

returns) from the loss on the sale or exchange of eligible small-business investments, amend the eligibility and other rules for small-business stock, provide an exclusion up to $250,000 ($500,000 if married filing a joint return) of capital gain realized on the sale or exchange of a principal residence, and allow individuals owning a 50-percent or greater interest in a farming business and materially participating in that business for five or more years, to roll over capital gains from the sale of the assets used in the active conduct of the business to an individual retirement account.

Family Retirement Equity Act of 1997 (S. 80) – introduced by Senator Kohl (D-WI) – would allow individuals owning a 50-percent or greater interest in a farming business and materially participating in that business for five or more years, to roll over capital gains from the sale of the assets used in the active conduct of the business to an individual retirement account.

In addition, there are several other capital gains relief bills which the Chamber is currently evaluating, including:

Long-Term Investment Act of 1997 (S. 252) – introduced by Senator Gregg (R-NH) – would retain the current 28-percent tax rate for individuals but would provide a 5, 10, and 20-percent deduction for assets held more than two, three, and four years, respectively. In addition, a surcharge of 5.6 and 2.8-percent would apply to assets held six months or less and between six and 12 months, respectively.

S. 306 – introduced by Senator Ford (D-KY) – would reduce the current 28-percent individual maximum capital gains tax rate for assets held more than two years on a sliding scale down to a 14-percent maximum rate for assets held more than eight years.

Conclusion

Our long-term economic health depends upon sound economic and tax policies. Today, we are critically shortchanging ourselves and, more importantly, our children, as we commit too many of our scarce resources into current consumption and away from prudent investment. Our tax system encourages waste, retards savings, and punishes capital formation – all to the detriment of long-term economic growth. As we prepare for the economic challenges of the next century, we must orient our current fiscal policies in a way that encourages more savings, more investment, more productivity growth, and, ultimately, more economic growth.

The U.S. Chamber believes that substantive capital gains reform is needed in order to spur business investment and productivity growth. Short of repeal, capital gains rates should be reduced for both individuals and corporations, capital assets should be indexed for inflation, and losses on personal residences should be treated as deductible capital losses.

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