S. Hrg. 104-24

# TAX TREATMENT OF CAPITAL GAINS

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

FEBRUARY 15, 1995

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

90-210—CC WASHINGTON : 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047122-2

## COMMITTEE ON FINANCE

BOB PACKWOOD, Oregon, *Chairman*

BOB DOLE, Kansas
WILLIAM V. ROTH, JR., Delaware
JOHN H. CHAFEE, Rhode Island
CHARLES E. GRASSLEY, Iowa
ORRIN G. HATCH, Utah
ALAN K. SIMPSON, Wyoming
LARRY PRESSLER, South Dakota
ALFONSE M. D'AMATO, New York
FRANK H. MURKOWSKI, Alaska
DON NICKLES, Oklahoma
DANIEL PATRICK MOYNIHAN, New York
MAX BAUCUS, Montana
BILL BRADLEY, New Jersey
DAVID PRYOR, Arkansas
JOHN D. ROCKEFELLER IV, West Virginia
JOHN BREAUX, Louisiana
KENT CONRAD, North Dakota
BOB GRAHAM, Florida
CAROL MOSELEY-BRAUN, Illinois

LINDY L. PAULL, *Staff Director and Chief Counsel*
LAWRENCE O'DONNELL, JR., *Minority Staff Director*

# CONTENTS

## OPENING STATEMENTS



## CONGRESSIONAL WITNESSES



## PUBLIC WITNESSES



## ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED



## COMMUNICATIONS

# TAX TREATMENT OF CAPITAL GAINS

---

**WEDNESDAY, FEBRUARY 15, 1995**

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

The hearing was convened, pursuant to notice at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Bob Packwood (chairman of the committee) presiding.

Also present: Senators Chafee, Grassley, Simpson, D'Amato, Nickles, Baucus, Rockefeller, Breaux, Conrad, Graham, and Moseley-Braun.*

## OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

The CHAIRMAN. The Committee will come to order.

I might explain to the witnesses what we have been doing over the past few weeks when Senator Moynihan and I jointly plotted out these hearings.

It started out first with hearings on does the Tax Code tilt toward consumption—or does it tilt toward investment? Just generally, which way does it tilt? The general tenor of the witnesses was that it seems to tilt toward consumption.

The second question of witnesses, is should it? Another set of hearings. Should it tilt toward consumption, or should it try to tilt towards savings and investment? Or can you do both?

There we had a split, with some wanting it to tilt toward consumption, and making it very clear. Others say no. But there was not much disagreement that it did tilt toward consumption.

Now, we are into the third series of hearings. If we are going to attempt to tilt toward savings and investment, is there a best way to do it?

Are capital gains and IRA's all we need? Is it Nunn-Domenici or a flat tax, or a value-added tax instead of Nunn-Domenici or capital gains? What should be the mix if we want to tilt toward savings and investment?

Or do we just take the present Tax Code and tinker with it, and add incentives for savings and investment? But the difficulty I have always found with that is that every single interest group is convinced they are the linchpin for savings and investment. And, if anybody is to be included, it is them, even if we exclude everybody else.

---

*Joint Committee on Taxation published a print relative to this hearing: "Tax Treatment of Capital Gains and Losses" (JCS-4-95), February 13, 1995.

And these people are not malevolent or selfish or greedy. They see the world through their eyes, and they are convinced that they are the linchpin for savings and investment.

So today and tomorrow, we are going to concentrate heavily on capital gains. You do not have to limit your statements to capital gains, but clearly we are talking heavily about capital gains in the next 2 days. And we will continue with these hearings until we have laid a sufficient groundwork. And then I am not sure where we come out in conclusion. If we want to tilt towards savings and investment, that will await further hearings and the conclusion of this Committee.

So, with that, as I see there is nobody else here to make an opening statement, we will start.

I think I will just take the witnesses in the order we have them. Your entire statement, of course, will be in the record. And, if you can abbreviate it as much as possible, we would appreciate it.

We will start with Mr. Ron Pearlman, who this Committee knows well from his Treasury days, and his serving as Director of the Joint Committee for several years. Ron, it is good to have you back.

## STATEMENT OF RONALD A. PEARLMAN, COVINGTON & BURLING, WASHINGTON DC

Mr. PEARLMAN. Thank you, Mr. Chairman. It is a pleasure to be here.

This morning I am not here as an advocate, or as an opponent, of a decrease in the capital gains rate. Rather, my purpose is to provide some background information that hopefully will be of assistance to the Committee.

I will focus on three structural issues that I believe are important. There are some other ones contained in my written statement.

First, let me just refer briefly to the history of capital gains. The tax law has provided individuals some form of capital gains preference since 1922, and continuously through the subsequent 73-year period, except for the 3-year period 1988 through 1990, following phase-in of the 1986 Act. However, the law was not settled during this period. It was changed on at least 10 different occasions.

The history of corporate capital gains has taken a different path. The preference was first made available by the Revenue Act of 1942, when a 25-percent maximum rate was enacted. Over the years, the rate bounced around, hitting a high of 30 percent in 1969. And, as a result of the 1986 Act, no corporate preference presently exists.

Now I would like to refer, as I indicated, to three of the structural issues discussed more fully in my prepared statement. They are depreciation recapture, the alternative minimum tax and an issue of rate conversion.

The first is depreciation recapture, which is discussed at page 10 of the written statement. Gain on the sale of a capital asset is calculated by comparing the sales price with the asset's adjusted tax basis. This basis is reduced dollar-for-dollar by the amount of allowable depreciation or amortization deductions.

Therefore, on the sale of the asset, the portion of the basis that has been depreciated or amortized is subject to tax, to the extent that the sales price exceeds that basis. However, absent a specific statutory provision, even though the depreciation deductions were taken against ordinary income, the resulting gain is taxable at capital gains rates.

Since the early 1960's, the tax law has contained specific provisions, known as recapture rules, designed to recharacterize as ordinary income, either all of some portion of gain attributable to prior depreciation or amortization deductions.

The current law depreciation recapture rules provide for full recapture of gain attributable to prior depreciation deductions on tangible property, such as machinery or equipment, for recapture of accelerated depreciation over straight-line depreciation in the case of certain real property that was eligible for pre-1986 accelerated depreciation, and for partial recapture in the case of certain Federally-insured and low-income housing property.

However, real property that is depreciated under the straight-line method is subject to no depreciation recapture.

President Bush's 1990 capital gains proposal included full depreciation recapture on all depreciable property. This treatment generally is justified on the basis that, if an asset is sold at an amount in excess of its depreciated basis, the prior depreciation deductions must have been overstated and, thus, appropriately subject to recapture at ordinary income rates.

Opponents of full recapture would argue that straight-line depreciation, over 39 years in the case of non-residential real property, for example, compensates for the inflationary gain inherent in a long-held asset, and is therefore not a tax benefit that should be subject to recapture at ordinary rates.

The Committee might consider whether the existing recapture rules are appropriate, or whether the current system should be replaced with a more comprehensive set of rules. Consideration might also be given to whether any distinction between the recapture rules applicable to machinery and equipment, on the one hand, and improved real property on the other, is appropriate, and whether the distinctions in recapture rules among classes of real property are appropriate.

The next issue relates to the alternative minimum tax found on page 13 of the statement. As you know, the 1986 Act included comprehensive alternative minimum taxes designed to assure that virtually every taxpayer pays at least some minimum level of tax.

The AMT subjects certain enumerated tax preferences to tax. Prior to the 1986 Act, the untaxed portion of capital gains was such a preference. This preference was deleted in 1986. In 1990, President Bush recommended that the untaxed portion of capital gains be included as a preference under the individual AMT. The Committee may wish to consider whether to include or exclude the untaxed portion of capital gains from the alternative minimum tax.

The third, and final, issue relates to an example of rate conversion. That is the ability to deduct against ordinary income, interest expense on indebtedness incurred to acquire a capital asset, and to pay tax on the profit on the sale of the asset at a lower capital gains rate.

This benefit is present in current law because interest expense is deductible by an individual at a 39.6 percent rate, and the gain on the sale of a capital asset is taxable at a maximum rate of 28 percent.

As a tax lawyer, I know that rate conversion encourages tax planners to design transactions to take advantage of the current deductibility of interest expense against ordinary income, the deferral of gain until the asset is sold, and the tax on the gain at a substantially lower capital gains rate.

I know of no advocate of an expanded capital gains preference who endorses or wishes to encourage uneconomic transactions. Thus, the Committee may wish to consult with the Finance staff, as well as the Joint Committee, IRS and Treasury staffs, to attempt to identify potential tax avoidance transactions that have little or no economic substance, but that appear not to be adequately covered by the tax avoidance provisions of current law.

However, in doing so, I urge you to direct the staffs to take into consideration, and make the Committee aware of the resulting complexity of any additional legislative safeguards.

Mr. Chairman, capital gains tax policy obviously is a very important subject. Not only are the broad economic and behavioral issues significant, but the issues surrounding the structure of an expanded capital gains preference are important. That is, the actual rules by which people and businesses will conduct their affairs.

I appreciate having been given the opportunity to discuss some of these issues with you this morning.

Thank you.

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

The CHAIRMAN. Ron, thank you.

Next we will take Dr. Henry Aaron, who is the Director of Economic Studies at the Brookings Institution. He has been before this Committee—Doctor, how many times have you testified before this Committee?

Dr. AARON. I do not know. It is enjoyable every time.

The CHAIRMAN. Well, it is a pleasure to have you. There is probably nobody on this panel who has been here half as much as you have been here over the years. We welcome your testimony.

## STATEMENT OF DR. HENRY J. AARON, DIRECTOR, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. AARON. Well, thank you for having me back, under new management. [Laughter.]

I have a written statement. I thank you for including it in the record. I also attached to the statement some graphics which, in effect, represent a road map through the written testimony. I would like to use my time before you to review those graphics.

The first presents the various reasons advanced for instituting a lower rate of tax on capital gains, or for indexing capital gains. They relate to arguments concerning economic growth, fairness, and efficient resource allocation.

My testimony and the remainder of these charts go through each of those arguments and evaluate them.

The second graphic I include because there is, I think, insufficient recognition of the very considerable tax advantages that capital gains already enjoy under current law. In particular, unrealized gains are never taxed under the personal income tax. They transfer to the heir, with a new basis. About half of capital gains are not realized because of that reason. Second, gains are taxed only upon realization, not on accrual. Deferral, as we all know from previous tax legislation, is a great advantage. The 1986 Act went to some lengths to curb avoidance mechanisms based on deferral.

Furthermore, as far as equities are concerned, a substantial fraction of equities are received by tax-exempt entities. Hence, the question of taxation of capital gains is irrelevant.

As far as equities are concerned, putting these three effects together means that the effective rate of tax on equity investments currently averages only about 7.2 percent, less than a fifth of the maximum statutory rate on ordinary income.

The third graphic, which staff asked me to focus on particularly, concerns an iron law, an identity, that I think needs to be kept in mind in thinking through the logic of how capital gains could spur economic growth.

As far as economic growth in the United States is concerned, what we are concerned about is U.S. domestic investment. U.S. domestic investment is identically equal to, it cannot be anything other than, the sum of U.S. national saving and our net foreign borrowing, which is our trade deficit.

Now, U.S. national saving, in turn, is simply the difference between private saving and the Government deficit. This chart is important. If we finance domestic investment through net borrowing from abroad, then the income from that investment flows to the owners who are not U.S. citizens. Therefore, the gain from that investment flows abroad, not to Americans.

Therefore, the critical place to look for whether capital gains can spur economic growth is to its effect on U.S. national savings, what I call Sp minus D—private saving less the deficit.

I am going to skip the next chart, which simply says that capital gains advantages are available to domestic and foreign investment alike and, therefore, do not give U.S.-based investment any advantage.

Graphic 5 examines the effect of the capital gains rate reduction on private saving. In doing this calculation, I have employed an estimate of the responsiveness of private saving to the rate of return done by Michael Boskin, which is at the upper end of empirical estimates. My own belief is that it is probably too high but, in order to get as large an estimate of the effect on saving as possible, I have used Professor Boskin's estimate.

Based on that savings elasticity estimate, the maximum effect on U.S. private saving would be under $2 billion per year. And I should point out that Professor Boskin's definition of saving, like that of most other economists, includes purchases of consumer durables. That is not the definition most of us use in thinking about what adds to productive capacity.

Will the effect on the deficit be as large as, or larger than, or smaller than the increase in private saving. The next graphic addresses this issue. It does not contain numbers, but presents some reasoning that I believe Jane Gravelle may go into at some greater length, concerning the effects on realizations that would have to be sustained for capital gains to break even or to raise revenue.

Based on the best estimates of what the effects on realizations will be, as incorporated in the revenue estimates prepared by the Department of the Treasury and by the Joint Committee on Taxation, the rate reduction is estimated to lose increasing amounts of revenue after the first couple of years, during which everybody agrees that there would be a burst of realizations. The revenue loss trends up toward $10 billion a year.

So the revenue loss from the rate reduction proposed in the proposal exceeds the increase in private saving.

The second major provision in the capital gains proposal relates to indexation. Mr. Pearlman has already referred to the fact that the rate reduction would increase opportunities for tax planning to avoid revenues that represents an additional source of revenue loss.

Indexation magnifies that incentive considerably because the proposed change in tax law explicitly would not index interest income. It would therefore encourage tax planning in which people borrow fully-deductible interest that would incorporate any inflation premium in it. They would then earn capital gains, only a portion of which would be taxed. The inflation component, of course, would then be completely excluded under indexation.

Furthermore, I believe it is important to recognize the effect of indexing capital gains, but not of other sources of income on large portfolios. I go into this at some length in my statement. It is natural for people who have both gains and losses to try to match gains and losses in sales in order to minimize their tax liability.

Indexation of capital gains would mean that there were significantly more assets on which there are now nominal gains, but would, under indexation, show real losses. Therefore, the opportunity to match transactions would be very substantially increased.

My recommendation is that, if indexation is to be included, one should index all capital income. I believe we can move a long way in that direction. It would raise some administrative problems of considerable magnitude. But indexation is desirable, if done across the board for capital income.

If we index only capital gains, I would suggest that indexation be permitted only to taxpayers who agree to mark to market all indexable assets, and pay tax on gains as accrued, not as realized.

The specific questions that you posed in your letter inviting us to testify, Mr. Chairman, mentioned a couple of other issues that you wanted us to address.

Let me focus on one particular question. What capital gains tax rate would maximize revenues from capital gains taxation?

I argue in my testimony, with all due respect, that is the wrong question to ask. If one's objective is to maximize revenues from capital gains taxation, the proper issue to address is not the rate of taxation, but constructive realization at death.

This is a change that would raise considerable revenue, would reduce the lock-in effect that currently exists, and would be a step in the direction of taxing income, which is supposedly the object of the personal income tax.

Let me stop at that point. I am sure there will be questions for all of us later on.

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

The CHAIRMAN. Mr. Bloomfield, whom I have known for a good many years. I know his partner or boss. I am never quite sure what Charlie is in your operation, ever since he was the Under Secretary of the Treasury in 1969.

It is good to have you with us.

STATEMENT OF MARK A. BLOOMFIELD, PRESIDENT, AMERICAN COUNCIL FOR CAPITAL FORMATION, WASHINGTON, DC., ACCOMPANIED BY DR. MARGO THORNING, CHIEF ECONOMIST

Mr. BLOOMFIELD. Thank you, Mr. Chairman. For the record, my name is Mark Bloomfield. I am President of the American Council for Capital Formation. I am accompanied by Dr. Margo Thorning, our Chief Economist.

We very much appreciate the opportunity to be part of today's hearings on the economic policy issues raised by proposals to reduce the capital gains tax.

As a predicate, it might be helpful, Mr. Chairman, to put your three excellent questions in a broader context, which I suggest has two premises.

First, we have a serious saving and investment problem. U.S. saving and investment in recent years, as you know, has lagged our competitors, and is at an historic low. We had better do something about saving and investment because it is the significant determinant of economic growth, higher living standards and jobs for our citizens.

The second premise is that we currently tax saving and investment as if it were a sin, rather than an economic virtue. This is primarily because the income taxes saving more than once—first when income is earned, and again when interest and dividends on the investment financed by savings are realized, or when capital gains from the investment are realized.

Taxes on income that is saved raises the capital cost of new productive investment for both individuals and corporations, thus dampening such investment in future growth, output and living standards.

The Chairman's first question—what is the economic case for reducing the capital gains tax?

The economic case for a low capital gains tax rests on the beneficial impact on lower capital costs, capital mobility, dealing with the ravages of inflation, and entrepreneurship.

First, capital costs. The capital cost concept is often called the hurdle rate because it measures the return an investment must yield from a firm willing to start a new capital project. Economists are in broad agreement that capital costs are affected by tax policy. For example, Stanford Professor John Shoven estimates that about one-third of U.S. capital costs are due to taxes. Low capital gains taxes hold down capital costs. Public finance economists refer to the tax on capital gains as a tax on retained income, which funds a large part of business investment. The higher the capital gains, the more difficult it is for management to retain earnings, rather than pay out dividends to fund real investment in productive projects. Research by Dr. Shoven, Ohio State Professor Patrick Henderschott, and Dr. Alan Sinai indicate that a cut in the capital gains tax rate to a range of 15 to 20 percent would reduce the cost of U.S. capital by 4 to 8 percent, which is not insignificant.

The second economic case for capital gains tax cut—capital mobility. High capital gains taxes reduce the mobility of capital and lessen economic efficiency by keeping capital from flowing to its most productive use. This is a point that Dr. Gravelle makes in her excellent brief on capital gains taxation.

Finally, inflation. The willingness to invest is hindered by taxing capital gains, which very often are just phantom earnings brought about by inflation.

The Chairman's second question—how do other developed countries tax capital gains? The U.S. taxes capital gains much more harshly than the rest of the world. In a survey we have done of 12 industrialized countries, the U.S. capital gains tax on long-term gains on portfolio securities was found to exceed all of the countries except for Australia and the United Kingdom. Even these two countries indexed the cost basis of an assets.

Further, many industrialized countries tax other capital income less harshly than does the United States. This is done to a very large extent by the integration of personal and corporate taxation. And note that, on average, the OECD countries collect 30 percent of their revenues from consumption taxes rather than only 15 percent from consumption taxes in the U.S. So, if one looks at the international taxation of capital gains, one needs to put it in a broader context also.

The Chairman's third question—at what rate would the Federal Government maximize tax revenues from capital gains? What is the analytical work out there? Well, you need to put it in the following context. Capital gains revenue estimates involve three elements: the static revenue loss; the unlocking effect; and the macroeconomic impact.

A National Bureau of Economic Research study in the late 1980's found the capital gains revenue maximizing rate to be in the range of 9 to 21 percent. And that is the point at which there is sufficient unlocking, because of a lower tax rate, to compensate for the static revenue loss.

I should point out that that study was undertaken by Larry Lindsay, now a member of the Federal Reserve. I had the opportunity to talk to Governor Lindsay the other day and ask him how he feels about his study now Has the evidence changed? And he sent me a fax, which I would like to include in the record when I get the printed copy. And what he says about his study at that time is that the present 28 percent capital gains rate could be reduced without adversely affecting capital gains revenue.

[The fax appears in the appendix with Mr. Bloomfield's prepared statement.]

Mr. BLOOMFIELD. He also points out that capital gains tax revenues have clearly failed to keep pace with the growth in financial wealth. As a matter of fact, if they had, we would have had an additional $50 billion in capital gains receipt.

Finally, he suggests that the revenue maximizing rate, to respond to your question, is probably between 15 and 20 percent. He would assign a probability of 60 percent to this range, but there is evidence to suggest it might be lower.

So that deals with the maximizing rate, dealing with unlocking and the static. But, what about the additional revenues stemming from the positive macroeconomic impact of increased investment, GDP and employment which results from a significant capital gains reduction?

I would suggest that some of the evidence you are hearing today is done from a partial equilibrium model. It is not running the whole impact through the U.S. economy. Dr. Alan Sinai, who is one of the most renowned economists in the country, did precisely that. He ran it through his macroeconomic model with some 700 equations, and found that it has a significant impact, and it would result in significantly higher tax revenues.

Finally, what about the historical experience of actual capital gains tax revenue receipts? During periods of low taxes, 1978 to 1985, and high taxes, 1987 to the present, the evidence strongly suggests the reduction in the current capital gains tax would have a positive impact on Federal revenues.

A concluding thought, Mr. Chairman. While capital gains taxes should be lowered or eliminated immediately to help encourage U.S. saving and investment, the policy makers should have comprehensive tax reform as their long-term goal.

Under the major tax restructuring proposals before the Congress, income in the form of capital gains is not taxed at all, or only taxed if the proceeds are consumed, because saving and investment would be taxed lightly and consumption more heavily than under current law.

Thank you.

The CHAIRMAN. Thank you. And Dr. Jane Gravelle, who is the Senior Specialist in Economic Policy at the Congressional Research Service, who also has been before this Committee numerous times.

Doctor?

## STATEMENT OF DR. JANE G. GRAVELLE, SENIOR SPECIALIST IN ECONOMIC POLICY, CONGRESSIONAL RESEARCH SERVICE, THE LIBRARY OF CONGRESS, WASHINGTON, DC

Dr. GRAVELLE. Thank you, Mr. Chairman, Members of the Committee, for the invitation to appear before you to discuss the economic effects of cutting the capital gains tax.

I would like to say that I am not here to favor or oppose the tax cut. The Congressional Research Service does not take advocacy positions on policies before Congress. I am here, rather, to tell you what I believe the economic analysis has to say to you about the consequences of capital gains tax cuts.

I would like to summarize my testimony discussing the revenue effects, effects on savings and growth, efficiency issues, equity issues, and administrative concerns associated with capital gains tax cuts.

First, I believe that the revenue consequences of cutting the capital gains tax may be larger than those currently estimated. And

I will be frequently referring to the tax cuts in the House Republican Contract with America for the illustrations that I use.

This issue is obviously important because of the current concern about the budget deficit. There is disagreement over the past few years over the revenue consequences of capital gains tax cut. Both the administration and the Joint Committee on Taxation include in their revenue estimates the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains, which will raise offsetting revenues.

This projected increase in realizations is substantial and, as an illustration, will lower the static loss estimate for a 50 percent exclusion in the 5-year budget window by over 60 percent.

Empirical research on this realizations response has yielded a wide range of estimates. Studies examining realizations and tax rates across different taxpayers in a given time period, which we call microdata studies, often suggested extremely large responses. These latter studies were criticized as being extremely flawed, in part because the estimates they yielded may have been reflecting responses to temporary, rather than permanent, tax rate changes.

For that reason, the Joint Committee on Taxation chose to rely largely on time series evidence, that is evidence on realizations of capital gains in the aggregate over time, although time series evidence is also subject to a number of serious problems.

Because of the wide variation in estimates based on statistical analysis, and the problems with that analysis, I used in a 1991 study an alternative approach to assessing the likely size of the realizations response.

This approach is based on a simple observation. Over time, realizations cannot exceed accruals. That is, realizations would equal accruals over a long period of time, year after year, only if individuals sold every asset after holding it for less than a year. And no one would ever expect gains to be realized in this fashion.

This observation of the historical ratios of realizations to accruals can be used to measure the upper limit of the realizations response and to suggest the likely size of that response.

This analysis suggested a much lower permanent realizations response. It basically provides a reality check on statistical estimates.

My analysis suggested that the very large realizations responses found in most microdata studies lead to implausible estimates of changes in realizations responses, results that are far outside the bounds of historical experience, and far in excess of accrued gains for tax revisions such as those in the Contract.

A major problem with these microdata studies—and I am very sorry for introducing technical issues here, but I think they are important—was that they could not control for timing effects. It is advantageous for an individual whose tax rate fluctuates from one year to another to realize gains in the years when tax rates are low.

Thus, the relationships that we found in this data, between low tax rates and high realizations, could be largely affecting responses to temporarily high or low tax rates. These responses would not hold up for a permanent rate change.

Indeed the surge in realizations, as you will recall in 1986, when tax rates were scheduled to go up the next year, is evidence of the power of this timing effect. The current tax rate did not change. What changed was an expectation that the tax rate would go up in the future.

A recent statistical study used a new approach to try to control for this temporary transitory tax problem. They looked at variations in tax rates across States. Every taxpayer faces the same Federal tax. The taxpayers face different tax rates across different States. The results of this study, which were just published in the American Economic Review in September, found results that were entirely consistent with the study that I did, using a simulation approach.

If the findings of these studies are correct, the revenue estimates for a 50 percent exclusion could be more than twice as large as they would be, based on current revenue estimating assumptions.

In addition, the long-run cost of the capital gains tax cut in the Contract will be larger because of the growth in the cost of indexing. Because indexing only applies to inflation occurring after the revision, the inflation component of the capital gains tax cut will grow over time. This effect alone could also more than double the cost relative to exclusion. And the combination of both effects, a smaller realizations response, and the eventual effect of indexing, could increase the cost of exclusion by several times.

So I am talking about what I believe are very significant increases in the long run in the cost of this provision. And you can see some of the growth of that revenue cost by looking at the estimates over a 10-year period.

I would like to add, however, that none of these revenue costs, which are currently estimated at $53 billion in the first 5 years, are really large, relative to the U.S. economy. They would still be characterized in that context as small.

You inquired about the question of the revenue maximizing tax rate, the rate that would yield the largest amount of capital gains revenues. This rate, obviously, depends on the realizations response. Under current estimating assumptions, that rate is approximately the top rate in the tax law right now, around 28 percent.

If this new evidence is used, the revenue maximizing tax rate is probably higher, perhaps much much higher, than 28 percent. It is almost certainly over 50 percent.

It is certainly unlikely that any capital gains tax cut, however small, would fail to lose revenue. And, of course, large cuts are going to lose significant amounts of revenue.

I would like now to turn to the effects on savings and growth. The effects of a capital gains tax cut on the capital stock, labor supply and output are likely to be modest, especially in the short run. Even an analysis which I presented in more detail in my written testimony, using assumptions favorable to a larger and positive effect, that is, using Mike Boskin's savings elasticity, and assuming that we are going to deal with any deficit by offsetting it with some harmless correction of another type, shows very small increases in economic growth arising from the capital gains tax cut in the Contract.

For example, that model predicts an increase in output of 1/20th of 1 percent after 5 years. And, let me say, it is not the number of equations in the model; it is the empirical estimates of behavioral change in the model that matter to the outcome. I can certainly produce very large effects from this model, with very large elasticities.

The revenue feedback from this calculation, just from the growth effects, under this very positive scenario, is about 1 percent.

You may have heard of models that produce very large increases in output, and predict a very large change in the capital stock. These models do so by the assumption of an infinite savings elasticity and a rapid adjustment, and not by reference to any empirical literature that I am aware of.

An argument made for cutting the capital gains tax is that lower rates would increase economic efficiency, primarily by reducing tax barriers to sale. Capital gains tax cuts could also affect the allocation of capital in other ways.

Unfortunately, the efficiency effects of cutting capital gains taxes are mixed. They are not completely clear. But I do think they would be more likely to result from cuts in cuts in capital gains taxes on corporate equities than they would for tax cuts on real estate.

Finally, whether indexation, rather than an equivalent value rate cut, would lead to greater economic efficiency, is in doubt.

With regard to equity issues, capital gains are currently penalized because of the taxation of inflationary gains, but they also benefit due to deferral and nontaxation of the gains passed at death.

Most of the direct benefits of a capital gains tax cut will accrue to high-income individuals. Data presented in 1990, showing the distribution of benefits by income level, of a 30 percent exclusion, for example, indicated that over half the benefits accrue to the top one percent of the population, and about three-quarters accrue to the top 5 percent of the population.

Finally, with respect to administrative issues, I think the Committee should concern itself with questions that have been raised about the complexity of indexation, as opposed to inclusion. That will be a more complicated change for taxpayers to deal with.

Thank you very much.

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

The CHAIRMAN. Thank you. And, lastly, we will take Jude Wanniski, who is the President of Polyconomics of Morristown, New Jersey. I remember, Jude, when we had breakfast in the late 1970's, and you were going to talk me into what became the Roth-Kemp tax bill.

I do not recall the argument, but I do recall the breakfast. You got so excited that the eggs became hard as rocks and the bacon was like railroad ties.

So I remember the breakfast very well, and you were indeed successful in getting your ideas adopted.

It is good to have you with us.

## STATEMENT OF JUDE WANNISKI, PRESIDENT, POLYCONOMICS, INC., MORRISTOWN, NJ

Mr. WANNISKI. Thank you, Mr. Chairman. I cannot begin to tell you, Mr. Chairman, how thrilled I am to be before the Committee to address the topic of capital gains taxation, especially having been informed by staff that you had requests from both sides of the aisle.

As you know from personal experience, I have been a "nagging wife" on the critical importance of this issue for several years, to the point where members of Congress or the Executive Branch cross the street when they see me coming.

If you will recall, Mr. Chairman, I had you in my clutches in 1989, in the earliest days of the Bush administration, at a point where you were dead set against any change in capital gains taxation.

I would like to think I had something to do with having you reverse yourself to the point where you may now be as persuaded as I am that there is no single thing we could do in fiscal policy that would energize our economy as much as a lower indexed capital gains tax.

Now since that milestone conversation that I vividly recall having with you in 1989, I have had a further epiphany on this issue, which I will make the centerpiece of my testimony today.

It began with a conversation I had 4 years ago with Alan Greenspan, who told me of his belief that the correct tax on capital gains is zero. His position, which he has since made parenthetically to the banking committees of this body and the other, when testifying on monetary matters, is that a tax on capital gains is a tax on the national standard of living.

My epiphany was completed a few weeks later, after this Greenspan conversation, with another that I had with Ted Forstmann, who may well be the most successful entrepreneurial financier of our time.

It was Forstmann, now a man of immense wealth, who began his career with nothing more than a good education at Yale and a trust fund that provided him $500 a month, who let me in on a secret. Men of wealth, he told me, are not interested in a lower capital gains tax because their gains are behind them. The people who benefit most from a lower capital gains tax, he said, are those who have no wealth , but aspire to it. Independently of Greenspan, Forstmann told me that the correct tax on capital gains is zero.

What we are talking about here is the essence of capitalism, which is why this has become the defining economic issue of the Republican party.

I spent most of my life as a liberal Democrat. If I were a liberal Democrat today, doing my analysis in a demand model, I would vote against a cut in the capital gains tax. Even as a conservative in a demand model, the impact is so trivial that I would place it way down the list of things that I would do. It is in a supply model where you see these tremendous effects.

Now in the kind of capitalism we have here in the United States, people invest in each other. People with capital invest in people without capital. Old people invest in young people. Rich people invest in middle-class people, and the middle class invests in poor people with promise. People in cities invest in country people, and farm people in town people. When all this activity is at a high level, the economy is too.

Now when Wanniski invests in young Forstmann—directly or through a bank, a credit union, a stock market, a thrift, an insurance company or a pension fund—and Forstmann succeeds, Wanniski gets to share in the fruits of his success. The more successful he is, the more I will get in return. If he loses, I lose. Now if the Government tells me that, if Forstmann succeeds, I have to pay Internal Revenue a high percentage of my share of his success, I will think twice about making the investment in the first place.

If Forstmann, Inc. looks like a sure thing, I might invest in it anyway. But, if he does not have a proven track record in business, I will pass. And Forstmann, Little and Company may not get off the ground. I will invest in a blue chip company or a Government bond, or a municipal bond, something else—secure.

When the capital gains tax is high, riskier investment in the young, the small and the promising, aspiring poor will dry up. People will stick close to home, which they know best. City people will not invest in country people and vice versa. And, because there are fewer people able to try for success, there will be less success for the country as a whole.

When the capital gains tax is low, and there are more people encouraged to invest in each other, there is also a lot of employment. People who start a new enterprise with new capital hire helpers. And whether the enterprise eventually succeeds or not, the workers are earning weekly wages, and paying taxes, not only income taxes to the Federal Government, but taxes of all kinds to State and local governments.

People on unemployment benefits and welfare rolls are employed, and they begin adding tax revenues to city hall and the county and the State, instead of living on public welfare. All this activity, remember, is occurring because someone with capital, by which we mean surplus energy, talent and time, is willing to bet on another person who is temporarily short of either energy, talent or time, or all three.

The payoff for success in the venture is called a capital gain. Failure is termed a capital loss.

Now it is bad enough when the Government puts a high tax on capital gain, because the people who lose the most from the high rate are the poorest, the youngest, those at the beginning of their careers, those who are furthest from sources of capital.

But when the Government also taxes gains that arise from inflation, not real gains, then the flow of fresh capital from those who have it to those who need it really dries up.

If the rate is 28 percent on a capital gain, but it takes five or 10 years for an enterprise to know whether it is a success or not, the investor must consider the inflation rate, compounded over those years, and added to the 28 percent. The rate then becomes confiscatory.

Now inflation is a direct result of the monetary or fiscal irresponsibility of Government. To penalize participants in the private economy for the mistakes of Government seems to me to be the height of arrogance and irresponsibility.

In my home State of New Jersey, almost everyone who owns property now has to consider that if they sell that property, the farm, the home or the business, they have to pay capital gains tax on what is, for the most part, an inflated gain. The price of their property has gone up in the last 25 years, but the value is about the same, in terms of other goods and services that have also risen in price.

So they do not sell the property unless they are forced to sell in distress. The capital is locked in. It cannot be sold to someone who could make better use of the farm, the home or the business, with the proceeds to the current owner then invested in a new enterprise.

In the entire United States, which is worth about $30 trillion altogether, lock, stock and barrel, about $7.5 billion, one-quarter of all, is in value that is pure inflation.

The Federal Government would grab 28 percent of that if it were sold tomorrow, and State and local governments would grab their pieces too. But, because it is almost all locked in, the Government gets almost none of it.

If the Government decided tomorrow that it was not fair to tax all that inflated gain, it would immediately come unlocked. As it changed hands, governments at all levels would be able to get their share of the real gains.

Not only would capital become more efficient, as the economists say, but people everywhere would be happy with this great burden lifted from them, economic activity would increase, and governments would find their budgets going from red ink to black.

Imagine you had a race track where purses were so high for winning races that fine horses came from near and far to enter, and bettors came from near and far to watch and wager on these fine horses. Imagine the Government announcing it would tax away most of the purse, and you will quickly see the destruction that is done by the current Federal capital gains tax of 28 percent, unindexed, as it applies to inflated as well as to real gains.

This is why both political parties should be dedicated to at least reducing the rate and removing the tax threat on inflated gains. Almost everyone in the country would benefit immediately and for generations to come. The only losers would be those who are now betting on the nation's continued decline and failure.

Now why is there such ideological opposition to this idea from the Democratic side? It is because the Democratic Party is the party of security, the Party of fairness and compassion and equality. It is like the mother in a family, whose role is to question risky enterprise. The Republican Party must play the role of risk-taker, the traditional husband and father role of enterprise. President Clinton and the Democrats of this Committee will naturally be skeptical of ideas that increase the levels of risk-taking in our society. It is up to the Republicans of the Committee to persuade them that without risk-taking, there can be no economic growth. I say that again: Without risk-taking, there can be no growth.

All growth is the result of risk-taking, all success is the result of failure. The dynamism of our National economy is dependent upon people who are secure in their wealth, investing portions of it in men and women who have get-up-and-go and a can-do attitude, but no capital. The Majority Leader of the other body, Dick Armey, born in Can-Do, OK, would eliminate the tax on capital gains altogether in his flat-tax proposal. He is in agreement with Alan Greenspan and Ted Forstmann.

I bring up Congressman Armey at this point of my testimony because of his well-known desire to change the method of scoring capital gains taxation by the Congressional Budget Office and the Joint Committee on Taxation. The reason is not that he would like the computers that do the scoring to be programmed by optimists instead of pessimists. It is rather that they should be programmed by supply-siders instead of demand-siders, as they are now.

In a demand model, whether Keynesian or Monetarist, or a combination of the two, there is no such thing as risk-taking. "Demand" means consumption, just as "supply" means production . All the computers in the legislative and executive branches at the present moment are programmed in the consumption mode, which assumes that production is automatic. You have heard the expression many times, "Demand creates its own supply." If all growth is the result of risk-taking, and our national policies of public finance are routinely ignoring risk-taking, inevitably all growth will stop.

Can the computers by programmed by supply-siders? Not really. The fact is, risk-taking cannot be converted into mathematical notation. In 1936, the great Princeton mathematician, John von Neuman, one of Albert Einstein's close friends, demonstrated that risk-taking could not be converted into mathematical notation. This meant that economics could not be converted into a mathematical science. Human beings are not identical hydrogen molecules.

Thomas Edison cannot be put into an equation, or the entrepreneurs of Silicon Valley.

The CHAIRMAN. Jude, I have got to ask you to summarize.

Mr. WANNISKI. All right. Just quickly, this is one important reason why our National economy has become so sluggish, why our National standard of living has been in decline for more than a generation.

And here I quite agree with Labor Secretary Robert Reich when he points to the discouraging decline in real wages over the last two decades. But where Secretary Reich would get us moving again by spending more Federal money on training workers for jobs that do not exist, I would eliminate the capital gains tax, stand back, and watch the boom unfold.

These are broad, general observations, Mr. Chairman, as I can only hit high spots in the time I was allotted for a prepared statement. As you well know from my nagging, I could sit here until the cows come home answering questions about the issue.

I would be happy to supply the Committee with answers to any questions you might have. I would be surprised if you come across with a question or criticism that I have not confronted in the last several years.

I genuinely believe we will open the 21st century without a tax on capital gains, as we opened the 20th century. The only question is what path we will take to get there, and how fast we will travel it.

Thank you again for the invitation to testify on this most important issue before this most important Committee.

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

The CHAIRMAN. Thank you.

Let me say this to the panelists. We are going to have a vote sometime between now and a quarter till 11. And we will have to leave. But I know we will have questions that will go beyond that. So if you will wait until we get back, we will appreciate it.

Jude, let me ask you this. Are you saying that there must be a capital gains differential? Or are you saying that if we had no income tax, you would need no incentive for capital gains either?

Mr. WANNISKI. I am saying that if the correct tax on capital gains is zero, that will maximize revenues.

The CHAIRMAN. Right. I understand the maximization argument. You are not saying, therefore, that you need a differential. If the regular tax rate was 20 percent, the capital gains should be zero. If we had a tax rate of zero, would you need any incentive for risk-takers? Or would they say, well, if there is no tax anyway, I am not going to take any risk. I will put it in savings bonds.

Mr. WANNISKI. Well, for most of the history of the United States, we had no income tax.

The CHAIRMAN. That is correct.

Mr. WANNISKI. And we had no tax on capital gains.

The CHAIRMAN. That is correct.

Mr. WANNISKI. So this is why the ultimate solution would be to clean up the whole tax system the way Congressman Armey would suggest in his flat tax, which will only tax income once, at its source. There would be no tax on capital gains, no tax on estates.

The CHAIRMAN. And you would argue here that both Treasury and the Joint Committee are wrong in their estimates when they say that he loses about $180 billion a year.

Mr. WANNISKI. I have had this argument with Michael Boskin, who Dr. Aaron cited earlier, saying that in a demand model, in the computers at the Congressional Budget Office or the Office of Management and Budget, when you ask the computer why happens when you cut a capital gains tax? Because you cannot get that concept into mathematical notation, the computer will answer back, almost nothing happens. It will say the rich get richer, because that is the only thing that a computer can see in a demand model. In a supply model, you have to consider the impact that this will have on human behavior. In classical economics, that brand of economics that existed up until the 1930's, economics was considered a behavioral science. It was only after World War II when the economics profession decided to turn it into a mathematical science and push all of us as if we are all the same hydrogen molecules into laws of physics that the economy broke down.

And the more the computers take over the system of our Government, the more they take over policy-making, the more real wages will decline because they minimize or trivialize the effect of risk-taking on the national economy.

So both Keynesians and Monetarists are equally deficient in their models. Milton Friedman is as deficient in his approach as James Tobin of Yale or Robert Soloff of MIT because their models are trying to manage the economy by changing aggregate demand, by taking money out of consumers' pockets. The liberal Democrats say consumers who have too much money in their pockets, and are not spending it fast enough, should have it taxed away and give it to people who are not spending it fast enough.

You see, it is a cash flow kind of economic model that does not address the essence of capitalism as we have known it for centuries, where people of surplus time, energy and talent, instead of dissipating it, not using it at all, will invest it in young people who are aspiring.

The CHAIRMAN. Now, would it be fair to call you a supply-sider?

Mr. WANNISKI. Absolutely.

The CHAIRMAN. All right.

Dr. AARON. Could I interrupt? Notwithstanding the claim of the term "supply-sider", every argument that Mr. Wanniski has made is a demand-side argument. The supply-side argument is the one that Jane Gravelle spoke to, and that I try to refer to.

What will be the effect on saving? Investment demand can go through the roof, but if U.S. national saving does not increase, no addition to economic growth will occur. The reason is that one must have additional resources to invest on the supply side for the growth effects to occur. The beginning point, therefore, must be what is the effect on private saving? What is the effect on the Government deficit? One cannot have a boot-strap argument and say, we assume growth and that will produce the revenue. The question is where does the growth come from? It comes from increased saving. And the initial effect from the capital gains change is to lower saving.

The CHAIRMAN. Let me ask you in the last 30 seconds I have, you talked about the effective capital gains rate, and you factored out capital gains at death. And you factored out pension funds that pay nothing, and came to a rate of 7 or 7½ percent.

Dr. AARON. On equities.

The CHAIRMAN. Yes. I understand that. And Mr. Wanniski made reference to Secretary Reich. When he comes and testifies, he often makes the statement that, on average, he and Shaquille O'Neill are six feet tall. But averages are deceptive.

Is your average the critical factor, or is the rate on those who take risks the more critical factor, and it is just deceptive to just average it out?

Dr. AARON. That question is important. Mr. Wanniski also raised it. He pointed out that it was not the old capital that mattered, but the new capital that counted. And that is the point that I think you are making as well.

The implication of that is that somehow capital gains cuts mean less to Bill Gates, who is sitting on $5 or $6 billion of accumulated wealth than it meant to the amateur scientist, Steve Jobs, sitting in his garage tinkering with computers.

The image we have here is that the innovator, who is absorbed in his new idea is somehow planning ahead for capital gains in the distant future. But the billionaire, with hundreds of millions of dollars at stake from possible taxes on accumulated wealth don't really care about the tax rate. The key point here is that capital gains are already favored over ordinary income. The argument that somehow capital markets are failing to recognize marvelous investment opportunities but instead channel capital into secure blue chip stocks, is a vicious criticism of capitalism. The case for capitalism hinges on—and, I believe, prospers on—the ability of capital markets to allocate funds to projects that have the best expected rates of return.

We do not want Government to do it. We should not try to microengineer and favor, even more than we now do, one particular category of investment. Capital markets work in the United States. They work damn well. And we ought not to operate under the presumption that projects already favored by the tax code because they disproportionately generate capital gains, need a still bigger edge to get ahead of other projects that generate capital income in other forms.

A capital gains tax cut cannot promote growth if savings do not increase. Capital gains cuts will further distort relative choices among investment.

The CHAIRMAN. Senator Grassley, and then Senator Breaux.

Senator GRASSLEY. It seems like the mail that I get on the subject of capital gains comes mostly from farmers or small business people. And I think I would classify them as mostly middle-income people. And, of course, the opponents of reducing capital gains, at least in the political scene, always tend to come up with the argument that I call the class warfare argument, that it is only going to help the rich. We get these statistics that 80 percent of the benefits are going to go to a small percentage of our most wealthy people.

But the problem is, as I see these statistics—and this is eventually what I am going to ask some of you to comment on—is that many of these so-called richer are only in this upper-middle-income for 1 year while they are getting rid of a major asset like a home, farm or business. Other than that 1 year, I think these people are basically middle-income. I think even our own Treasury Department in 1990 was using these statistics that throw these people into the dirty-rich column.

I have just one example that I want to read from a constituent, a January letter. "Dear Senator Grassley: We are some of the rich that the Democrats do not want to assist by changing capital gains tax. We farm 120 acres, of which we own only 40. We both work in town in addition to farming, and having a shelling business. We have five children, three still at home. We own no new vehicles, have not taken a vacation in 10 years, rarely eat out. Because of tight financial circumstances, we sold 120 acres recently. The following year, because of dry weather, we sold most of our machinery to remain current with the bank. This still was not enough, and we were forced into Chapter 12. We now owe over $17,000 to the IRS for capital gains, and we do not have it."

Now my question is, do we know how many of the so-called "rich" that would benefit from a tax reduction are only actually rich for that 1 year that the asset is sold, and therefore are otherwise only middle- or lower-income people the rest of their lives? Anybody?

Mr. BLOOMFIELD. Senator, could I address that please?

Senator GRASSLEY. Please. Both of you.

Mr. BLOOMFIELD. Senator Grassley, let me throw out two numbers to you. The first number is that three-quarters of all filers who have capital gains——

Senator GRASSLEY. All what?

Mr. BLOOMFIELD. Filers. The number of people who file tax returns. Three-quarters of them have salary and wage income of $50,000 or less. If you talk about the dollar amounts of capital gains, half of all capital gains go to people with wage and salary income of $50,000 or less.

In other words, a lot of these people are not people who have capital gains every year. Let me refer to some Joint Committee numbers. Forty-four percent of all taxpayers who report capital gains report them only once in every 5 years. It is backed up in my Q&A's on capital gains that are attached to my testimony.

But you raise another issue in terms of how it affects your constituencies. Let me give you five examples of people who have capital gains, who are not considered rich: A middle-class family who has carefully invested in a small piece of real estate several years ago. They want to sell it to send their kid to college. Because the gain is taxed at 28 percent, and is not adjusted for inflation, they are going to lose part of their college fund.

What about the older rancher whose spouse has passed away? She wants to sell the land. It has been in the family for a lifetime. She needs it for her retirement.

What about the small businessman who wants to sell the dry cleaning business, and move to another State? His doctors say that his health will improve in a better climate, but he loses too much of it in terms of capital gains to do that.

What about the young family who puts away money each month for a few years, and invests in stocks and bonds? Now they want to sell those investments and use it for a down payment for their first home. They are not able to do so.

Or what about the farmer who wants to sell some of his acreage, and make it available for other uses? Its value has increased greatly since he took the place from his dad, and the Federal capital gains tax hits him pretty hard.

So I think, statistically, and in terms of real people out there, more middle-class people have capital gains than some of the statistics indicate.

Dr. GRAVELLE. The data that I cited in my testimony about the top 1 percent getting over 50 percent of a capital gains tax cut, and top 5 percent getting about three-quarters, that was based on a study that took into account the very issue you raised, which averaged taxpayers over 5 years in order to classify them into incomes.

So it takes that into account. The vast majority of the dollars of capital gains are realized by people who realize them all the time.

You have to think about a difference between numbers of people and numbers of dollars. Let me just give you an illustration. If I had 100 people in the room, and I gave one person in the room $10,000, and the other 99 people one dollar, certainly most of the people who got a benefit from my distribution would be the 99, the large group. But I think most people would agree that the benefits of that distribution went primarily to the one.

So it certainly seems to me that you would want to look at the dollars of benefits when you are looking at distributional issues.

Dr. AARON. Could I just mention one other point? That is, in 1986, Congress repealed income averaging because, at that point, the range of rates was sufficiently narrow that averaging did not seem worth the trouble.

Rates have spread out some more now. The maximum rate is not 28 percent—it is 39.6. To speak partially to the problem you raise, Senator Grassley, it might be worth reconsidering bringing back income averaging.

Senator GRASSLEY. Thank you.

The CHAIRMAN. Yes?

Mr. WANNISKI. In my testimony I mentioned the total wealth of the United States being roughly $30 trillion, and that the unrealized capital gains in that total is one-quarter, roughly $7½ trillion. There is no net unrealized capital gains in our economy. In other words, if we sold all of the capital that is now on the books, there would be no gain to the Federal Government because there are no net capital gains. It is all inflation. It is almost all in property.

The greatest burden is on the farm sector because that is where most of the property is. When Senator Dole asked a farmers' convention six or seven weeks ago—and he reported this on "Face the Nation" I think—what can we do most for you? They said index the capital gains tax retroactively. In other words, free us of this burden of 28 percent tax on $7½ trillion worth of gains that are pure inflation. You are taxing capital—not capital gains.

Senator GRASSLEY. If you have no net gain overall this year of all this property, then actually the application of the capital gains tax is confiscation, not taxation.

Mr. WANNISKI. It is all confiscation.

The CHAIRMAN. Senator Breaux. Then Senator Rockefeller. Then Senator Moseley-Braun.

Senator BREAUX. Thank you, Mr. Chairman. I thank the panel.

I have a white German Shepherd at my house. And sometimes when I tell him to sit, and he does not really understand, he kind of looks at me with his head tilted this way and that way, with a look of total confusion about what I am trying to say. I am getting the same reaction from people when I tell them what the Congress is trying to do with the balanced budget amendment that is pending on the floor.

We are talking about reducing the deficit between $900 billion and $1.2 trillion over the next 7 years, but we are going to increase defense spending, cut taxes, and not reduce Social Security. And we are not going to cut Medicare, and we are not going to reduce Medicaid. And some of the people I talk to respond like my German Shepherd with a really puzzled look on their face. And their response is, "You have got to be kidding."

So, having said that, we are talking about a capital gains tax reduction, which I have always supported. But I am concerned that with all these other things that we are trying to do, it just does not fit. We got an estimate from the Joint Committee on Taxation that says a capital gains tax cut loses almost $54 billion over 5 years. The Treasury Department says it loses $57.5 billion over 5 years. And both estimate losses of $170 billion over the next 10 years.

So faced with the current economic situation, if we are looking at tax cuts versus deficit reduction from an economic standpoint, which is the sounder policy? I do not see how we can do both. Anybody?

Dr. AARON. I think the point on which probably all five of us up here would agree is that the United States saves too little. I know we do disagree about the effects of capital gains tax law changes, but I think the beginning of sound economic policy—not the end but the beginning—is to ask the question, will the action being taken add to or subtract from U.S. national saving?

Senator BREAUX. Let me answer that.

Now, regardless of what it may do to the deficit——

Dr. AARON. The deficit is a constituent of national saving.

Senator BREAUX. It is what?

Dr. AARON. It is a constituent apart. I know the word "constituent" attracts attention here. [Laughter.]

Senator BREAUX. Does it vote?

Dr. AARON. U.S. national saving is simply private saving, less the Federal deficit. That is the way we measure it. Anything you do that increases the deficit reduces national saving. That does not mean you should not do anything that raises the deficit. Maybe there are some situations in which you should. But there is a very heavy burden of proof.

I have tried to argue at more length in my statement that I do not think the capital gains cut rises to that burden of proof. Because it will, on balance, reduce national saving, it will reduce growth. It will reduce revenues. The supply-side effects are negative, not positive. And, in any event, I think your constituents, who are looking a little cross-eyed at you when you say that you want to balance the budget and cut revenues at the same time—or some people are proposing it—are asking just the right question.

And it seems to me, in this case, one ought to say whatever we may think about the capital gains cut—you say that you have favored it in the past—we should put it on hold, at least until we have gotten the deficit under control.

Senator BREAUX. Dr. Gravelle?

Dr. GRAVELLE. Well, my remarks would be very similar to Henry Aaron's. I think that one thing that really differentiates trying to induce private savings rate versus the public savings rate, the deficit, is that I think we can be a lot surer about what we are accomplishing when we reduce the deficit.

We call things tax incentives, but that does not mean that they work. It may surprise people but, in fact, neither economic theory nor the empirical evidence on savings assures us that when we cut taxes, savings will go up. I have discussed in my testimony why that is true.

Therefore, if we reduce the deficit by a dollar, we can be fairly sure that we have increased national saving by a dollar. If we reduce capital income taxes by a dollar, we cannot be sure that that translates into any savings.

I think the things that ought to guide tax policy are how we have an efficient tax policy that minimizes the distortions in the economy, and how we have a fair tax policy. And most of all—well not most of all, but something that is often forgotten—we have got to have a tax policy that is not so complicated to deal with that people cannot fill out their tax returns.

Senator BREAUX. Mr. Bloomfield, your blood pressure is going up.

Mr. BLOOMFIELD. Yes. I think there is no doubt in terms of agreement on the fundamentals, that we have got a national saving problem. The concern I have is very often, Senator, when we reduce Government dissaving in the deficit, we do so at the expense of private saving. We have a private saving problem in addition to a Government deficit.

What is at issue here—and it is a judgment that you are going to have to make—I happen to think, and there is a lot of work in the academic community that indicates that tax policy does affect private saving.

Talk about your interest in IRA's, for example. And I think that is the fundamental disagreement between Dr. Aaron and Dr. Gravelle, and myself. Having said that, not all tax cuts are the same. I think the middle-class tax cut makes no economic sense. I happen to think—and contrary to what my friend, Dr. Henry Aaron suggests—there is a lot of empirical and a lot of good work out there that says that the capital gains tax cut has a positive impact on saving and investment.

I asked people to respond to Dr. Sinai's analysis of a capital gains tax cut. I might also point out that whether you are a supply-sider or a demand-sider, when Dr. Sinai got into this debate several years ago, Michael Boskin criticized his model for being too Keynesian. But there is work by John Shoven, Michael Boskin and others that suggests that you can impact private saving.

Therefore, if you do tax cuts to encourage private saving, and that is sufficient to deal with the loss from the deficit, which is just one aspect, on that you can do something productive. But please do not let the hearing end by saying that all we need to do is address the deficit, and not address our serious private saving problem in this country.

Senator NICKLES. Thank you very much. I want to call on Senator Moseley-Braun, if she would.

For my colleagues information, we have a vote on. Senator Packwood has left, and he will return. We will continue with the hearing throughout the vote if we can.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. What is the time on the vote, Senator Nickles?

Senator NICKLES. The vote just started about three minutes ago. You have plenty of time.

Senator MOSELEY-BRAUN. I will be brief then. My question has to do with private savings. I am hopeful that with all the public conversation from constituents who vote about deficit reduction, that we in the Congress will start to do the right thing with regard to Government savings. I think that the point is very well taken concerning the importance of deficit reduction.

But specifically with regard to private savings, and the private savings rate, statistics show clearly that our savings rate falls below that of our industrial competitors in this world economy. The low level of savings here in this country is a major concern regarding our economic future.

There have been, and there are, any number of different proposals around regarding different variations and iterations of the capital gains tax reduction. Are any of these approaches more likely to increase private savings than others?

Dr. GRAVELLE. Well, our theory tells us that consumption-type tax changes, as opposed to wage-type income tax reductions like reductions in the tax rates, are more likely to increase savings.

Now, the capital gains tax cut, by and large, is of the second type. It is largely reducing tax rates on existing returns to capital. So in general, if you are trying to get something more effective in increasing savings, you want something that is aimed more at new investment.

But I would have to caution you, that is what our models say. These are fairly stylized models. It is very difficult to find much evidence, frankly, out there in the economy, that the savings rate responds to either tax rates or to changes in the rate of return.

Let me take the example of the 1980's. Our income tax rates now are about as low as they have been since perhaps the 1960's, in terms of effective tax rates, and yet this is not an era when we have observed increases in savings rates. That was a period when we had a lot of generous depreciation. We have individual retirement accounts. And yet we really did not see anything in the savings rate that indicated there was a response.

So that is why I say, I can give you a lot of empirical studies that try to look at this question. But they just do not offer much hope in general for using tax policy for the objective of increasing private savings.

Senator MOSELEY-BRAUN. Thank you so much.

Mr. WANNISKI. Senator, I am the only supply-sider at the table. Supply-side economics is classical economics as we knew it for most of the history of the world, based on production. Supply is production. Adam Smith was a supply-sider. Karl Marx was a supply-sider. Alexander Hamilton was a supply-sider. Supply side was the dominant economic theory on the planet Earth up until the 1930's when the demand side theory was introduced.

So, this may be shocking to you, but supply-siders have no interest in increasing the savings rate.

Senator MOSELEY-BRAUN. Excuse me sir. I attended the University of Chicago, and I studied economics there. I know a lot about supply-side.

We do not need to get into that. With regard to the specific question that I asked, if you could respond to that I would appreciate it.

Mr. WANNISKI. Savings rate is not important in a classical model. Production is what is important. Increasing the size of the economy. Production equals savings plus consumption. So, rather than look at part of the equation that asks shall we consume, or shall we invest—that is what the demand-siders look at—we look at the side that says how do we increase the size of the economy? And when you increase the size of the economy, you increase consumption and savings simultaneously.

Mr. BLOOMFIELD. Senator Moseley-Braun, may I respond to your question?

Senator MOSELEY-BRAUN. Please.

Mr. BLOOMFIELD. The evidence suggests that most of the capital gains that are realized are not spent, they are reinvested. So, in that sense, it has an impact on saving. There are proposals to target capital gains. I would not do that because, as I indicated, I am concerned about four aspects of capital gains—reducing capital costs, mobility of capital, entrepreneurship and others.

Let me also respond to a basic debate we have about the deficit versus increasing savings. One can argue that one should oppose spousal IRA's. Why should one oppose spousal IRA's? Because the Joint Committee and the Treasury would count it as a revenue loss. The question is, when does a spousal IRA or an IRA make sense?

Right now, if you look at the taxation of savings, and you look at IRA's, probably for every dollar that one puts into an IRA, the Government loses 25 cents. Why? Because that is the tax rate.

So you as legislators need to decide, if you have something like a spousal IRA, whether more than 25 percent of the money put in there is not shifting, but is new saving.

Senator MOSELEY-BRAUN. Interestingly, the testimony that we heard about spousal IRA's is that, essentially, you wind up that the people that are going to save anyway will continue to do so. But it does not change behavior in terms of aspects or segments of the population saving more.

And I guess my question is how do we begin to affect behavior to increase private savings in this country. I believe we have run out of time. We have a vote.

Dr. AARON. Could I say that I think that is a very important goal? I wish we knew the answer to it as economists. The record to date indicates that our attempts through tax policy to influence saving have come to naught. It is dismal to tell somebody who has to make a vote now on a real policy issue that more research is needed.

But the evidence to date suggests that if you give away money through reductions in tax rates, ostensibly to increase saving, the one thing you can be sure of is that you will be reducing people's tax liabilities and increasing the deficit. The one thing you cannot be sure of is that you will affect their private savings behavior.

Senator NICKLES. I thank you for your comments. Senator Simpson, you will be next if you wish to return. We need to leave. I think Senator Packwood will be back shortly. So I ask our panelists to please stay if they would not mind. He should be back in just a few moments. We will recess for a moment so we can vote.

Thank you.

[The Committee recessed at 10:18 a.m. to reconvene at 10:55 a.m.]

The CHAIRMAN. The Committee will come back to order. We will go to Senator Conrad at the moment because he is here. And when you are done, I will go back to the order that we were in.

Kent, go ahead.

Senator CONRAD. Thank you very much, Mr. Chairman. I thank the witnesses. I think this is an excellent panel. I wish very much I could have been here for all of it.

One of the things that has always troubled me about the capital gains proposal is that, on equity grounds, it is a little hard for me to look somebody in the face that makes $30,000 a year of wage income, works hard, has a family and is paying at one rate. And to say that, on the other hand, there may be a wealthy individual, somebody who has inherited his or her wealth, never worked a day in their lives, on their capital gains income they would pay a rate that is a fraction of what somebody pays who goes to work every day, perhaps at a modest salary.

Mr. Bloomfield, how do you address what I see as a difficult threshold to jump?

Mr. BLOOMFIELD. Very simply. If we cannot make the economic case for a capital gains tax cut, it is probably not worth doing.

Now, having said that, we can get in trouble because I do not think that the questions that Senator Grassley asked are relevant. And that is that a lot of middle-class people have capital gains. So, in terms of a fairness issue, that is a valid point. They should not have their savings taxed.

I want to throw out another concept, which you may throw at me. And that is, how about resolving the capital gains tax cut by just limiting it to the middle class? As you know, there are people in the House and the Senate who say just limit it to $200,000 over your lifetime.

My response to that, if that may address your concern about fairness—but the ultimate fairness is a job—is that it does not deal with the economic case for it. Because then we are in a situation where I am at a meeting trying to do a deal. And you have a German, a Japanese and myself, and I have to look at the class origin of my capital. Capital is capital. It should not matter where it comes from.

But the debate that you have got to decide is, does it do anything for saving and investment? Or does it do anything for the four issues I raised?

I think Jude Wanniski did a good job talking about the spirits. Those are hard to quantify. I think everybody here will agree that there are tremendous amounts of unlocked capital gains. Jude referred to $4.5. It is actually $7.5 in unrealized capital gains. Equities are $5.5. I do not think those are ever going to be realized. Jane Gravelle talks about the fact that sooner or later you are going to run out of them. They keep adding up, they keep accruing. And that is the capital mobility problem, the capital cost problem also.

So, it is the economic case that you have to win on. And I really want to stress that that is not a clear-cut debate. The numbers here may suggest that it does not have any impact on saving and investment, but the leading economists out there differ. I can bring John Shoven here, Michael Boskin, any number of people. Talk about Larry Summers at the Treasury Department, one of the best economists in the country. He thinks that taxes have a big impact on saving.

And, if you want to be very specific, look at the Republican Contract. Alan Sinai modeled that. He said the capital gains thing was the most powerful economic aspect of the contract. And he talked about very specific things that Henry Aaron and Jane can disagree on. I can talk about the impact on GNP, employment, business capital spending, cost of capital, and so on.

Senator CONRAD. Let me ask Dr. Gravelle if I could, what is your reaction to that underlying tension that we have?

Dr. GRAVELLE. Well, as an economist, I really cannot tell you about the distributional issue. If there is anything that is your job to sort out, it is the distributional, how you want the taxes to be distributed. But, if you are going to argue this distributional issue on the basis of their trickle-down or spill-over benefits to ordinary people, ordinary wage-earners, from this capital gains tax cut, I just do not think there is a strong case for it.

For example, we keep hearing about risk capital. And, if you look at the data on where the capital gains arise from, that is just not the case. The vast majority of capital gains arise from stock in existing corporations that have been in business for a long time, or from real estate. Real estate is a big piece of the capital gains. So I just do not think the case is there to be made.

Michael Boskin was the one whose estimates of the savings response I used in my model. And my model is a supply-side model. I think the Keyenesian model, the demand-type model, that Alan Sinai used is the wrong model for a permanent tax change. And those empirical estimates simply do not suggest that you are going to have a big effect on the economy from this change. And that is the way I read the evidence.

Senator CONRAD. Mr. Chairman, might I ask one other question?

The CHAIRMAN. Go ahead.

Dr. AARON. Senator, Mr. Pearlman. Could I just say one thing about the saving effect of capital gains changes? The estimates I used from Professor Boskin indicate that the increase in private savings will be less than one-fifth of the Federal revenue loss. One would have to believe that the responsiveness of saving to the rate of return was five times larger than the highest estimate, based on empirical research, available in the economics literature to conclude that the cut was even a wash.

Senator CONRAD. I thank you for that answer.

There is a question here of efficiency of improving the savings rate. What is the most efficient way? And I think that is a very basic question.

Mr. Pearlman, tomorrow we are having a hearing on indexing. And I know this is something you have looked closely, and I just would be interested in what your conclusion is with respect to indexing. Is it your position that that is something we should go forward with? Is it your position that, after review, you have concluded that it is too complex? I would be very interested in your reaction on that subject.

Mr. PEARLMAN. Well, I did not come here with positions, Senator Conrad. So let me just respond to your question by making a couple of suggestions.

It seems to me that from my perspective—and my perspective really is as a tax lawyer, not an economist—there are two issues that I believe are the ones that require the most attention, and that I would suggest that you might want to focus on with the witnesses that appear before the Committee tomorrow.

One is the complexity issue. And when you talk about indexing, complexity should not be perceived as sort of a remote concept, as we generally talk about it in the tax law. The simple fact is that indexing proposals are going to impose extraordinary recordkeeping and computational burdens on the economy, not just on individuals, but on the economy. It seems to me that this is something you should want to pursue. Is it an unacceptable burden? Are they burdens that can be simplified? Are there ways to achieve the overall objective of indexing in a less burdensome way? So that is issue number one in my opinion.

And number two is the issue that Dr. Aaron referred to earlier. And that is the issue of indexing the asset side of the balance sheet, or the capital gain, and not indexing the debt side. Of course, I come at it from a different perspective, that is, the tax lawyer's standpoint. Allowing someone to fully deduct interest expense, including the inflationary component of interest, and indexing the gain on the asset, creates extraordinary pressure on designing tax-strategized transactions. And those transactions could be very artificial transactions because of the way that particularly sophisticated security transactions can be put together and minimize the risk of loss to an investor.

I think that is another issue that needs to be looked at very carefully in your review of indexing. From my perspective, for a tax lawyer's perspective, having worked principally on the outside of Government and seeing how people respond to changes in the tax law, I believe those are the two most significant issues for the Committee to address as you look at the indexing subject.

Senator CONRAD. I thank you very much for that. And I apologize to the Committee. I apologize to the Chair. I did think that Mr. Pearlman's take on that issue is especially important for the consideration of the Committee.

The CHAIRMAN. He comes at it from an interesting viewpoint, having both been at Treasury and the Joint Tax Committee, and then most of his life practicing on the outside.

Senator Simpson, and then Senator Nickles.

Senator SIMPSON. Thank you, Mr. Chairman.

It has been a most interesting discussion, Dr. Aaron, when you said that essentially anything we craft here will not impel people towards savings. And I think in the past we have shown that. I remember Senator Danforth's—what was the name of that little whiz-bang back in 1980?

The CHAIRMAN. The all-savers account.

Senator SIMPSON. The all-savers account. That was a marvelous thing. It just brought a surge of thrill to us all as we passed it. And nobody took advantage of it, as I understood. Maybe a 4 percent increase, or something, in the activity with regard to that. So that is interesting. And then one of the experiences you cited, Mr. Bloomfield, some experiences of people. I was in a very fancy restaurant. Someone else was paying for it. Now that I am on the Finance Committee, that is very simple. I did not realize it all these years ago, but now I have. But it was not the fat cats in the fivestar restaurant who were talking about capital gains. It was the waiter. He was about 60. He said, "I have worked here for 30 years, and got this home on Long Island, and I want to get rid of it. What are you guys going to do. It makes a difference to me."

Or the railroader in Laramie who bought a house in the 1950's for 60 grand. Now it is worth $125,000, and he or she wants to sell it. So I see it out there, and no one can tell us what it does. Everybody certainly has a differing view on that, those who support a cut in the capital gains tax rate, even though it would cost a bundle. Forget what it might cost.

Do you support cuts in the mandatory spending or increases in other taxes to pay for it? Because we are going to get stuck in it where we cannot play the game of budget rules. We cannot use cuts in discretionary spending to offset new tax cuts. Only mandatory spending cuts and revenue increases can be used. So how are we going to pay for it?

Dr. AARON. If I were on staff, I would feel impelled to answer that question. As a witness, I am impelled to say I would not vote for the deficit-increasing measure in the first place. I think that is the place to begin and end.

Mr. BLOOMFIELD. Senator Simpson, I would respond three ways. You obviously know more about the Federal budget than I do. Obviously, from a capital formation point of view, I would prefer to pay for it with spending cuts, focused on one part of the budget. I would hope we would focus on other parts.

Secondly, if you look at one plan, which is the House plan. If there are going to be some tax cuts, I would say make them capital formation tax cuts. As you know, in the House, 60 percent goes to child care credits and middle-class tax cuts which make no economic sense.

I honestly believe, and I think the evidence is out there, that there is a debate about capital gains tax cuts but it is different from IRA's. It is different from child care credits because of the powerful impact of unlocking. And, if you talk to people about it, there are extremely sensitive assumptions about elasticities. You make judgments about things. And I feel comfortable that you could make a judgment that it is a wash, or a very small revenue loss, and it has economic import in a macro-sense, and in a micro-sense to the people you were talking about in the restaurant or to the animal spirits that Jude Wanniski wants to unleash.

Senator SIMPSON. Anyone else care to comment?

Dr. GRAVELLE. Senator, I cannot answer your question.

Mr. WANNISKI. Yes. Senator, the only tax cut that I would support with confidence that it would easily increase and pay for itself is the capital gains tax cut, and the indexation backwards and forwards. Senator Lugar has made the same point, that he opposes the other parts of the Contract with America that would reduce tax rates because it is not clear at this point that they would yield increased revenues.

But the unlocking effects alone of capital gains would pay for themselves if you had the right questions asked to the computers that are doing the scoring.

Dr. AARON. Incidentally, you should tell your waiter that he can sell his house. There is $125,000 exclusion on the sale of owner-occupied housing for people over the age of, I think, 55.

Senator SIMPSON. That is true. I mumbled that to him. But he still was waiting. Maybe it was for his sister's house or something. But our real problem is not this, and what it will save and what it will do.

Our real problem is that in April we are going to vote for a $5 trillion debt limit. Five trillion bucks, and forget all the other applesauce here. We have had a budget presented to us which does not reduce the deficit at all. It just strings $200 billion along until we get to 1997 when it starts rocking right off the chain. And then in the year 2002, the debt limit will be $6.7 trillion. And that is in the President's figures.

So if we can avoid blaming Ronald Reagan and George Bush and Bill Clinton, and know that it all started right here with some of the bravest cats I have ever seen who babble all day long, and vote it up and drag it home like a pack mule. And they just cover their States with Federal funds, and have the guts to stand here and give us lecture after lecture.

And I am going to start going through the State-by-State haul-home ratio of the last forty years. And there are some States that are almost sunk in Federal funds. And their people stand there and babble all day about how we are not doing it. I cannot wait.

The CHAIRMAN. Senator Nickles.

Senator SIMPSON. Other than that, I have no strong feelings. [Laughter.]

Senator NICKLES. Mr. Chairman, thank you. And I wish to thank our panelists for their presentations, which I think were excellent, and very informative.

A couple of comments. Dr. Gravelle, is that pronounced correctly?

Dr. GRAVELLE. Yes. That is correct.

Senator NICKLES. I believe you mentioned in your statement—correct me if I am wrong—that 50 percent of the dollar benefit would go to the upper 1 percent of income persons. Is that correct?

Dr. GRAVELLE. That is right, approximately.

Senator NICKLES. Would other panelists, Mr. Pearlman, anybody, dispute that?

Mr. BLOOMFIELD. Yes. I dispute it because what that basically says is that suppose you have a husband and he earns $50,000, and his wife earns $50,000. They happen to live in Wyoming and they sell their ranch or their farm for $100,000, they are then considered a $200,000 family that year and every other year.

So the numbers that I used—and this started with a CBO discussion—is I can say the same thing and distort it the other way and say that three-quarters of all filers who have capital gains have wage and salary income of $50,000 or less. And half the dollar amount goes to people with $50,000 or less. We are both distorting it. Because what Jane Gravelle alluded to is, how often do these people realize capital gains? And that is why I said 44 percent only realize a capital gain once every 5 years.

So I am not going to disagree with the fact that rich people have capital gains. A lot of our saving has to come from rich people. But I am saying that more middle-class people have capital gains.

And I would make one other point that I would make to Mr. Simpson. I suggested to the Chief of Staff of the Finance Committee that they get somebody else in my place. And that person I suggested was a fellow by the name of Joe Dolman. Who is Joe Dolman? Joe Dolman is this poor painting contractor in New Jersey who, after the election, was asked why, if he is unemployed, did he vote for Republicans, or why did he vote for capital gains taxes. And the reason he said he did is because he thought he could get some work that way. He has never been hired by a poor person. This is the judgment you are going to make about what the economic impact is or is not about capital gains.

Senator NICKLES. Several of the examples, Mr. Bloomfield, that you mentioned, that Senator Grassley mentioned. Senator Simpson and others talked about the inequities on the person that owns the family farm or the small business, and they sell it, and they have to pay capital gains based on inflation. It is confiscating their property. I am concerned about that. Most of the way to solve that, at least proposals I have seen, Mr. Chairman, is to talk about indexing.

I happen to concur with Mr. Pearlman. I want to solve it. I do not want the Federal Government to make money off the trading of an asset that just happened to be inflated primarily through Government policies, and have the Government take 28 percent. I think that is inequitable.

But, conversely, I happen to be one that wants a very simplified Tax Code. And if you go back and try to index assets, both backwards and forwards, that could be a disaster. So I am kind of torn. I happen to be one of those entrepreneurs who has owned a small business and sold it. I have owned another business and sold it. I happen to work with a lot of people in the farming, ranching and small business communities. I do not like the Government making money off of their inflated policies through capital gains. So I see some real inequities, but I do not know that the solution is indexing because I see that as a real problem.

One final comment. I do not know what the solution is. And I might mention, I do not know that I lay awake at night trying to figure out how to help that upper one percent, but I am real concerned about the examples in real day life for a lot of people, maybe the people you were talking about in your examples, of the inequity of capital gains tax, and how unfair it is.

Dr. AARON. Senator Nickles, if that is the concern, then the statistics that Jane Gravelle cited were not a distortion, as Mr. Bloomfield said, since they refer to classifying people on the basis of 5-year average income. The solution would be to average income.

Senator NICKLES. I heard your——

Mr. BLOOMFIELD. No. Senator Nickles, with regard to your point, look at this number. Marty Feldstein at the National Bureau of Economic Research looked at capital gains realizations, capital gains revenues, in 1973. There were $4.5 billion of capital gains that were paid. If you adjusted for inflation, those taxpayers paid taxes on $1.5 billion of capital losses. So here is a very concrete example of what a lot of people are doing. That is not fair, to pay on gains which are really losses. And it makes no economic sense.

Senator NICKLES. I appreciate your comments.

One final comment, Mr. Chairman, and that is what other countries are doing. I did notice in Mr. Bloomfield's statement—and I have glanced through all the statements—but it mentioned that Japan has almost no capital gains tax, 1 percent of the sales price and 20 percent of the net gain. I am not sure about the 20 percent of the net gain. Hong Kong is exempt.

I do think money is becoming more and more movable, transferable across international boundaries, through funds and so on. I think we have to be very cognizant of the somewhat more aggressive and successful entrepreneurial counties are doing. For our consideration, I think we need to be competitive. And I hope that we would have one of the lower taxes on the transfer. We keep calling it a tax on capital gains. It seems to me to be more applicable to call it a tax on transfer of assets.

Mr. WANNISKI. Senator, the fairness question you raised—the same as Senator Conrad's very important political question at the center of this debate for many years—is why should we be taxing capital income more lightly than ordinary income? And the simple answer is that the only way you can get a capital gain is to put after-tax ordinary income at risk.

In other words, there is no possibility of a capital gain occurring until you first go out and by the sweat of your brow earn some bread and decide to forego consumption of the whole loaf. Take part of it and either put it into debt or into equity. And the capital gain tax discourages you from putting that into equity, which is a risky venture. And it encourages you to either put it into debt, which is fixed income and secure, and is not likely to get economic growth, or to eat the whole loaf.

So that is why capital income must be taxed lightly. Otherwise, people are not going to invest in each other. That is the essence of the capitalist discussion.

Senator NICKLES. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. I am interested in the issue of long-term interest rates. I think one of the most important aspects of a growing, sustainable economy is to keep long-range interest rates as low as economically possible.

I would like your thoughts as to what a repeal, or variations on a total repeal of, capital gains tax mean in terms of long-term interest rates.

Mr. BLOOMFIELD. Obviously, if you have higher levels of national savings, you will have lower interest rates. Therefore, if it is true that a capital gains tax cut increases national saving, you are making a very minor improvement. I think what is more interesting is the comments that the Chairman of the Committee is making about perhaps restructuring the whole tax system. Again this is the debate. Will it result in an increase in saving and investment. I am talking about the Nunn-Domenici proposal, Boren-Danforth, and others.

Therefore, to the extent to which those have a significant impact, there are a lot of economists who have studied what happens if you have a consumption tax as opposed to an income tax? Will the level of saving in the country be higher? There is evidence to suggest that it might. Or that it might increase in incremental stages.

What I am talking about today is doing this now as a step toward something more radical in terms of the bias of our tax system against saving and investment. If that is done, I think you are going to have more saving and less pressure on the monetary side.

Senator GRAHAM. So is your answer that you think it will have a minimal or modest effect?

Mr. BLOOMFIELD. Just a capital gains tax cut alone will be a minimal impact.

Dr. AARON. I think the effects would be small but they would raise interest rates for the following reason. Private saving would rise a little. The Government deficit would increase more. That is a decrease in U.S. national saving.

Senator GRAHAM. Do you think the net would be a decrease in savings?

Dr. AARON. I think that is inescapable. And I am using the estimates of the Joint Tax Committee and the Treasury. I believe that Jane Gravelle's comments deserve your attention. If anything, the JCT revenue losses are understated. But let us take them as the starting point. Private saving up a little, Government deficit up more, national saving down.

There would be a positive effect—small but positive—on investment demand. What happens when supply drops and demand increases? The price goes up. The supply of funds to support investment drops because national saving declines. The demand for investment rises somewhat. The price of the resulting thing that they are fighting over, investable funds, goes up.

Interest rates would rise. Would the increase be large? No, I do not think it would be large. And it would be attenuated by capital inflow from abroad, as we increased our borrowing from foreigners.

Dr. GRAVELLE. Senator Graham, I actually calculated in my testimony the absolute upper limit of any sort of beneficial interest rate reduction we might have by assuming not a .4 percentage elasticity, but an infinite one. And there is a long way between .4 and infinity, I will assure you.

That, translated for the Contract, based on realization levels for 1992, to 16 basis points, which is equivalent to less than two-tenths of a percent of the interest rate—and I say that to say that this is not big. It is not going to be a big effect on the cost of capital—what I really think is more likely is that it would raise interest rates because I suspect that private savings are not likely to go up, and certainly not likely to go up as much as the deficit might if you just look at the proposal by itself.

But I do not think you can expect significant effects in either direction from this essentially small change.

Mr. WANNISKI. Senator Graham, Alan Greenspan has testified before the banking committees of both bodies on this question several times. As you well know, he has said that we should cut spending before we cut taxes. The exception again, with Greenspan, is that a cut in the capital gains tax will cause an increase in the demand for dollars unambiguously, and make it easier for him to manage monetary policy. That is the one thing he would advocate.

I would suggest that the Committee get just Greenspan before this Committee for two or three hours of discussion on the interplay between monetary and fiscal policy, and you would learn an enormous amount.

Senator CONRAD. We will just talk about Mexico if he is here. [Laughter.]

Mr. WANNISKI. Mexico, by the way, has a zero capital gains tax for the big guys. Little guys pay ordinary rates, which begin now at 34 percent income tax rate at $4,000 annually. Big guys get zero.

Dr. AARON. If only we were doing as well as Mexico.

Senator GRAHAM. Are we going to have another round?

The CHAIRMAN. Yes. Well, I will start.

Mr. Bloomfield, you say that during 1978 to 1985, when the capital gains rate fell from 50 to 20 percent, tax revenues from capital gains increased from $9.1 to $26.5 billion. is that because of the cut?

Mr. BLOOMFIELD. I think there was a tremendous amount of unlocking. And the other converse information, obviously, is what happened from 1987 to the present. And what you have if you look at the numbers is a very low amount of capital gains receipts.

The CHAIRMAN. Now that I understand. I wanted to ask the other witnesses. I want to stick to this 1978 to 1985 because the figure has been used over and over. And indeed your figures are right. We cut the rates and revenues increased. What I want to know is if there is a connection. And, Dr. Aaron, I would assume you would not agree with that.

Dr. AARON. Oh, no. I do believe there is an interrelationship. There were a lot of other things going on, of course, during that period. We had one of the biggest bull markets. At least after 1982, we had a real estate boom of very considerable proportions. And that industry is the source of about half of all capital gains.

But there is a subtle point here which, in particular, is revealed by Larry Lindsay's letter that Mr. Bloomfield cited which you need to keep in mind.

Larry Lindsay's letter, as Mr. Bloomfield quoted it, said nothing about the effect of capital gains on Federal revenues. It referred to the effect of changes in capital gains tax collections. What you were interested in, I presume, is the effect on overall Federal revenues.

The CHAIRMAN. Yes.

Dr. AARON. And one should take account of Mr. Pearlman's observations about the incentives that arise from the a differential to recharacterize ordinary income as capital gains. The effect could easily be a boost in capital gains tax collections, but a fall in revenues from other sources. You need to look at the overall revenue effects, not just the effects on capital gains.

The CHAIRMAN. I understand. And I am talking about the overall revenue effects. But at some stage, it is almost Greek. I have heard enough economists and enough people testify.

Now Jude would indicate that if you cut the capital gains rate to zero, obviously you are not going to get any capital gains. There is no capital gains. But I will bet he would argue that general revenues would increase. Am I correct?

Mr. WANNISKI. Absolutely.

The CHAIRMAN. Now, you would not agree with that.

Dr. AARON. No, I would not. Because the incentive to convert interest payments, dividends, and earnings into capital gains would be extreme. Revenue from other sources than capital gains would drop like a rock.

The CHAIRMAN. Let us take supply-side for a moment. I started into that earlier. And I am going to separate capital gains from regular income taxes. Do we agree that at some stage there is a supply-side correct theory. We are not going to get much revenue from a zero rate of taxation, and we will not get much from a 100 percent rate of taxation. And someplace between zero and 100 on regular income there must be an optimum level that produces the greatest revenue. Is that correct?

Dr. AARON. You are absolutely right.

The CHAIRMAN. Mr. Pearlman?

Mr. PEARLMAN. I agree completely.

The CHAIRMAN. Mr. Bloomfield?

Mr. BLOOMFIELD. Yes.

The CHAIRMAN. Dr. Gravelle?

Dr. GRAVELLE. That is right. The question is where.

The CHAIRMAN. I understand. If you knew where, you would be in the stock market or someplace else.

Jude?

Mr. WANNISKI. We are going to return to the idea that, if you do not have risk-taking in your model, it is not a supply model.

The CHAIRMAN. I just want to know about the regular income tax at the moment. Between zero and 100, we get nothing at either end of the scale probably.

Mr. WANNISKI. Exactly.

The CHAIRMAN. Unless some people are willing to work and give it all to the Government. But my hunch is that not many would do that.

Dr. GRAVELLE. No.

The CHAIRMAN. All right. Now let us come to capital gains. Is there no similar supply-side curve to capital gains that at some stage—and I think you say 28 percent, Dr. Gravelle——

Dr. GRAVELLE. No. I do not say that. I say that is what the current revenue estimating assumption is.

The CHAIRMAN. All right. That is the high revenue point. So you are agreeing that there is a supply-side curve to capital gains.

Dr. GRAVELLE. Well, sure.

The CHAIRMAN. All right. Dr. Aaron, would you agree?

Dr. AARON. Of course. I would also add that if you want to boost revenues from capital gains, there are other things to do than fiddle with the rates. In particular, the treatment of capital gains held until death is a critical area for possible legislation.

The CHAIRMAN. Mr. Pearlman?

Dr. GRAVELLE. You could also tax corporate equities on an accrual basis.

The CHAIRMAN. All right. Let's come back. She said 28——

Dr. GRAVELLE. I am saying that is a different thing.

The CHAIRMAN. I know. You say 28 percent. Is there no basis to say that if we lowered that to 15 percent, we would raise more money? Are you saying, Dr. Gravelle, that if we lower it to 10 percent, you are going to lose money? Twenty-eight is the optimum?

Dr. GRAVELLE. I am saying that in the current revenue estimating practices, any rate cut is going to lose money.

The CHAIRMAN. And any rate increase will lose money.

Dr. GRAVELLE. Any rate increase will gain money.

The CHAIRMAN. Well then 28 percent is not the magic point.

Dr. GRAVELLE. Yes. That is right. If 28 percent is the revenue maximizing point, then either way——

The CHAIRMAN. If we raise it, we will lose money. If we lower it, we will lose money. We have reached Nirvana.

Dr. GRAVELLE. But I do not think that those realization responses are right. I think that the revenue maximizing tax rate is probably about 50 percent. The goal is that is you raise the capital gains tax, you raise money.

Dr. AARON. Senator Packwood, the goal of setting tax rates is not to maximize revenue. As a Democrat talking to a Republican Senate Finance Committee Chairman, surely I do not need to say that.

The CHAIRMAN. No. Say that again.

Dr. AARON. The goal of setting tax rates——

The CHAIRMAN. Is not to raise revenue?

Dr. AARON. Is not to maximize revenue. You were asking about the revenue maximizing tax rate.

The CHAIRMAN. Yes.

Dr. AARON. The goal of setting tax rates is to find the combination of tax rules that withdraws sufficient resources to cover Federal spending, in a way that minimizes the burdens on the private economy. What you are hearing among us is disagreement about whether the capital gains rules should be changed in order to do that.

The CHAIRMAN. Well, I always thought one of the principal purposes of the Tax Code was to raise revenue.

Dr. AARON. Of course it is. But what I am saying is the fact that to be at the tax rate that would maximize revenues is neither here nor there as to whether that is good tax policy.

The CHAIRMAN. No. But if you will then go to Senator Chafee, if indeed you could empirically prove that cutting the tax rate on capital gains to 15 percent raised revenue, and it all came from the rich, why should we care?

Dr. AARON. You are absolutely right.

I think it would be important to acknowledge that there are other ways of affecting capital gains rates, in particular, realization at death or carryover basis, which I think is administratively more cumbersome, that also get to the same issue.

But if we have a tax rate such that you lower it and raise revenues, you had better lower it because those tax rates waste resources and impose unnecessary burdens.

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman. I have not been here through this discussion, so I am a little bit behind the curve.

Undoubtedly you have answered this, but just for my help, if you would bear with me I would appreciate it. If we cut the capital gains rate to 14 percent, would there be a gain or a loss of revenue over a 5-year period? How many say there would be a loss of revenue?

[A show of hands.]

How many say there would be a gain of revenue?

[A show of hands.]

That is two-two. Mr. Pearlman did not vote.

Mr. PEARLMAN. I am abstaining from this vote.

Senator CHAFEE. Well, that is a big help—two-two. [Laughter.]

Mr. BLOOMFIELD. Senator Chafee, could I——

Senator CHAFEE. Yes.

Mr. BLOOMFIELD. You just missed a little crossfire.

Senator CHAFEE. I AM SORRY. I did miss it.

Mr. BLOOMFIELD. No, no. Because I did not get hit yet, so I want to get in the dogfight here.

What we referred to is some work done by Larry Lindsay, who is at the Federal Reserve. I apologize to Mr. Packwood for not having this letter, but I would like it inserted in the record.

[The letter appears in the appendix with Mr. Bloomfield's prepared statement.]

Reviewing the work he did in the 1980's, he says the maximizing rate for capital gains is now between 15 and 20 percent. And the question that the Chairman asked, and Dr. Henry Aaron got into, was that are there factors that go in there, other than realizations?

The maximizing rate, obviously, is there sufficient unlocking to pay for the static loss? One of the ways that Larry Lindsay got at it is to look at the increase in financial wealth. Financial wealth rose between the period 1985 (which is the 1986 Act) to the present by 75 percent. And yet realizations fell by 16 percent, which implies that the locking effect had some impact on Federal revenues.

Another number that I would throw out is something that my colleagues and I have debated this for years—and maybe we will continue to debate it for the rest of our lives—what about changes in the domestic GDP, rise in the stock market, and so on and so forth? And if you look at those, the growth in revenues pales with the increase in GDP and the rise in the stock market during that period.

All that suggests is that there is strong empirical evidence that we are above the maximizing rate. You may not want to go as far as Archer, but there are ways that you can reduce the capital gains tax and not lose revenue.

Where I would differ with Dr. Aaron is that if it does not cost the Government a nickel, if it does not add to our dismal saving rate by reducing the saving, there are beneficial impacts. You need not go as far as the animal instincts, but you can perhaps take comfort in some of the evidence of cost of capital. If there is some beneficial impact, why not do it, if it does not cost any money?

Senator CHAFEE. Well, that is a good argument. Mr. Bloomfield, what rate would you go to?

Mr. BLOOMFIELD. I believe the rate should be between 15 and 20. That is what I think the revenue maximizing rate is, based on the academic work out there.

Senator CHAFEE. All right.

Dr. AARON. Could I just take off on a point Mark just mentioned?

Senator CHAFEE. Please.

Dr. AARON. The effect of cutting capital gains rates on asset values. I believe he is right. There would be a positive effect on asset values. And you know what the first consequence——

Senator CHAFEE. I am not sure I know. There would be a positive effect on assets.

Dr. AARON. Stock market prices would tend to rise. Real estate would increase in value if the tax treatment were more favorable. The reason is that a tax cut makes any given flow of returns worth more after tax than it was before the cut. The result of the tax cut, therefore, is an increase in stock prices and real estate prices, and the prices of other assets.

Now there are two predominate factors that influence consumption in any economy—the incomes people receive and the value of their wealth. The higher the income, the greater the consumption. The higher the wealth, the greater the consumption. Therefore, the effect of an increase in asset values is to promote consumption, to reduce saving.

The CHAIRMAN. Is the converse true then?

Dr. AARON. That is correct. If asset values go down, if the stock market declines in value, people consume less. That means they take less out of current production for current consumption, leaving more over for investment.

Mr. BLOOMFIELD. I think you are talking about substitution in income effect.

Dr. AARON. No, I am not. I am talking about the fact that the wealthier——

Senator CHAFEE. The poorer you are, the more you save?

Dr. AARON. No. I am saying the poorer you are, the less you consume.

Senator CHAFEE. Oh, I gather that. I will go along with that. [Laughter.]

Dr. AARON. And the last I heard, saving in this country was defined as the difference between what we produce and what we consume privately and publicly.

Mr. WANNISKI. Senator, the revenue effects are much better than you might imagine. Because cutting the capital gains tax—actually, a 50 percent exclusion on income which would bring the rate down to 14 percent is the best way to do it—would increase revenues in every political jurisdiction in the United States. Because you are holding local, county and State taxation constant. You are reducing the Federal risks to capital formation. So, therefore, all new enterprises that begin will immediately begin throwing off State and local income taxes, sales taxes, property taxes.

So the benefits that you get from a small change in the capital gains tax at the Federal level has enormous effects throughout the whole system, positive effects. This is why Chairman Greenspan would jump in a second because this is the reverse of crowding out in the capital markets. It is crowding in, as he would call it.

Senator CHAFEE. Well, I will put you down as enthusiastic. [Laughter.]

The CHAIRMAN. Senator Graham.

Senator CHAFEE. Why don't we just complete that? Thank you very much, Senator Graham. Go ahead doctor.

Dr. GRAVELLE. Well, I just wanted to remind you of some of the material presented in my testimony. If you are going to raise revenue by cutting the capital gains tax in half, you are going to have to double realizations. And this is going to be a change that certainly we have not experienced historically.

Now ask yourself, now that we have doubled realizations, what if we cut the tax rate more? The problem is that, if you assume those large effects, you are going to run out of accruals over time. It is just something that cannot occur consistently year after year. You might have a big effect in the short run, and some of Larry Lindsay's material was looking at short run. But you cannot sustain that kind of increase, at least based on the evidence we have about history.

So I just think you have to be cautious about expecting that this is going to be a free lunch on a revenue basis. I think there is a lot of new research that has been done since Larry Lindsay did his study that should give you pause about that.

Senator GRAHAM. Can I correctly surmise that the principal objective of considering a capital gains reduction is to increase national savings? You are nodding no. If that is not the principal objective of a capital gains reduction, what is the principal objective in your definition?

Mr. WANNISKI. To increase the nation's wealth. To increase its production. To increase the size of the economy. Again I cite the equation that all economists accept is that production equals consumption plus savings. So the demand-side economists, all my colleagues here at this table, are looking at the side of the equation that says we want to increase savings and we want to reduce consumption. That is a zero-sum game. Someone has to really lose. When you are increasing savings, they have to reduce their consumption.

What we are looking at is a reduction in the capital gains tax as a way of increasing the freeing of all of the unused talent, energy and intelligence that is now not being used in our country.

Senator GRAHAM. So your statement of the objective is to increase national production?

Mr. WANNISKI. Increase national production and wealth.

Senator GRAHAM. And wealth. Mr. Bloomfield, what is your definition of the objective?

Mr. BLOOMFIELD. Well, Senator Graham, it is to increase saving and investment. But, obviously, saving and investment is a way that you increase national wealth. There are four dimensions to that goal, and this is what the debate is about. It increases our investment and saving by reducing the cost of capital.

We are also concerned about the mobility of capital. We are also concerned about the pernicious effect that inflation has on investment. And, finally, there is this encouragement of entrepreneurship.

Senator GRAHAM. All right.

Dr. AARON. I think in a way I agree with at least one sentence of what Mr. Wanniski said. The objective of this is to increase national production.

Unlike him, however, I do not believe one can just wave one's hands and assume increased production into existence. As Mr. Bloomfield just said, increased production results from more saving, from which we can support more capital accumulation. Or it results from using the saving we have more efficiently than we have done in the past. Or it results from encouraging people to work more or acquire more skills.

Now nobody I have heard has suggested that capital gains tax cuts will directly increase people's desire to work, or to acquire training. If there are any such effects, they are not a first order of consideration. They are not something we ought to take into account. All the effects of a cut in capital gains taxes that might lead to additional production have to occur through capital. We are talking about capital taxes after all.

And I think one must begin with the question of whether this tax change induces sufficient additional savings to offset what those who do the revenue estimates agree is a loss in revenue to the Federal Government.

One can assume animal spirits. One can cite epiphanies. And one can do various other things. But one cannot find actual research done by economists in refereed journals to support a savings response anywhere near large enough to offset the revenue loss estimated by the Treasury and the Joint Tax Committee. Therefore, you start with less capital and less investment, and reduced growth—not increased growth. I wish it were otherwise. I wish we did know a tax lever to lift the world. But, unfortunately, it has not been invented yet, and this is not it.

Senator GRAHAM. Well, the question that I wanted to get at, following up on the first question, is that if you accept that it is a desirable national goal to increase productivity and overall wealth, and some would argue that the reduction or elimination of the capital gains tax is a contribution towards that, particularly those who do not believe that the capital gains is an appropriate part of the mix of achieving that objective, what would you offer as alternative policy steps that in your judgment would more efficiently accomplish the objective of enhanced wealth and productivity?

Dr. AARON. I would suggest two things. First of all, the United States is lagging in its investment and in research and development. To a very large degree, practical applied research must be carried out in the private sector by capitalists who are putting their funds at risk, and are making a bet on the future. But there is a large role for publicly-supported research. And that support has waned with the end of the Cold War and the decline of the defense spending. Federal support of civilian general research has not been traditionally very popular, but it is important, and it needs to be attended to.

The second measure that I would recommend is moving expeditiously to reduce the Federal deficit, both to increase saving, but indirectly through added saving to reduce long-term interest rates. That will encourage private investment and enable private investors to begin to have a longer horizon.

One of the effects of high interest rates is to make it unprofitable for investors to look beyond a few years. They discount it. Investments for deferred returns look unattractive. At low interest rates, you can begin to look 5, 10, 20 years in advance, and those returns are still worth a lot.

So those are the two measures—promote scientific research through the budget and promote private investment through lower interest rates achieved by deficit reduction.

Mr. BLOOMFIELD. Senator Graham, in other words, we want to increase national saving. Dr. Aaron and I, and Dr. Gravelle I think, are in agreement that a very good way to do it is reducing the deficit. We disagree because I think not all ways to reduce the deficit are the same. To the extent to which you reduce the deficit by completely eliminating deductions, by completely eliminating any private pension plans, you have reduced the deficit, but you have hit private saving.

What concerns me is the fundamental question of can we or should we do something about private savings? I think we can and should. The other witnesses disagree.

What would I do? I would go with a capital gains tax cut for all the reasons we have discussed. Even Dr. Gravelle has mentioned that the revenue consequences in the aggregate are not that big. We would differ, and very rightly so, that I think the impact is bigger, and she thinks it is much less.

But capital gains is only one piece of the overall taxation of saving and investment. And, therefore, I would reduce the capital gains tax now and begin to move very seriously, as I think Members of this Committee are doing, in looking at fundamental tax reform.

The question I would then ask the witnesses is whether or not fundamental tax reform can do anything for private saving and investment. And that, it seems to me, may bring forth the same type of debates that we have here over the impact of a capital gains tax cut.

The CHAIRMAN. Well, that is exactly what I was going to pursue. I get a feeling from some of our witnesses, not just today, that it does not really matter what we do, that there is no response to tax incentives, high, low or otherwise. And, therefore, we might as well forget it.

I do not know if I overstated this, Dr. Gravelle, but——

Dr. GRAVELLE. Well, there are a lot of important issues in tax policy. It is just that it may not be that savings is the most important one. It is important to have a tax policy that is efficient, that minimizes distortions in the economy. You cannot always do that, but it is important to consider what you feel is an equitable tax system. it is fairly distributed. And it is really important to have a tax system that can be complied with. We have a lot of compromises that we have to make with the tax system.

So just because taxes may not be that successful in this one goal of changing savings behavior, does not mean that there are not a lot of important issues.

The CHAIRMAN. Well, I agree with you totally. Fairness is an argument. Simplicity is an argument. They have nothing to do savings. They may have something to do with savings. At the moment we are talking about savings and revenue. These are the things we are concerned with. And if it does not make any difference what we do with the Tax Code in terms of savings, we can quit worrying about it.

Is there anything we can do, in your judgment, with the Tax Code that would increase savings?

Dr. GRAVELLE. I think there is very little you can do with very much certainty as to what it is going to accomplish. And I think there probably a pretty safe bet to decrease the deficit ana increase savings, probably regardless——

The CHAIRMAN. We all agree on the deficit. Even those who are going to vote against the balanced budget amendment say we should do it.

Dr. GRAVELLE. Mark was suggesting that if you have to raise capital taxes to reduce the deficit, that he considers that not to work. And I do not think the evidence says it. I think the evidence says that you are likely, regardless of how you reduce the deficit——

The CHAIRMAN. Well, I think you mentioned pension funds. Unless I am mistaken, if you take it out of one form of savings, and reduce the deficit, your net savings have not changed. You are just taking it from the private sector and putting it in the public sector, and the net is still the same.

Mr. BLOOMFIELD. It is the fiscal equivalent of running in place.

Dr. AARON. Well, let's agree that this is not a good idea. I think there is one point that might be surprising since I have made clear that I am against the particular changes in capital gains rules. I would urge members of Congress either to vote it up or to vote it down, but to stop dangling in front of American taxpayers.

Of one thing you can be sure. Dangling the prospect that next year capital gains rates will be lower discourages realizations. Whether you definitively cut capital gains rates or if you definitively reject such cuts, be done with it. That will increase revenues.

The CHAIRMAN. Let me ask you something. How would we ever be done with it? When we did the tax reform and we lowered the rates, and everybody said it was fine, it was not two or 3 years before the demagogues were back again saying the rich are not paying enough, and we need to raise their rates. There is no certainty in this.

And the very people we took the deductions away from said I know what is going to happen. You are going to take the deductions away and then you are going to raise the rates, which is exactly what happened.

Dr. AARON. For at least two or 3 years during the Bush administration, it was administration policy, but not Congressional policy, to cut capital gains rates. And hearings were held on it every year. Now it seems it is possible that the reverse is true. All I am saying, Mr. Chairman, is that if you can muster a majority for the cut, so be it. If you cannot, then I would urge dropping the proposal for a while because you will see an increase in revenues if people come to believe that, at least for a few years, the rate is going to stay where it is.

The CHAIRMAN. Let me ask a further question. When we were doing tax reform, we used to ask this question. How low would the rates have to be before you did not care about deductions? We did not talk too much about capital gains. We talked about deductions—20 percent, 30 percent, 25 percent. It was a kind of random net range.

We could, if we wanted to, have a flat tax, still exempting the poor, at about 18 or 19 percent if you included everything as income, and no deductions. And if you could guarantee that for 5 or

10 years, what would be the effect? And I will start with Mr. Pearlman and go left. You have to tax everything as income.

Mr. PEARLMAN. If you really mean tax everything as income, and that does not just mean eliminating deductions, that raises very difficult issues——

The CHAIRMAN. You are putting things in the base that are not now in the base.

Mr. PEARLMAN. If you really mean that, from my perspective— and really, this is what we were doing at the Treasury Department in 1985—the broader the tax base, the less intrusion in the tax system, the healthier the system is.

Now I am leaving the issues of progressivity aside because, as you said, you think you can deal with that.

The CHAIRMAN. You can deal with the poor.

Mr. PEARLMAN. And, assuming that you are not producing a new revenue loss so that you increase the deficit, in my judgment, the most healthy thing all of us can do for the tax system in this country is reduce the amount of intrusion that it has on economic activity.

I think that would be very constructive if it were done with those constraints.

The CHAIRMAN. Dr. Aaron.

Dr. AARON. I agree completely with what Mr. Pearlman just said. Almost anything you can do to broaden the tax base is worth doing.

In moving to a flat tax, as you said, you can protect the poor with personal exemptions or a zero bracket amount. Low earners will lose, however, unless you retain the earned income tax credit. What you cannot avoid is a very sizable redistribution of burdens in two directions—from higher income groups to middle-income, and from recipients of significant amounts of capital income to those whose income is only from labor.

Those are issues like fairness.

The CHAIRMAN. Why is that, if you include everything?

Dr. AARON. Because the flat tax proposals that I have seen do have the effect of exempting capital income.

The CHAIRMAN. No. I am not talking about that.

Dr. AARON. You are not. Well, all right. Well then, only the first of my two effects would come into play.

As Ms. Gravelle said earlier, fairness is a judgment call, which you are elected to do for your constituents, the American people. I can only speak as an individual. It strikes me that, in light of income developments that have occurred over the past two decades, in which middle- and lower-income households have had little or no gain or actual decreases in income, substantially all of the growth in income that has occurred has been in the top decile and, more particularly, in the top 1 percent of the income distribution.

In that kind of an environment, to engineer a significant redistribution that favors the rich strikes me as dubious policy.

The CHAIRMAN. Mr. Bloomfield.

Mr. BLOOMFIELD. Mr. Chairman, before we continue, would you tell me what you mean by a flat tax. Is it 18 percent for everybody, or how do you get the progressivity?

The CHAIRMAN. You can exempt probably, as best I can figure, at $13,000 top $14,000 single, $28,000 couple, unless you want to keep the marriage penalty and have some exemptions for children. I attempt to make no progressivity once you go beyond that. People who make $500,000 would pay the same percent as somebody who makes $100,000.

Mr. Bloomfield.

Mr. BLOOMFIELD. What is the tax base? Is it an income tax base, or is in a consumption tax base?

The CHAIRMAN. It depends on your definition.

Mr. BLOOMFIELD. Can I choose the definition?

The Chairman. It is all sources of income derived. Even many that are not now counted as income are taxed as income.

Mr. BLOOMFIELD. The reason I ask is that, obviously, if you have a consumption tax base, saving and investment are only taxed once. And they are taxed very lightly. So I would respond that, if you replace the income tax with some something called a non-income tax. You can talk about a Nunn-Domenici. I am concerned that, to the extent to which you exclude saving and investment, I think you will have a positive economic impact. I thought your question was going to be, what about eliminating the mortgage interest deduction?

The CHAIRMAN. Oh, all of those fall into this category.

Mr. BLOOMFIELD. Well, let's talk about the mortgage interest deductions, because I know you have raised that question. As you know, what happens under the Nunn-Domenici proposal, you are able to keep your mortgage interest deduction. You are not able to keep it under Armey's flat tax. But you eliminate equity loans, and you do not tax saving and investment but once.

So what I am suggesting is that you need to look at the pieces a lot more before you talk about the economic impact. You also know that under some of these, you can deduct labor, and under other plans you cannot.

But my bottom line is yes. If you exclude saving and investment from the income tax, I think you would have a beneficial impact over the long term. I like the lower rates for efficiency reasons. My difference is that, about 10 years ago, you lowered the rates, but you paid for it by increasing the tax on private saving and investment.

The CHAIRMAN. Dr. Gravelle.

Dr. GRAVELLE. Well, in general, if you can succeed in broadening the base, lowering the rates should produce a more efficient economy. And I think we did a lot of that in 1986. But, of course, we did not go all the way. That is something that I think most public finance economists would agree on. If you can broaden the base and lower the rate, you will have less distortions in the tax introduced into the private decision-making with an income-based or a consumption-based tax.

The CHAIRMAN. Mr. Wanniski.

Mr. WANNISKI. The Armey flat tax was designed in a supply model, to maximize the development of entrepreneurial capitalism in a way that would have the most positive effects on the national economy. The biggest problem with the Armey flat tax is that it would make the economy grow so fast that all 93 million Mexicans would come across the border. They would want to live here. So we have to export that idea to Mexico City as quickly as possible.

The most beneficial thing about the Armey flat tax is that it would, by the simplification process, eliminate taxation on capital gains and estates. Because you are only taxing once at the source, you would have the kind of fluid society that was characteristic of this country for 200 years. By fluid I mean that anyone who is born in the United States can get to the top within his or her lifetime. And that means that anyone that is born at the top has to be able to get to the bottom within his or her lifetime.

The tax system, as now designed, has become encrusted with taxation that helps the people at the top stay there and, therefore, produces a ceiling for people who are trying to come up. So I think that is by far the most——

The CHAIRMAN. Then we ought to tax capital gains at death.

Mr. WANNISKI. That is a preferable way of doing it, taxing capital gains at death. But insofar as the entrepreneur is interested in expanding his wealth, in order to take care of a family that may not be interested in acquiring wealth, but may be interested in only public service, the entrepreneur will then be able to leave to them an estate of some income that will enable them to engage in public charities, for example, rather than to continue the accumulation of material wealth. That will have damaging effects on that side.

The CHAIRMAN. Senator Chafee, I am going to let you conclude. And then we have a vote.

Senator CHAFEE. Thank you, Mr. Chairman.

My principal concern and major worry is the deficit of the country. And if you can tell me something we should do in connection with capital gains that would reduce the deficit, I would look on it with considerable favor. In other words, the test I would put on it is, is the loss of revenue replaced by a contribution to our society that in some fashion is going to make up for that loss of revenue, and hope to reduce our deficit?

Mr. BLOOMFIELD. Yes, Senator. The answer is yes.

Senator CHAFEE. And the answer is yes, as you said. But we get right back to the two-two split.

Dr. AARON. This is not a matter for a plebiscite. I think one needs to look, or have one's staff look at the analytics and weigh the evidence and form a judgment. We are not a random sample of the profession of economics.

Senator CHAFEE. But, Mr. Bloomfield, you are quite certain that we would receive additional revenue, and thus be able to reduce our deficit?

Mr. BLOOMFIELD. No. I am not certain. But I would suggest that there is strong evidence that there is a heck of a lot more unlocking than people would think, which minimizes the static loss. And then I would suggest that there are very credible economists who have run it through their models, and think that it will have a positive impact on capital costs, GNP saving and investment.

It is different than other tax cuts because with other tax cuts, you do not have that added dimension of unlocking. And it is very dramatic. You remember that Dr. Gravelle indicated that the problem with unlocking is that sooner or later you are going to run out of realizations. And it is hard to double realizations in a given year. Well the answer was that it was not that hard because during the time 1985 to 1986, realizations went from 173 to 326. And that was because there was a anticipation of a higher tax rate. Dr. Gravelle is right in that.

But taxpayers do respond very greatly to changes in tax rates. There are a heck of a lot of unrealized gains out there. There are $7.5 trillion in unrealized gains.

Senator CHAFEE. What do you say about that, Dr. Gravelle?

Dr. GRAVELLE. I am not talking about something that is going to happen in 1 year. And, as Mark knows, 1986 was an extraordinary and peculiar year. People rushed to realize gains before the tax rates went up.

What I am saying is that year after year you cannot have this large increase of realizations because realizations cannot be more than accruals. I spent a lot of time going back over the data to try to establish how much of accruals are realized over a long period of time. In any 1 year, of course there are a lot of accruals. But your question is, for permanent tax policy, you want to ask what is going to happen not in year one and two, but three, four, five and on.

Senator CHAFEE. You are right.

Dr. GRAVELLE. You cannot sustain that large level of realizations. You will run out of accruals.

Senator CHAFEE. Mr. Bloomfield must acknowledge that.

Mr. BLOOMFIELD. I do. I am just saying that there is a lot of unrealized capital gains out there, $7.5 trillion.

Dr. AARON. If that is the case I think Mr. Bloomfield, unintentionally perhaps, is giving us a key to increased realizations. You should enact a capital gains tax schedule, the rate of which rises steadily with the taxpayer's age, and include constructive realization at death. You will unlock like the dickens.

I am not recommending that tax schedule. I think that is a nonneutral provision that would be undesirable. But if your goal is to raise realizations, a steadily increasing rate schedule with the taxpayer's age will work wonders.

Senator CHAFEE. Now we have got to vote. Bob, do you want me to close it up?

The CHAIRMAN. Yes. I am going to go shake hands with him.

Senator CHAFEE. Oh. All right.

Well, thank you all very much. [Laughter.]

[Whereupon, at 12:04 p.m., the hearing was adjourned.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED

---

### PREPARED STATEMENT OF HENRY J. AARON

Thank you for the invitation to testify on the proposed changes in the taxation of realized income from long-term capital gains.[1]

I apologize for this cumbersome description of the subject of today's hearings. But the fact is that most capital gains are not realized in the year in which they are accrued and that roughly half of all gains are never realized at all. This fact means that *the effective rate of tax on capital gains would be less than half the statutory rate on the average, even if all realized income from capital gains were taxed at statutory rates applicable to ordinary income in the year earned*. In fact, of course, the top statutory rate on capital gains, 28 percent, is well below the top brackets of 36 percent and 39.6 percent, in which recipients of most capital gains are taxed on most of their income.

Deferral of tax for four years, the average holding period of realized gains, further reduces effective tax rates by an additional 26 percent (assuming a discount rate of 8 percent). In addition, approximately 30 percent of all equities are held by tax-exempt entities. *Thus, the effective tax rate on income from capital gains on equities for a taxpayer in the top marginal tax bracket is already less than one-fifth of that on ordinary income*.

The purpose of this hearing, therefore, is not to explore whether income from capital gains should be treated more leniently than is income from other sources. That issue has been settled. Capital gains are now enormously favored over other forms of income. *This hearing and the proposed legislation with which it is concerned address whether forgiving two-thirds to four-fifths of the tax that would be applied to other income is insufficient and needs to be increased.*

Three proposals for increasing those concessions are currently under discussion. One proposal would cut the tax rate applicable to income from capital gains by one-half. The second would index capital gains; or, more precisely, it would adjust the basis used in calculating capital gains for inflation between date of acquisition and sale. The third would allow taxpayers to deduct losses on the sale of personal residences. I shall examine each of these changes separately and then consider them together.

---

[1] Director of Economic Studies. The views expressed in this statement do not necessarily reflect those of staff members, officers, or trustees of the Brookings Institution.

## Cutting Rates

I attach eight graphics that set forth in outline the issues relating to the desirability of cutting tax rates on income from capital gains. I ask that they be attached to my testimony and included in the record.

The first graphic lists the three broad classes of reasons advanced for taxing income from realized capital gains at lower rates than are applied to other income:

- to promote growth,
- to improve fairness, and
- to increase efficiency of resource allocation.

*The second graphic explains why the effective tax on income from capital gains on equities averages only about 7 percent and the effective rate on income from capital gains on other assets averages only about 10 percent.*

### Effects on Growth

The next several graphics address the question of whether cutting the tax rate on income from realized capital gains would increase economic growth. *My conclusion is that such a tax cut is more likely to lower growth than to raise it.*

The third graphic explains a relationship among domestic investment, national saving, and the trade balance that must be kept in mind to understand how cutting tax rates on capital gains can affect economic growth. Domestic investment is identically equal to national saving (which is the difference between private saving and the deficit on government budgets) and net borrowing from abroad (represented by the excess of imports over exports).

The fourth graphic points out that cutting capital gains taxes applies equally to capital gains from assets located abroad and assets located in the United States. Thus, *cutting capital gains taxes does not increase the relative attractiveness of domestic investment.*

The third and fourth graphics together show that lowering tax rates on capital gains can affect gross domestic product only by raising domestic investment, which can occur only if national saving or net borrowing from abroad increases. For reasons I shall come to presently, *a cut in taxes on capital gains taxes is likely to lower, not raise, national saving.*

Furthermore, while an increase in investment financed by foreigners can increase gross *domestic* product, it cannot raise gross *national* product, because the net return to investment financed by foreigners flows abroad. In particular, increases in foreign-financed investment lower returns to domestic savers and raise earnings of workers.

The fifth graphic shows that *cutting capital gains taxes* will, at best, slightly raise U.S. private saving. Based on Michael Boskin's estimates of the responsiveness of private saving to the rate of return, *private saving will rise less than $2 billion annually*. Boskin's estimates of the responsiveness of private saving to the rate of return generate are at the upper end of empirically calculated elasticities. Estimates of the effect on private saving of cuts in capital gains taxes based on other empirical research would suggest smaller increases in private saving or even decreases.

*Thus, a cut in tax rates on income from capital gains will increase U.S. national saving only if the change causes government revenues to fall by less than $2 billion annually. The estimates of the Joint Committee on Taxation suggest that rate reductions will lower tax revenues and hence an increase in government dissaving over the first ten years by an average of somewhat more than $10 billion annually, for a drop in national saving of at least $8 billion annually*. These estimates do not take into account the effect of narrowing the federal income tax base for state revenues in those states that base state income taxes on the federal tax base. Eventually, the bond-rating services will force states to either raise other taxes or cut government spending. In the short run, however, some additional loss of national saving can be expected through increased state budget deficits or reduced state budget surpluses.

The sixth graphic indicates why sizeable revenue losses are inevitable. If capital gains rates are halved, realizations would have to double to sustain revenues. An increase in realizations is possible in the short run, and both the Treasury and the Joint Tax Committee anticipate a short run increase. That is why the estimated revenue loss in the early years after a rate reduction are so much smaller than revenue losses in later years. *The sixth graphic shows that a sustained increase in realizations sufficient to sustain revenue collections is virtually impossible*. The revenue loss in the second five-year period averages $13 billion to $16 billion annually.

## Effects of Cuts on Realizations

Some observers claim that they can infer from historical series on capital gains realizations that cutting capital gains tax rates actually *raises capital gains revenues*. *Such evidence tells essentially nothing about the effects on government revenues of a cut in tax rates on income from capital gains*. One reason, already stated, is that a brief and unsustainable increase in realizations is likely to occur simply because a tax cut puts realizations of capital gains "on sale." It is the normal and sustainable rate of realizations that determines whether a cut in capital gains rates will raise or lower *capital gains taxes*.

A second, and much more important reason why historical rates of *tax collections on capital gains say nothing whatsoever about the effect of cutting capital gains rates on government revenues is changes in revenues from taxes on capital gains realizations reveal only part of the effects on what really counts – total federal revenues*.

A cut in taxes on income from capital gains produces three distinct effects.

- The first direct effect is to lower revenues on asset sales that would have occurred even if tax rates had not been cut.
- The second direct effect is to induce additional sales, which tends to raise revenues.
- The third effect is more subtle and complex. Enlarging a wedge between taxes on income from capital gains and taxes on other forms of capital income or on earned income generates incentives for people to convert interest and dividends into capital gains. Companies will face increased incentives to retain earnings, which cause stock values to increase, rather than to pay dividends. Businesses will face increased incentives to pay top management through stock options, which hold the promise of capital gains, rather than through salary. These and countless other devices exist to "recharacterize" ordinary income as capital gains.

*To the extent that this process occurs, any increase in tax collections on capital gains comes at the expense of larger cuts in tax collections on ordinary capital and labor income. To that extent, the larger the increase in tax collections on capital gains, the greater the overall revenue loss.*

## Effects on Investment Demand

The seventh graphic reviews a series of reasons for cutting tax rates on income from capital gains based on the potential for such cuts to encourage investment. I conclude that *there is no reason to think that cutting capital gains taxes would perceptibly improve access to capital of investors with promising ideas*. The underlying points are simple. Most capital markets are highly efficient. Unless one can show that markets currently deny capital to significant quantities of investment with returns superior to investments that actually secure financing, giving investments that cannot win support from financial markets a still larger advantage than they now enjoy over other investments that now secure financing can only reduce the efficiency with which capital is allocated.

To justify reduced capital gains tax rates, it is necessary, therefore, for advocates to show that current effective rates, already a small fraction of tax rates on ordinary capital and labor income, egregiously deny resources to highly profitable projects and that these misallocations are so large that the net gains from lowering rates still further are sufficient to offset the loss of domestically financed investment that will occur because U.S. national saving will be reduced.

I have listened to debates on capital gains taxes for many years. Not only have I never heard such a justification, I have never heard attempts at making the case that go beyond bald *ex cathedra* assertions without supporting evidence.

Double Taxation

An additional reason advanced for reduced rates is the fact that corporate source income is subject to double taxation. By further reducing the rates on capital gains, it is argued, Congress can partially ameliorate this inequity and inefficiency. This argument has some merit, but not much. *Double taxation exists and should be ended, but cutting capital gains rates is a perfectly awful way to try to do it*.

The problems are several. First, roughly half of capital gains occur in real estate, where partnerships and subchapter S corporation are typical and, hence, double taxation is not an issue. This industry already benefits from the sharply lower effective rate of tax on capital gains. Because income through capital gains is more common in this industry than in most others, current rules already favor real estate investments over equally productive investments in other assets that typically generate income in fully taxable forms.

Second, the principle problem of double taxation concerns dividends, which are fully taxable when received by taxable individuals and businesses, not capital gains on which effective rates already are tiny. Third, *if the problem of double taxation deserves attention, and I believe that it does, then the way to fix that problem is to fix that problem. The Bush administration, in its waning days, put out the most thoughtful and complete study of the problem of double taxation ever seen and showed the way to fixing the problem*.

The last graphic examines the fairness of further reducing effective taxes on capital gains. I recognize that fairness is not a matter on which hard judgments are possible. But a correct understanding of the facts is possible. During the past two decades, the distribution of incomes in the United States has become progressively more unequal, and incomes in the lower third of the income distribution have fallen sharply. Cuts in capital gains taxes disproportionately benefit households in the top 1 percent of the income distribution, the one part of the income distribution that has done quite well over the past two decades. Moreover, *most of the near term revenue loss is in the nature of a windfall, based on asset appreciation that has already occurred. Such revenue loss can do nothing to promote economic growth*. It is simply a gift. I frankly do not understand how anyone can defend the fairness of such a gift at this time.

## Indexation

The second major proposed change in the taxation of capital gains would address some of the problems that arise from taxing nominal capital gains. The proposal would adjust the basis used in calculating capital gains for inflation that occurs after 1994. This method will, in general, result in the correct measure of real capital gains, except for the fact that it does not apply during any period over which prices fall. Although deflation has not occurred in many recent years, this peculiar asymmetry raises the possibility that at some time in the future the same taxpayer could file a tax return in which he or she reports inflation-adjusted capital gains held over inflationary periods and inflation-unadjusted gains held over some other deflationary period. This asymmetry makes no sense whatsoever.

In fact, *indexing of capital gains income alone will raise more problems than it solves*. The problem is that *indexing one form of capital income, but not all, inevitably creates opportunities for tax avoidance*. In particular, since interest payments and debt explicitly will *not* be indexed, the indexation of capital gains strengthens incentives to borrow to finance purchase of capital-gains-generating assets. In such cases, the inflation component of interest rates is fully deductible, but the inflation component of capital gains is exempt. In the absence of interest rate adjustments, this option for coining money would be virtually open-ended -- financially riskier than forgery, but legally much safer. Consequently, one would expect real interest rates or prices of indexable assets to rise as a result of indexation.

To the extent that asset prices rise, the reduction in national saving caused by cuts in tax rates on income from capital gains will be enlarged. It is well established that personal consumption rises when household assets increase. One would expect household assets to increase by approximately the present discounted value of the reduction in taxes from indexation. The Joint Committee on Taxation estimates the revenue loss ten years after indexation takes effect at more than $9 billion and rising steadily as the period after the effective date of the legislation increases. But the revenue loss is rising steadily and may be expected to continue rising for at least another two or three decades.

This revenue loss directly increases the deficit. To the extent that the loss grows, it could induce additional increases in private consumption in anticipation of future tax savings. In any event, *indexation approximately doubles the revenue loss and the associated reduction in national saving attributable to rate cuts, bringing the total loss to approximately $20 billion annually*.

Exactly how large the ultimate revenue loss from indexation will become is hard to estimate, *but I think it is close to the truth to say that indexation will substantially eliminate taxes on portfolios of more than modest size*. The reason is quite simple. Indexation has the effect during inflationary periods of lowering large capital gains, of converting small nominal capital into real losses, and of enlarging real losses. If all gains were taxed as accrued (universal "mark to market") and if other capital income were also indexed, this adjustment would be the correct one to make. But neither of these two conditions is satisfied.

Not only can investors use unindexed debt to finance indexed assets, as noted above, but, in addition, investors can choose which assets to sell and which to retain. By increasing the share of capital gains assets that will show taxable losses, indexation greatly increases the opportunity for investors to match losses and gains, thereby obviating the need for them to realize gains in excess of losses. Owners of small portfolios and some lucky owners of large portfolios containing nothing but big winners may find themselves unable to engage in such "balancing," but indexation greatly increases the scope for this method of tax avoidance.

Let me be clear. I am not simply opposing indexation of capital gains. *I am urging that vigorous efforts be made to index all capital income and that such treatment be granted to any taxpayer who agrees to mark assets to market annually or at some other stipulated frequent interval*. Owners of capital assets who do not wish to mark assets to market would forego indexing.

## Capital Losses on Owner-Occupied Housing

Owner-occupied housing is the most tax favored asset under current law. The income from this asset, imputed gross rent, is excluded from the tax base. Owners are nonetheless permitted to deduct two expenses of ownership normally permitted only for income-generating assets, interest expense and property taxes. Capital gains on sale of a principal residence are excluded from tax if the owner purchases another house within two years. In addition, current law excuses the first $125,000 of capital gains on sale of a principal residence for homeowners over age 55 who sell their houses.

*The result of all of these concessions is the allocation of an excessive share of the U.S. capital stock to housing and too little to less favored assets*. To this list of incentives, some people would add the still further advantage of allowing deduction of capital losses. About the only favorable observation that one can make about this change is that the revenue loss is not very large. From any other standpoint it is deplorable tax legislation, enlarging an incentive to resource misallocation and doing so in a way that helps most those who need help least. As with any deduction, the relief is proportional to tax rates and hence assists most those who are in the highest tax brackets. Furthermore, the limit on capital loss deductions means that losses in excess of $3,000 must be carried over unless one has sufficient capital gains to offset losses on sale of a house.

Rather than enlarge the already excessively generous tax treatment of owner-occupied housing, Congress should be taking steps to curb current advantages by limiting mortgage interest and property tax deductions. I recognize the political obstacles to such changes and therefore suggest limits on these deductions that would affect few people today but that would bite increasingly as prices rise. A limit on mortgage interest deductions to, say, $10,000 in excess of reported capital income would be a good place to begin.

## Concluding Comments

In your invitation, Mr. Chairman, you raised three broad questions. Most of my testimony has been devoted to answering the first, concerning the effects of the proposed changes in tax rules applicable to income from realized capital gains on economic growth. I have argued that the effects would be pernicious.

- By reducing national saving, because government revenues would fall more than private saving would increase, the capacity of the U.S. economy to invest from its own resources would be reduced, economic growth would be slowed, and economic welfare reduced.

- Not only would growth be slowed, inequality would be increased.

*If you want to reduce growth and increase inequality, you should vote for the proposed cuts in capital gains tax rates, indexing, and liberalized treatment of owner-occupied housing. If you want increased growth and reduced inequality, you should vote against these changes.*

Your second question concerns how other countries tax capital gains and how their practices have affected their economies. In general, other countries do a poor job of taxing capital gains. To the extent that their economies resemble our own, my preceding comments respond to how their practices affect their economies.

One point deserves emphasis, however. The United States should determine the personal income tax on capital gains without concern about how the personal income tax systems of other countries operate. The United States asserts world-wide jurisdiction over income of U.S. nationals and residents. Thus, foreign personal income tax rules, however favorable they may be to capital gains, are not relevant to economic incentives facing people subject to U.S. tax rules. To be sure, the fact that the United States taxes capital gains somewhat more heavily than other countries do might lead a few wealthy U.S. nationals to renounce citizenship and take up residence abroad or discourage a few wealthy foreign residents from taking up residence in the United States. I do not believe that this possible distortion rises to a level worthy of legislative notice.

The final question you posed concerns the tax rate at which the Federal government will maximize revenues from taxes on capital gains. To this question, two answers are appropriate.

First, it is the wrong question to ask. *If you want to maximize revenues from capital gains taxes, the most obvious and fertile change would be to impose constructive realization at death – that is, all gains unrealized at the taxpayer's death would be taxed as if realized at market value. This change would not only raise considerable revenue directly, it would also significantly reduce the lock-in effect of capital gains taxes, thereby shortening holding periods.*

It is the wrong question for another reason. The objective of taxation is not to find the rate at which taxes maximize revenue. It is to find the combination of tax rules and rates that produces sufficient revenues to pay for public services and that does so in a way that produces the best possible combination of economic efficiency and fairness. Lowering capital gains tax rates, indexing capital gains income but not other asset income, and widening the advantages accorded owner-occupied housing fail this test miserably.

GRAPHIC 1

# Reasons for Cutting Capital Gains Taxes

✔ **Growth**
- -- Increase saving
- -- Increase investment demand
- -- Increase venture capital

✔ **Fairness**
- -- Offset failure to index
- -- Offset double taxation

✔ **Efficiency**
- -- Tax cut that loses no revenue

GRAPHIC 2

## What *is* the tax rate on capital gains?

1. The top rate on capital gains is 28 percent.
2. Roughly half of capital gains are never taxed, reducing average effective rate to 14 percent.
3. Deferring gains for 4 years reduces the present value of tax liabilities by 26 percent, at an 8 percent discount rate, lowering the effective rate to 10.3 percent.
4. 30 percent of equities are held by tax exempt entities
5. *Thus, the average effective rate of tax on equity investments is now about*

   **7.2 percent,**

   *one fifth or less of the 36 percent or 30.6 percent rate on ordinary income paid by recipients of most capital gains.*

GRAPHIC 3

## Savings and Investment

$$I_D = S_P - D + (M - X)$$

$I_D$ = Domestic Investment

$S_P$ = Private Saving

D = Government Deficit

M = Imports

X = Exports

*In words: domestic invesment is* <u>*identical*</u> *to the sum of national saving ($S_P$-D) and the trade deficit (M - X).*

GRAPHIC 4

# Investment Demand

Reduction in tax on capital gains would apply to gains earned abroad, as well as to gains originating in the United States.

☛ *Therefore:*

A cut in taxes on capital gains will not change the proportion of U.S. financed investment located in the UnitedStates

☛ *Therefore:*

A cut in taxes on capital gains can increase investment in the United States *only if* it increases U.S. saving ($S_P$ - D)

GRAPHIC 5

# Effects on Private Saving

## Assumptions

- -- One-third of return of total asset return is capital gains
- -- Tax rate cut from 28 percent to 14 percent
- -- Current effective tax rate on capital gains is about 7.2 percent
- -- Saving elasticity = 0.4 (Boskin, 1978)

## Implication

*Private saving will rise by less than* ***$2 billion*** *per year*

GRAPHIC 6

# Effects on the Deficit

✔ Revenue falls if proportionate cut in taxes is *larger* than proportionate increase in realizations

✔ Revenue rises if proportionate cut in taxes is *smaller* than proportionate increase in realizations

☛ *Therefore*: If tax rate is halved, realizations must *at least* double or revenues will fall

☛ *Fact:* Currently half of gains are never realized

*Calculation:* If realizations double, the proportion of gains that is realized would have to rise from ***50 percent*** to ***95 percent***[1]

*Conclusion*: Cutting capital gains rates will reduce income tax collections

[1]Based on formula reported in Alan J. Auerbach, "Capital Gains Taxation and Tax Reform, *National Tax Journal*, vol. 42 (September 1989), pp. 391-401. Annual realizations averaged 3.3 percent of assets from 1978 through 1987. Assumes that 23 percent of assets ever realized are realized in a given year, that the annual gain averages 10 percent

90-210 O - 95 - 3

GRAPHIC 7

# Access to Capital Markets

## 1. Existing Corporations

Currently have ready access to capital

## 2. Venture Capital

-- Only 12 percent of venture capital is from taxable sources, and venture capital represents about 1 percent of total net investment

-- Given effective tax rate oncapital gains of less than 10 percent, cutting the rate in half would increase a profit of, say, $100 to, perhaps, $105

## 3. Inflation

-- Solution is indexation (note: requires indexation of *all* capital income, a desirable reform)

-- A paradox: when part of gains are inflation-generated, the proportion of gain subject to tax should rise with the holding period

## 4. Double Taxation

-- The solution is integration

-- Capital gains cut will aggravate the problem because the biggest gainers will be real estate, where no double-taxation problem exists

GRAPHIC 8

# Equity

## *Horizontal equity*

Investors equalize expected returns, *given existing tax rules*

☞ Therefore, inequity occurs only when tax rules *change*

## *Vertical Equity*

Judgments are *entirely subjective*

**Facts:**

-- Top 1 percent of income recipients would receive more than 50 percent of benefits

-- Bottom 80 percent of income recipients would receive approximately 10 percent of benefits

-- Averaging income over many years reduces this disparity only slightly

# ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Mark A. Bloomfield, President
American Council for Capital Formation
before the
Committee on Finance of the United States Senate
February 15, 1995

**Executive Summary**

1. **OVERVIEW.** We commend the emphasis that Chairman Packwood places 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. It is clear that U.S. tax policies toward saving and investment must be revised if we are to increase real wages for U.S. workers and retain our leading role in world affairs.

2. **TRENDS IN U.S. CAPITAL FORMATION.** Recent U.S. saving rates and investment spending compare unfavorably with those of other nations as well as with our own past experience. The U.S. saving rate averaged 4.8 percent over the 1973-1991 period, compared to 19.1 percent in Japan and 10.7 percent in West Germany. During the same period, gross residential investment as a percent of GDP was lower for the United States than for any of our major competitors.

3. **TAX POLICY AND ECONOMIC GROWTH.** To those who favor a truly level playing field over time for 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. A number of studies show 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 such as those proposed by several prominent members of Congress.

4. **ECONOMIC CASE FOR LOW CAPITAL GAINS TAXES.** The economic case for low capital gains taxes rests on the beneficial impact of such a change on capital costs, capital mobility, entrepreneurship, and the ravages of inflation. One recent study shows that a substantial reduction in capital gains taxes, when macroeconomic "feedback" effects as well as "unlocking" of unrealized gains are included, would result in new and better jobs and lower capital costs, as well as increased capital formation, stronger economic growth, and higher federal tax revenues than under current law.

5. **TAXATION OF CAPITAL IN OTHER DEVELOPED COUNTRIES.** The United States taxes individual and corporate capital gains more harshly than most other industrialized countries. A survey of twelve industrialized countries showed that the U.S. capital gains tax rate on long-term gains on portfolio securities exceeded that of all countries except Australia and the United Kingdom and even these countries index the cost basis of an asset.

1750 K Street, NW • Suite 400 • Washington, DC 20006-2300 • 202/293-5811 • 202/785-8165 FAX

6. **CAPITAL GAINS RATE REDUCTIONS AND TAX REVENUES.** Capital gain revenue estimates involve three elements: the "static" revenue loss, the "unlocking" effect, and the "macroeconomic" impact. A National Bureau of Economic Research study in the late 1980s found the capital gains revenue maximizing rate to be in the range of 9 to 21 percent—the point at which there is sufficient "unlocking" because of a lower tax to compensate for the static revenue loss because of a lower tax rate. This maximizing rate does not account for the additional revenue stemming from the positive macroeconomic impact of increased investment, GDP, and employment, which would result from a significant reduction in the capital gains tax. A new study by nationally renown economist Dr. Allen Sinai demonstrates this significant macroeconomic effect and the resulting additional federal revenues.

Finally, the historical experience of actual capital gains tax receipts during periods of low taxes (1978-1985) and high taxes (1987 to the present) strongly suggest that a reduction in the current capital gains tax would have a positive impact on federal revenues.

7. **CONCLUSION.** The hard fact is that we can no longer afford the luxury of government economic policies that reward consumption, discourage saving and investment, overregulate American business, and penalize economic growth. Enactment of capital gains tax reform would help move the United States toward a tax system that is more neutral toward saving and investment and pave the way for more fundamental tax restructuring.

ACCF

AMERICAN COUNCIL FOR CAPITAL FORMATION

Statement of
Mark A. Bloomfield, President
American Council for Capital Formation
before the Committee on Finance
United States Senate
February 15, 1995

## INTRODUCTION

My name is Mark A. Bloomfield. I am president of the American Council for Capital Formation (ACCF). I am accompanied by Dr. Margo Thorning, our chief economist. The ACCF represents a broad cross section of the American business community, including the manufacturing and investment sectors, Fortune 500 companies and smaller firms, individuals, and associations. Our board of directors includes cabinet members of prior Republican and Democratic administrations, former members of Congress, prominent business leaders, and public finance experts. We appreciate this opportunity to present testimony on the impact of a capital gains tax reduction on U.S. investment and economic growth. In addition, I will share the results of an international comparison of capital gains tax rates and discuss the revenue maximizing capital gains tax rate.

To encourage a constructive debate on the taxation of capital gains this year, our affiliated public policy think tank, the ACCF Center for Policy Research, has prepared a special report for today's hearing, "Questions and Answers on Capital Gains," which is attached to our testimony.

We commend the emphasis that Chairman Packwood places 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. It is clear that U.S. tax policies toward saving and investment must be revised if we are to increase real wages for U.S. workers and retain our leading role in world affairs.

## TRENDS IN U.S. CAPITAL FORMATION, PRODUCTIVITY INCREASES, AND ECONOMIC GROWTH

Investment spending in the United States in recent years compares unfavorably with that of other nations as well as our own past experience. From 1973 to 1991, gross nonresidential investment as a percent of Gross Domestic Product (GDP) was lower for the United States than for any of our major competitors (see Table 1). The U.S. saving rate averaged 4.8 percent over the 1973-1991 period, compared to 19.1 percent in Japan and 10.7 percent in West Germany. 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. Net private domestic investment averaged 7.4 percent of GDP from 1960 to 1980; since 1991 it has averaged only 3.0 percent (see Table 2).

Reflecting the reduced share of GDP being invested each year, the U.S. capital stock has also grown more slowly. In the three decades prior to 1980, the total capital stock grew at 4.0 percent per year; in the 1980s and 1990s, the rate fell to 2.7 and 1.4 percent respectively (see Table 3).

1750 K Street, NW • Suite 400 • Washington, DC 20006-2300 • 202/293-5811 • 202/785-8165 FAX

The stock of equipment, which many experts regard as critical for strong productivity growth, has increased only about half as fast since 1980 as in previous decades. Industrial equipment stocks, which grew at an average rate of 4.3 percent over the 1950-1979 period, increased by just 1.2 percent annually in the 1980s and 0.1 percent since 1990.

- *Link Between Investment, Productivity Increases, and Economic Growth*

The importance of investment in plant and equipment for economic growth is emphasized in a new book by Harvard Professor Dale Jorgenson. Professor Jorgenson's book, *Productivity: Postwar U.S. Economic Growth*, analyzed economic growth between cyclical peaks in the business cycle over the 1948-1979 period. Allocating increases in output to three sources—growth in the capital stock labor, supply, and multifactor productivity— ofessor Jorgenson found that increases in the capital stock contribute most to increases in output (see Figure 1).[1]

Investment's key role in advancing technological progress and productivity growth is also stressed in recent research by New York University Professor Edward N. Wolff. He argued that U.S. labor productivity growth rates are depressed by the recent slower growth in the capital-to-labor ratio—from a peak of 2.0 percent per year in the 1950s to 1.2 percent per year in the 1972-1992 period. He emphasized that the effects of the decline in U.S. capital-labor growth are perhaps even more pernicious than they appear at first glance.

Thus, a slowdown in capital formation may doubly hurt labor productivity growth—directly by slowing down the rate of capital deepening, and indirectly by slowing down the rate of technological advance. Professor Wolff's research also shows that U.S. labor productivity growth lags behind our competitors; OECD countries outstripped the United States during much of the 1950-1990 period. He noted that countries such as Japan and Germany, which experienced strong productivity growth in the 1970s and 1980s, showed significant gains in their capital-to-labor ratios. Our competitors' gains in capital-to-labor ratios are a direct result of their higher levels of investment.

- *Implications of Lagging Investment and Slow Growth in Labor Productivity for Current and Future Living Standards*

Real family income in the United States has been nearly stagnant since the mid-1970s and in recent years has actually fallen. For example, real median household income was $39,869 in 1989; income has declined in each subsequent year, and in 1993 stood at $36,959. These trends have not only made it harder to maintain living standards but have also jeopardized our future economic health and our ability to remain the principal leader in international affairs.

In addition, looming in the future is the need to finance the retirement of the baby boom generation. Research by Stanford Professor B. Douglas Bernheim, commissioned by the ACCF

---

[1]Jorgenson's analysis uses *multifactor* productivity, which relates output to inputs of both labor and capital. The traditional productivity measure commonly found in popular articles is *labor* productivity, which relates output to labor input alone.

Center for Policy Research, our public policy think tank, shows that current saving by members of the baby boom generation is seriously inadequate. The typical baby boom household saves at only one-third the rate required to finance a retirement standard of living comparable to that enjoyed before retirement.

## TAX POLICY AND ECONOMIC GROWTH

To those who favor a truly level playing field over time for 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 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 University's Dale Jorgenson; the University of Texas' Don Fullerton; and Joel Prakken of Laurence H. Meyer have used macroeconomic models that incorporate "feedback" and dynamic effects in simulating the effect 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, all come to the conclusion 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.

## THE ECONOMIC CASE FOR LOW CAPITAL GAINS TAXES

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, which 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 economy is expanding, worries about the future appear to be multiplying. A cut in the capital gains tax to a top marginal rate of, say, 15 to 20 percent would by no means act as an economic panacea. However, it would surely give a boost to values of capital assets (e.g., real estate and the stock market), encourage investment by both mature and new businesses, and constitute fairer taxation of peoples's savings.

A new study by Allen Sinai, chief global economist at Lehman Brothers and highly respected economic forecaster, shows that a substantial reduction in capital gains taxes would, when macroeconomic "feedback" effects as well as unlocking of unrealized capital gains are included, result in new and better jobs, as well as increased capital formation, stronger economic growth, and federal tax revenues that are larger than under current law.

According to Dr. Sinai's study, a 50 percent capital gains exclusion, combined with prospective indexing for all taxpayers (individual and corporate) would, by the year 1999, increase real GNP by 2.3 percent, or about 0.5 percent per year compared to a baseline (see Table 4). In addition, the capital gains tax reduction would increase capital spending and capital formation, increase household net worth (household wealth), lower the cost of capital for business and increase business profits, increase employment and lower the unemployment rate, shift the financing of business activity away 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.

The economic case for a low capital gains rests on the beneficial impact on capital costs, capital mobility, the ravages of inflation, and entrepreneurship.

- *Capital Gains and Capital Costs*

The user cost of capital is the pretax return on a new investment that is required to cover the purchase price of the asset, the market rate of interest, inflation, risk, economic depreciation, and taxes. This capital cost concept is often called the "hurdle rate" because it measures the return an investment must yield before a firm will be willing to start a new capital project.

Economists are in broad agreement that capital costs are affected by tax policy. For example, Stanford Dean John B. Shoven estimated that about one-third of the cost of capital is due to taxes. In other words, hurdle rates are 50 percent higher than they would otherwise be due to the tax liability on the income produced by the investment. Thus, the higher the tax on new investment, the less the investment that will take place. Although the Tax Reform Act of 1986 (TRA) substantially reduced corporate and individual income tax rates, the legislation's capital cost recovery provisions raised effective tax rates and capital costs for productive and pollution-control assets. Capital costs increased because of increases in capital gains taxes, the loss of the investment tax credit, lengthening of depreciable lives for many assets, and the creation of the corporate alternative minimum tax.

Low capital gains taxes help hold down capital costs. Research by public finance economists refer to the tax on capital gains as a tax on retained income, which 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) to fund real investment in productive projects. Research by Stanford Dean John Shoven, Ohio State Professor Patric Hendershott, and Dr. Allen Sinai, indicates that a cut in the capital gains tax rate to a range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

- *Capital Gains and Capital Mobility*

High capital gains taxes reduce the mobility of capital—and thus economic efficiency—by keeping capital from flowing into its most productive uses. The "lock-in" effect was demonstrated in a recent *Tax Notes* article (December 26, 1994) by attorney Mark Greenstein.

Greenstein explains how high capital gains taxes "lock-in" investors through the example below:

> Amy has a building that cost $50,000, is worth $1,000,000, and yields $70,000 in rent net of expenses. If Amy lives in a high-tax state, such as New York, more than one-third of the value of the building would disappear in taxes on disposition. To obtain the $70,000 she was receiving, Amy would have to obtain a yield of over 10 percent on the roughly $650,000 she would receive, net of taxes, if she sold the building. Because of this disincentive, it is likely that Amy will never sell her building. Instead, she will simply leave it to her heirs and, under current law, the gain will never be subject to an income tax.

Greenstein's example makes clear that if capital gains taxes were substantially reduced, Amy would be more likely to sell the building because any subsequent acquisition would not have to yield anything close to 10 percent to produce the $70,000 in income she earned on her original building. The example given above is also appropriate for investments in equities.

- *Capital Gains and Inflation*

Opponents of capital gains tax reductions fail to recognize that capital gains investments are inherently high risk and that realized capital gains include purely inflationary gains that are not income. The willingness to invest is hindered by taxing capital gains, which are phantom earnings brought on by inflation. The combined effect of taxing inflationary gains and limiting the deductibility of capital losses leads to a severe over-taxation of many investments that will earn capital gains.

A study by National Bureau of Economic Research chairman Martin Feldstein and University of Michigan Professor Joel Slemrod documents the overtaxation of capital gains due to inflation. They found that in 1973 individuals paid capital gains taxes on more than $4.5 billion of nominal gains on corporate stock. Their finding provides evidence that capital gains taxation is distortionary and unfair. If the cost of these shares had been adjusted for inflation, the $4.5 billion nominal gain would be a real capital loss of nearly $1 billion. In other words, individuals paid a substantial capital gains tax even though, after inflation, they received less from their sale than they originally paid.

The distortion, it should be pointed out, was greatest for middle-class investors. That obviously makes little economic sense and is unfair.

- *Capital Gains and Entrepreneurship*

Capital gains taxation has a particularly powerful impact on the entrepreneurial segment of the U.S. economy—a reality that econometric models do not capture—making possible new technological breakthroughs, new start-up companies, and new jobs.

A few words about the entire entrepreneurial process are pertinent. A number of factors are involved including entrepreneurs, informal investors, venture capital pools, and a healthy public market. All, I should stress, are sensitive to after-tax rates of return, which is why the level of capital gains taxation is important.

Foremost is the entrepreneur. By taxing his potential capital gains at a higher rate, either the pool of qualified entrepreneurs will decline or 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, of course, needs capital. Fledgling start-ups depend heavily on equity finance 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, 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, therefore, sensitive to the capital gains tax rate.

## THE TAXATION OF CAPITAL IN OTHER DEVELOPED COUNTRIES

- *Capital Gains*

The United States taxes capital gains much more harshly than does the rest of the world. In a survey of twelve industrialized countries, undertaken by the American Council for Capital Formation, the U.S. capital gains tax rate on long-term gains on portfolio securities was found to exceed that of all countries except Australia and the United Kingdom, and even these two countries index the cost basis of an asset. Germany, Japan, and South Korea exempt or tax only lightly capital gains from portfolio stock (see Table 5). The U.S. corporate capital gains tax rate is at an historic high and is not competitive with many other countries.

Do they know something we don't know? Perhaps, yes. They recognize the contribution a capital gains tax differential can make to lower capital costs, mitigate the distortions of inflation, increase capital mobility, nurture entrepreneurship, and stimulate new business creation.

While it is difficult to prove that low (or no) taxes on capital [illegible] cause higher rates of saving and investment, the circumstantial evidence is compelling. Personal saving rates tend to be higher in countries with low or no tax on capital gains on portfolio securities (see Table 5), and investment is also higher (see Table 1). For example, Japan taxes long-term capital gains on securities lightly; Japan's personal saving rate as a percent of GDP averaged 11.9 percent over the 1973-1991 period and non-residential fixed investment averaged 24.1 percent. The comparable saving rate for the United States is 5.9 percent; and U.S. investment averaged only 13.9 percent.

- *Other Capital Income and Investment*

The U.S. tax on capital gains should also be evaluated in the broader context of the taxation of all capital income. On that score, the United States also fares poorly. Many industrialized countries (see Table 5) tax other capital income less harshly than does the United States. Most provide for the integration of corporate and individual taxes and many tax interest income at lower rates than the United States.

In addition to having lower taxes on capital income than does the United States, many other industrialized countries tax new investment more favorably than we do. A new study by Harvard's Dale Jorgenson found that in 1990, the marginal effective corporate tax rate on investment in equipment was 18.5 percent in the United States compared 11.5 percent in Germany, 8.8 percent in Japan, and 8.0 percent in the United Kingdom. Thus, tax differentials may help explain why U.S. investment as a percent of GDP lags behind that of our competitors.

- *Consumption Taxes*

Finally, an international comparison needs to address the more fundamental issue of the overall taxation of saving and investment. This is extremely important because the level of a country's saving and investment is a major factor in determining its economic growth. The evidence is clear that almost all of our international competitors rely to a much greater extent on consumption taxes to fund government expenditures than does the United States. On average, the OECD countries collect 30 percent of their tax revenues from consumption taxes such as the value-added tax, compared to only 15 percent from consumption taxes in the United States.

## CAPITAL GAINS RATE REDUCTIONS AND TAX REVENUES

Capital gains revenue estimates involve three elements. First, there is "static" revenue loss stemming from taxing realizations at lower rates. Second, there is the "unlocking" effect peculiar to capital gains because it is a voluntary tax. Taxpayers tend to be locked in if the rate is too high and will unlock if the rate is lower, thereby generating tax revenues. Third, there is the macroeconomic effect of additional revenue generated by the impact of lower capital gains on capital costs, saving and investment, and economic growth. The challenge to this Committee is to evaluate all three dimensions and the net impact on total revenues to the U.S. Treasury.

Critics of a low capital gains tax argue that such cuts will result in significant federal revenue losses, 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.

- *Is There a Revenue Maximizing Rate?*

In the late 1980s, experts at the prestigious National Bureau of Economic Research examined the question of the revenue maximizing capital gains tax rate or, at what point is there sufficient "unlocking" to compensate for the "static" revenue loss resulting from a reduction in rates. The study by former Harvard Professor Lawrence Lindsay (now a 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 does 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.

Subsequently, Professor Lindsay modeled the revenue impact of a 15 percent capital gains tax. He chose that rate because it fell in the middle of the revenue maximizing range of 9 to 21 percent. Professor Lindsay concluded that a 15 percent capital gains rate would have substantially increased capital gains revenues. Again, it needs to be emphasized that this analysis does not include the revenue impact of a stronger economy.

- *Historical Experience*

Experience 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 marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent—but total individual capital gains tax receipts increased from $9.1 billion to $26.5 billion. After surging to $326 billion in 1986 (the year before the rate increases in the Tax Reform Act of 1986 took effect), capital gains realizations have trended down and have remained at less than $130 billion per year in the 1990s. Taxes paid are averaging only $27 billion per year. Given the increases in the stock market, inflation, and growth in GDP since the late 1980s, realizations and taxes paid are almost certainly being depressed by the current high capital gains rates.

- *Unlocking and Macroeconomic Impact on Revenue*

Scholars have researched two elements affecting capital gains tax revenues, the "unlocking" of unrealized gains and the macroeconomic impact of a low tax on capital gains. Estimates of unlocking are extremely sensitive to assumptions of the elasticity of taxpayer response. Very minor differences in assumptions can result in large differences in revenues. There is a wide range of credible assumptions about elasticity. The important point is that all the studies recognize a significant unlocking effect. For example, Princeton Professor David Bradford noted that the revenue estimates of President Bush's 30 percent capital gains exclusion resulted in a "static" loss over 1990-1995 of $100 billion, according to the Joint Committee on Taxation (JCT) and the Department of Treasury. However, induced realizations—the "unlocking" effect—and depreciation recapture would have recouped almost 90 percent of the loss, according to the JCT, and 110 percent as estimated by the Treasury. This arithmetic accounts for only one behavioral response—the "unlocking" effect—and the Treasury recoups almost all of the revenue loss.

Government revenue estimates do not factor in the macroeconomic consequences of lower capital gains tax rates on U.S. capital costs, investment, economic growth, and overall tax revenues. However, Dr. Allen Sinai's new analysis (cited earlier) shows significant increases in GDP, employment, and investment as well as a positive impact on federal tax revenues as a result of substantial capital gains reductions.

## LONG-RUN STRATEGIES FOR TAX REFORM

While capital gains taxes should be lowered or eliminated immediately to help encourage U.S. saving and investment, policymakers should have comprehensive tax reform as their long-term goal.

Restructuring the U.S. federal tax system to reduce the multiple taxation of saving and investment inherent in the income tax—and thus to promote productivity and higher living standards—should be high on the agenda of the 104th Congress. Several congressional tax reform proposals have been introduced or are close to being introduced as legislation.

Under the major taxation restructuring proposals before Congress, income in the form of capital gains is not taxed at all or only taxed if the proceeds are consumed. A common theme of the congressional tax reform proposals is that saving and investment are taxed more lightly and consumption more heavily than under current law.

## CONCLUSION

The hard fact is that we can no longer afford the luxury of government economic policies that reward consumption, discourage saving and investment, overregulate American business, and penalize economic growth. Enactment of capital gains tax reform provisions would help move the United States toward a tax system that is more neutral toward saving and investment and pave the way for a more fundamental tax restructuring.

| | United States | Canada | Japan | France | West Germany | United Kingdom |
|---|---|---|---|---|---|---|
| **SAVING** | | | | | | |
| Net saving[1] | 4.8% | 8.1% | 19.1% | 8.8% | 10.7% | 4.7% |
| Personal saving[2] | 5.9% | 7.7% | 11.9% | 6.9% | 8.2% | 3.2% |
| Gross saving (net saving plus consumption of fixed capital)[3] | 16.6% | 19.7% | 32.8% | 21.2% | 22.9% | 16.2% |
| **INVESTMENT** | | | | | | |
| Gross nonresidential fixed capital formation | 13.9% | 15.3% | 24.1% | 15.0% | 14.7% | 14.3% |
| Gross fixed capital formation | 18.4% | 21.7% | 30.3% | 21.1% | 20.6% | 18.0% |

*[1]The main components of the OECD definition of net saving are: personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce, primarily because of the treatment of government capital formation.*
*[2]Personal saving is comprised of household saving and private unincorporated enterprise.*
*[3]The main components of the OECD definition of consumption of fixed capital are the capital consumption allowances (depreciation charges) for both the private and the government sector.*

*Source:* Derived from National Accounts, Vol. II, 1973-1985 and 1979-1991, Organization for Economic Cooperation and Development (OECD), 1987 and 1993 eds. Prepared by the American Council for Capital Formation Center for Policy Research, February 1994

| | Average 1960-1980 | Average 1981-1985 | Average 1986-1990 | Average 1991-1994[3] |
|---|---|---|---|---|
| Net private domestic saving | 8.2% | 7.2% | 5.1% | 5.2% |
| State and local government surpluses | 0.4% | 1.2% | 0.9% | 0.4% |
| Subtotal of private and state saving | 8.6% | 8.4% | 5.9% | 5.6% |
| Less: federal budget deficit | -1.0% | -4.1% | -3.2% | -3.6% |
| Net domestic saving available for private investment | 7.6% | 4.3% | 2.7% | 1.9% |
| Net inflow of foreign saving[1] | -0.4% | 1.2% | 2.4% | 1.1% |
| Net private domestic investment | 7.2% | 5.5% | 5.1% | 3.0% |
| Personal saving | 5.1% | 5.6% | 3.4% | 3.4% |
| Net business saving[2] | 3.1% | 1.6% | 1.7% | 1.8% |

*[1]In the 1960-80 period the United States sent more capital abroad than it received; thus net inflow was negative during this period.*
*[2]Net business saving = gross private saving - personal saving - corporate and noncorporate capital consumption allowance.*
*[3]The 1994 figures included in this average reflect only the first two quarters.*

*Source:* Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by the American Council for Capital Formation Center for Policy Research, October 1994.

| | 1950-59 | 1960-69 | 1970-79 | 1980-89 | 1990-93 | 1993 level (billions of 1987 $) |
|---|---|---|---|---|---|---|
| Total | 3.6 | 4.5 | 3.8 | 2.7 | 1.4 | 4979.5 |
| Equipment | 4.1 | 5.0 | 4.9 | 2.6 | 2.3 | 2359.7 |
| Information processing | 8.8 | 8.9 | 8.9 | 9.3 | 7.3 | 747.7 |
| Equipment less information processing | 3.8 | 4.7 | 4.4 | 1.0 | 0.3 | 1612.1 |
| Industrial[1] | 5.0 | 4.3 | 3.6 | 1.2 | 0.1 | 754.6 |
| Structures | 3.3 | 4.2 | 2.8 | 2.8 | 0.6 | 2619.7 |

[1]*Industrial equipment includes fabricated metal products, engines and turbines, metal working machinery, special industry machinery, general industrial (including materials handing, equipment, and electrical transmission), distribution, and industrial apparatus.*

Source: "Fixed Nonresidential Private Capital, by Type of Equipment and Structures," Department of Commerce, Bureau of Economic Analysis, July 21, 1994. Chart prepared by the American Council for Capital Formation Center for Policy Research, September 1994.

| | FY 1995-1999 |
|---|---|
| Real GNP | |
| (Total change in real $ compared to baseline) | 2.3% |
| (Total change in GNP growth rate) | 0.7% |
| Employment | |
| (Total change-millions) | 1.4% |
| Business Capital Spending | |
| Total-(average annual change) | 2.1% |
| Equipment | 1.6% |
| Structures | 3.6% |
| Cost of Capital | |
| After-tax cost of debt & equity (average annual change) | -3.7% |
| S&P 500 Stock Index | |
| (average annual change) | 1.1 |
| Total Federal Tax Revenues[1] | |
| (billions) | $9.0-$18.0 |

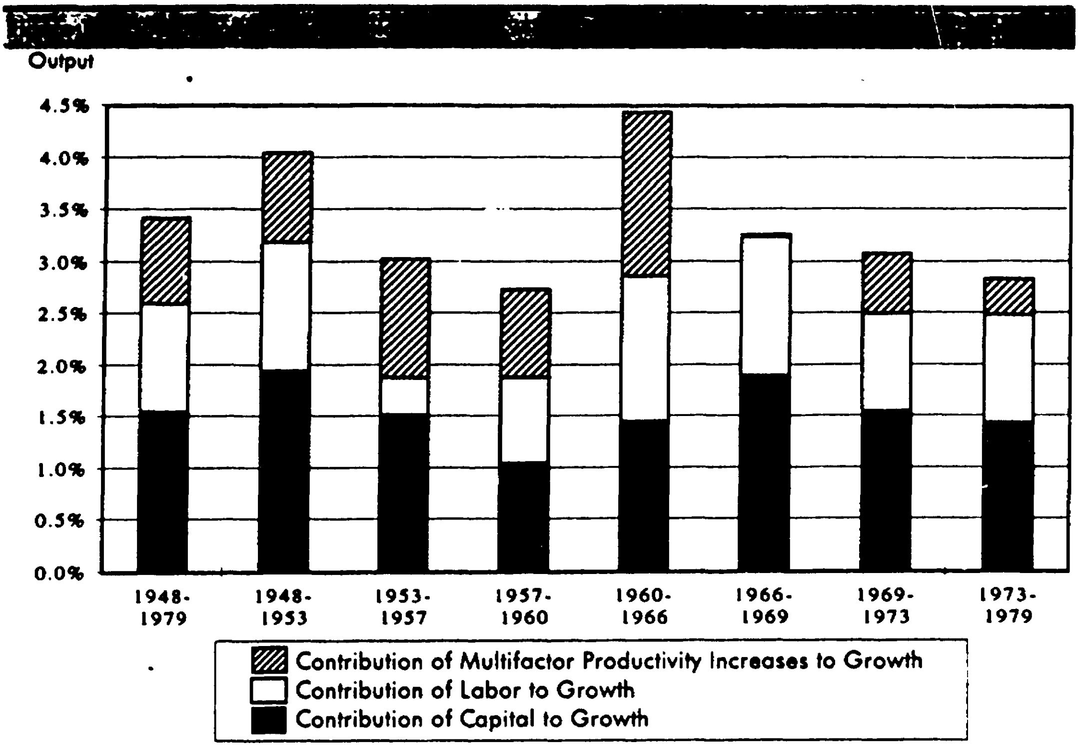
[1]The revenue impact varies according to the degree of unlocking assumed in response to a reduction in capital gains tax rates.

*Testimony of Dr. Allen Sinai, chief global economist with Lehman Brothers, before the House Committee on Ways and Means, January 24, 1995.

| Country | Capital Gains Maximum Individual Tax Rate[1] | | Personal Saving Rate[2] |
|---|---|---|---|
| | Short-term | Long-term | 1975-1991 |
| United States | 28.0% | 31.3%[3] | 6.8% |
| Japan | 1% of sale price or 20% of net gain. | 1% of sale price or 20% of net gain.[4] | 17.3% |
| Australia | 48.3% | 48.3%; asset cost is indexed. | 9.3% |
| Belgium | Exempt | Exempt | 14.7% |
| Canada | 23.80% | 23.80% | 12.5% |
| France | 18.1% | 18.1% | 15.6% |
| Germany | 53.0% | Exempt | 12.7% |
| Hong Kong | Exempt | Exempt | N/A |
| Italy | 25.0% | 25.0% | 19.8% |
| Netherlands | Exempt | Exempt | 2.9% |
| Sweden | 25.0% | 25.0% | 1.4% |
| United Kingdom | 40%; asset cost is indexed. | 40%; asset cost is indexed. | 9.8% |

[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* 52, December 1992, Table R 12, p. 212.
[3] While the top statutory rate is 28.0%, the actual top marginal rate for an individual faced with reduced itemized deductions and phasing out of personal exemptions is 31.3% for a family of four.
[4] The investor can choose the method which xxxx( Margo, I can't read it) the tax owed.

Prepared by the American Council for Capital Formation Center for Policy Research.




[1]The endpoints for each period are years in which a cyclical peak occurred. The growth rate is the average annual growth rate between cyclical peaks.

*Source:* Dale Jorgenson, *Productivity, Vol. I: Postwar U.S. Economic Growth.* (Cambridge, Mass.. MIT Press, 1995). Chart prepared by the ACCF Center for Policy Research, January 1995.

AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

January, 1995

# Questions and Answers on Capital Gains

**Q. *Does the United States Need a Capital Gains Tax Cut?***

A. Yes. To those who favor a truly "level playing field" over time for 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 because the individual or company that saves and invests pays more taxes over time than if all income is consumed and no saving takes 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 productivity and living standards is impaired.

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, which 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.

Favorable tax treatment of capital gains is especially important in encouraging the "start-up" of new but risky enterprises, which provide significant dynamism and growth to the U.S. economy. Much of that start-up money comes from friends and relatives of the entrepreneur. Their return will be in appreciated stock and thus low capital gains taxes makes them more willing to risk their savings.

The unfairness of taxing capital gains is significantly increased in those cases in which gains are "phantom earnings" brought on by inflation. Indexation of capital gains taxes would obviate this.

Although the economy is expanding, worries about the future appear to be multiplying. A cut in the capital gains tax to a top marginal rate of, say, 15 to 20 percent would by no means act as an economic panacea. However, it would surely give a strong boost to values of capital assets (e.g., real estate and the stock market), encourage investment by both mature and new businesses, and constitute fairer taxation of peoples' savings.

**Q. *Will Capital Gains Tax Cuts Increase U.S. Job Growth and Economic Growth?***

A. Yes. Dr. Allen Sinai, chief global economist at Lehman Brothers and a highly respected economic forecaster, argues that when macroeconomic "feedback" effects as well as unlocking of unrealized capital gains are estimated, a substantial reduction in capital gains taxes results in stronger economic growth, increased capital formation, and federal tax revenues that are significantly larger than under current law.

His estimates show that cuts in capital gains taxes:

- raise real and nominal gross national product,
- increase capital spending and capital formation,
- raise stock prices,
- increase household net worth,
- lower the cost of capital for business and increase business profits, and
- increase employment.

A capital gains tax reduction would also shift the financing of business activity away from debt to

*The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, regulatory, and environmental policies. The Center is located at 1750 K Street, N.W., Suite 400, Washington, D.C. 20006; Telephone: 202/293-5811; Fax: 202/785-8165*

equity, and induce portfolio allocations by households toward equity to take account of changes in expected after-tax returns on stocks and bonds.

**Q. *How Do Capital Gains Affect Capital Costs?***

A. The cost of capital is the pretax return of the new investment needed to cover the purchase price of an asset, the market rate of interest, inflation, taxes, and the return required by the investors. Capital costs are an important factor in determining which investments firms will make and how much investment occurs. High capital costs mean that only those projects with the greatest expected return will be undertaken because only they will yield a return large enough to satisfy investors, resulting in less overall investment and an aversion toward higher risk projects.

Research by Stanford's Dean of the College of Arts and Sciences, Professor John Shoven, Ohio State Professor Patric Hendershott, and Dr. Allen Sinai of Lehman Brothers indicates that a capital gains tax rate in the range of 15 to 20 percent would reduce the cost of capital by 4 to 8 percent.

**Q. *Aren't Cuts in Capital Gains Tax Rates Simply Another Version of "Trickle-Down" Economics that Won't Help Working Americans?***

A. No. The econometric studies of Dr. Allen Sinai demonstrate that a cut in capital gains tax rates will begin quickly to promote jobs, growth, and investment. This is because the tax cut would lower business capital costs, increase start-ups of new companies, and raise the value of equities and real estate. This is precisely the sort of economic environment in which "working Americans" prosper.

Perhaps the best anecdotal answer to those who argue that high taxes on capital gains hurt working Americans comes from a New Jersey painting contractor who (as quoted in the *Washington Post*) was "trying to scare up some work..."

> **"...you're looking at a poor man who thinks the capital gains tax [cut] is the best thing that could happen to this country because that's when the work will come back. People say capital gains is for the rich, but I've never been hired by a poor man."**

**Q. *Still, Isn't it True that Most of the Direct Benefits of a Capital Gains Tax Cut Go to the Rich?***

A. No. The facts are that many middle-class taxpayers realize a capital gain every once in a while but are counted as permanently rich under IRS statistics. But when those tax payer returns are adjusted to exclude their temporary capital gains and include only their wage and salary income, it becomes clear that middle-class taxpayers are major beneficiaries of lower capital gains tax rates. A special U.S. Treasury study covering 1985 shows that nearly one-half of all capital gains were realized by taxpayers with wage and salary income of less than $50,000. In addition, three-fourths of all returns with capital gains were reported by taxpayers with wage and salary income of less than $50,000. The issue of counting as wealthy the middle-class person who occasionally realizes a capital gain which artificially inflates his income in a given year has been studied by the Joint Committee on Taxation (JCT). A panel analysis for the year 1979-1983, by the JCT, found that 44 percent of taxpayers reporting gains realized a gain in only one out of five years.

It is true that many upper-income people have large capital gains. By realizing them, they pay more taxes, making revenue available to finance government programs which benefit lower-income recipients.

**Q. *How Do Capital Gains Rates Affect "Start-Up" Companies?***

A. Capital gains taxation has a particularly powerful impact on the entrepreneurial segment of the U.S. economy—making possible new technological breakthroughs, new start-up companies, and new jobs. Starting new businesses involves entrepreneurs, informal investors, venture capital pools, and a healthy public market. All are sensitive to after-tax rates of return, which is why the level of capital gains taxation is important.

Foremost is the entrepreneur. By taxing his potential capital gains at a higher rate, either the pool of qualified entrepreneurs will decline or 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 finance 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, 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.

### Q. *Can We "Afford" a Capital Gains Tax Cut?*

A. Yes. 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.

There is actually little difference between congressional estimates of capital gains tax cuts and those of the U.S. Treasury. For example, when President Bush proposed a 30 percent exclusion for capital gains in 1989, the JCT estimated a "static" loss over 1990-1995 of $100 billion. However, induced realizations—the "unlocking" effect—and depreciation recapture would have recouped almost 90 percent of the loss, according to the JCT, and 110 percent as estimated by the Treasury. [This arithmetic accounts for only one behavioral response—the "unlocking" effect—and the Treasury recoups almost all of the revenue loss. There is no revenue accounting for lower capital costs and increased economic activity. This impact would be substantial.]

Experience 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 marginal federal tax rate on capital gains was cut from almost 50 percent to 20 percent—but total individual capital gains tax receipts increased from $9.1 billion to $26.5 billion.

Research by experts at the prestigious National Bureau of Economic Research indicates that the "maximizing" capital gains tax rate—i.e., the rate that would bring in the most Treasury revenue—is somewhere between 9 and 21 percent.

### Q. *How Do Our Competitors Treat Capital Gains?*

A. Our international competitors recognize the contribution a capital gains tax differential can make to new risk capital, entrepreneurship, and new job creation.

The United States taxes capital gains more harshly than almost any other industrial nation. A survey 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 1). Germany, Japan, and South Korea exempt or tax only lightly capital gains on portfolio stock.

Not only do virtually all industrialized countries tax individual capital gains at lower rates than the United States; they also accord more favorable treatment to corporate capital gains.

### Q. *What Should a Sensible Capital Gains Tax Cut Look Like?*

A. Capital gains tax reform should satisfy three criteria. First, it should make economic sense by lowering the excessively high cost of U.S. capital, reducing the bias against high-risk capital, and ameliorating the taxation of inflationary gains.

Second, it should be fair to all income groups and sectors of the U.S. economy: Main Street and Wall Street, middle-class investors and farmers, new entrepreneurs and retiring businessmen, and individual investors and businesses.

Finally, although there is controversy about the revenue consequences of the capital gains tax reduction, a very strong and credible case can be made that this initiative, with its important macroeconomic consequences, will not reduce total tax revenues and, in fact, is a revenue-raiser.

### Q. *Isn't Indexing the Best Way to Lower the Capital Gains Taxes?*

A. Indexing is a very good idea because it adjusts for inflation, but taken alone it is a far from complete solution to the problem. A traditional capital gains tax exclusion is also needed.

Indexing for inflation will not offset much of the negative effects on the cost of capital caused by the very high capital gains taxes resulting from the Tax Reform Act of 1986.

**Q. *What Is the Capital Gains Tax Proposal in the GOP "Contract With America?"***

A. The GOP "Contract With America" contains three capital gains incentives:

- *Fifty Percent Capital Gains Deduction*—The "Contract With America" would substantially cut the tax rate on capital gains by allowing taxpayers to exclude one-half of the amount of their net capital gains. Currently, capital gains are taxed at the same rate as ordinary income, subject to a cap of 28 percent. Thus, there is a modest capital gains differential for the upper tax rate brackets, but principally because the 1993 tax law raised income tax rates. The Contract would halve the effective capital gains tax rate for lower- and middle-income taxpayers. The new effective capital gains tax rates would be 7.5 percent, 14 percent, 15.5 percent, 18 percent, and 19.8 percent

**Table 1: International Comparison [illegible] and Personal Saving Rates**

| Country | Capital Gains Maximum Individual Tax Rate[1] | | Personal Saving Rate[2] |
|---|---|---|---|
| | Short-term | Long-term | 1975-1991 |
| United States | 28.0% | 31.3%[3] | 6.8% |
| Japan | 1% of sale price or 20% of net gain. | 1% of sale price or 20% of net gain. | 17.3% |
| Australia | 48.3% | 48.3%; asset cost is indexed. | 9.3% |
| Belgium | Exempt | Exempt | 14.7% |
| Canada | 23.80% | 23.80% | 12.5% |
| France | 18.1% | 18.1% | 15.6% |
| Germany | 53.0% | Exempt | 12.7% |
| Hong Kong | Exempt | Exempt | N/A |
| Italy | 25.0% | 25.0% | 19.8% |
| Netherlands | Exempt | Exempt | 2.9% |
| Sweden | 25.0% | 25.0% | 1.4% |
| United Kingdom | 40%; asset cost is indexed. | 40%; asset cost is indexed. | 9.8% |

[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* 52, December 1992, Table R 12, p. 212
[3] While the top statutory rate is 28.0%, the actual top marginal rate for an individual faced with reduced itemized deductions and phasing out of personal exemptions is 31.3% for a family of four.

Prepared by the American Council for Capital Formation Center for Policy Research for individuals, depending upon the individual's tax bracket. Corporations would be subject to a top effective capital gains tax rate of 17.5 percent.

- *Capital Gains Indexation*—The "Contract With America" would end the current practice of taxing individuals and corporations on capital gains due to inflation. Currently, taxpayers must pay capital gains taxes on the difference between an asset's sales price and its "basis" (the asset's original purchase price, adjusted for depreciation and other items), even though the increase in value may be due to inflation. The Contract would increase the basis of most capital assets to account for inflation occurring after 1994. Taxpayers would be taxed only on the real—not inflationary—gain.

- *Loss on the Sale of a Home*—The "Contract With America" would treat a loss on the sale of a principal residence as a capital loss. Currently, if a home-owner sells his or her home at a loss, that loss is not deductible (even though gains on future residence sales may be taxable). The Contract would allow taxpayers to deduct the loss on the sale of a principal residence. This loss would be subject to the capital loss limitation rules, which allow a net capital loss (determined after netting capital gains and capital losses) to offset up to $3,000 annually of ordinary income, with the unused portion of the loss carried forward into succeeding years.

### Q. *What Is a Capital Gain?*

A. A capital gain or loss is the difference between the selling price of an asset and its basis (cost). The basis (cost) is the purchase price of the asset, including any brokerage fee. For example, if corporate stock is purchased for $2,000 and later sold for $2,500 (net of broker commissions), the capital gain is the difference between the $2,000 purchase price and the $2,500 received from the sale, or $500. If the asset purchased is a physical asset, such as a building, and the owner had made improvements, then the tax basis is the purchase price plus the cost of the improvements. If the asset depreciates over time, the basis is the original sale price reduced by the decline in value from depreciation.

The distinction between capital assets and other forms of property is the most important concept in the law relating to the taxation of capital gain. Under the Code, any property is a "capital asset" unless it is covered by one of numerous exceptions. The theme running through the exceptions is that capital gains treatment is appropriate only for income resulting from the appreciation in value of investment property or property used in a trade or business. Thus, there are exceptions that deny capital gain treatment for income from personal efforts, income from property not attributable to appreciation (such as interest, dividends, royalties, and rent), and the ordinary profits of business operations.

The primary assets that typically yield capital gains are corporate stock and business and rental real estate, according to a recent report by the Senate Budget Committee. Corporate stock accounts for from 20 to 50 percent of total realized gains, depending on the state of the economy and the stock market. There are also gains from assets such as bonds, partnership interests, owner-occupied housing, timber, and collectibles, but all of these are relatively small as a share of total capital gains.

### Q. *What Is the Current Federal Capital Gains Tax Rate?*

A. Gains on the sale of capital assets held for more than a year are limited to a maximum tax rate of 28 percent under the federal individual income tax, even though rates on ordinary income go up to 39.6 percent (or even higher in some cases). Also, gain on the sale of property used in a trade or business is treated as a long-term capital gain if all gains for the year on such property exceed all losses for the year. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than a year, but not inventory.

Benefits of the 28 percent maximum tax rate are limited to individuals with tax rates above 28 percent—that is, those in the 31 percent bracket, the 36 percent bracket, or the 39.6 percent bracket. For 1994, a taxpayer filing a joint return would have to have taxable income of $91,850 before the 31 percent tax rate applied (single taxpayers would have to have $53,500). Taxable income would have to be $140,000 before the 36 percent rate applied, and $250,000 before the 39.6 percent rate applied.

| Years | Holding Period (%) | Individuals Top Marginal Rate (%) | C-G[a] Rate (%) | Diff.[b] | Corporations Top Marginal Rate (%) | C-G[a] Rate (%) | Diff.[b] (%) |
|---|---|---|---|---|---|---|---|
| 1942-43 | 6 mos. | 88.0 | 25.0 | 63.0 | 40.0 | 25.0 | 15.0 |
| 1944-45 | 6 mos. | 94.0 | 25.0 | 69.0 | 40.0 | 25.0 | 15.0 |
| 1946-50 | 6 mos. | 91.0 | 25.0 | 66.0 | 38.0 | 25.0 | 13.0 |
| 1951 | 6 mos | 87.2 | 25.0 | 62.2 | 50.8 | 25.0 | 25.8 |
| 1952-53 | 6 mos. | 88.0 | 26.0 | 62.0 | 52.0 | 26.0 | 26.0 |
| 1954 | 6 mos. | 87.0 | 26.0 | 61.0 | 52.0 | 26.0 | 26.0 |
| 1955-63 | 6 mos. | 87.0 | 25.0 | 62.0 | 52.0 | 25.0 | 27.0 |
| 1964 | 6 mos. | 77.0 | 25.0 | 52.0 | 50.0 | 25.0 | 25.0 |
| 1965-69 | 6 mos. | 70.0 | 25.0 | 45.0 | 48.0 | 25.0 | 23.0 |
| 1970 | 6 mos. | 70.0 | 29.5 | 40.5 | 48.0 | 28.0 | 20.0 |
| 1971 | 6 mos. | 70.0 | 32.5 | 37.5 | 48.0 | 30.0 | 18.0 |
| 1972-76 | 6 mos. | 70.0 | 35.0[c] | 35.0 | 48.0 | 30.0 | 18.0 |
| 1977 | 9 mos. | 70.0 | 35.0 | 35.0 | 48.0 | 30.0 | 18.0 |
| 1978-10/31/78 | 1 yr. | 70.0 | 35.0 | 35.0 | 48.0 | 30.0 | 18.0 |
| 11/1/78-6/9/81 | 1 yr. | 70.0 | 28.0 | 42.0 | 46.0 | 28.0 | 18.0 |
| 6/10/81-6/22/84 | 1 yr. | 50.0 | 20.0 | 30.0 | 46.0 | 28.0 | 18.0 |
| 6/23/84-86 | 6 mos. | 50.0 | 20.0 | 30.0 | 46.0 | 28.0 | 18.0 |
| 1987 | 6 mos. | 38.5 | 28.0 | 10.5 | 40.0 | 34.0 | 6.0 |
| 1988 | 1 yr. | 33.0[d,e] | 33.0[d,e] | 0 | 34.0 | 34.0 | 0 |
| 1990 | 1 yr. | 31.0[f] | 28.0[f] | 3.0 | 34.0 | 34.0 | 0 |
| 1993 | 1 yr. | 39.6 | 28.0 | 11.6 | 35.0 | 35.0 | 0 |
| Rep. Contract Proposal[g] | 1 yr. | 39.6 | 19.8 | 19.8 | 35.0 | 17.5 | 17.5 |

[a] Maximum capital gains tax rate
[b] Differential between marginal income tax rate and capital gains rate.
[c] Interplay of minimum tax and maximum tax on earned income results in a marginal rate of 49.125%
[d] Statutory maximum of 28% but "phaseout" notch increases rate to 33%
[e] Interplay of all "phaseouts" can increase marginal rate to 49.5%
[f] The Budget Act of 1990 increased the statutory rate to 31.0%, and capped the marginal rate on capital gains at 28.0%. Until 1996, however, some taxpayers will face effective marginal rates of more than 34.0% due to the phase out of personal exemptions and itemized deductions
[g] The Republican Contract provides. (1) a 50 percent capital gains deduction for individuals and corporations, (2) indexation of the basis of capital assets to eliminate gains due to inflation, and (3) a provision to treat the loss on the sale of a home as a capital loss. The 50 percent capital gains deduction means that capital gains tax rates would be 7.5%, 14.0%, 15.5%, 18.0% and 19.8% for individuals.

Prepared by the American Council for Capital Formation Center for Policy Research.

Under current law, capital gains net of capital losses realized by an individual are taxed at a top marginal federal tax rate of 28 percent in taxable income. Net losses are included up to a maximum of $3,000. Net capital losses in excess of $3,000 are carried over to later taxable years. This constraint limits the ability of investors to time the realization of gains and losses so as to minimize taxes.

Corporate capital gains are taxed at a rate of 35 percent, the rate applied to ordinary corporate income.

## Q. *What Is the History of Capital Gains Taxes in the United States?*

A. Although the original 1913 Income Tax Act taxed capital gains at ordinary rates, legislation in 1921 provided for an alternative flat-rate tax for individuals of 12.5 percent for gain on property acquired for profit or investment. This treatment was to minimize the influence of the high progressive rates on market transactions. Over the years, many revisions in this treatment have been made. In 1934, a sliding-scale treatment was adopted (where lower rates applied the longer the asset was held). This system was revised in 1938. In 1942, the sliding-scale approach was replaced by a 50 percent exclusion for all but short-term gains (held for less than six months), with an elective alternative tax rate of 25 percent (see Table 2). The alternative tax affected only individuals in tax brackets above 50 percent.

In 1978, a 60 percent exclusion for individuals was introduced and the alternative rate for corporations was lowered to 28 percent. In 1981, the maximum tax rate on capital gains was reduced to 20 percent; the corporate gains tax remained at 28 percent.

The Tax Reform Act of 1986 (TRA), which lowered overall tax rates and included only two tax rate brackets (15 percent and 28 percent), provided that capital gains would be taxed at the same rate as ordinary income.

In 1990, a 31 percent rate was added to the rate structure for ordinary income. There had been, however, considerable debate over proposals to reduce capital gains taxes. Since the new rate structure would have increased capital gains tax rates for many taxpayers from 28 percent to 31 percent, a separate capital gains rate cap of 28 percent was maintained. The 28 percent cap was continued when the 1993 Omnibus Budget Reconciliation Act added a top rate of 36 percent and a 10 percent surcharge on very high incomes, producing a maximum rate of 39.6 percent on ordinary income.

## Q. *Do States Also Tax Capital Gains?*

A. Yes. Of the 42 states which tax capital gains, the majority apply this tax to the gain reported on the federal tax return. TRA, which eliminated the 60 percent exclusion for capital gains income, dramatically increased state capital gains taxes. As noted in a recent op-ed in the *Washington Times*:

> ...State capital gains taxes add another layer of impediment to investment and entrepreneurship, thereby further hampering economic growth and job creation...
>
> Even though a state capital gains tax rate of 4.5 percent, for example, as levied in Connecticut, is less than the national state average of 5.4 percent, it can turn out to be much more daunting after inflation is factored into the equation. For example, if one considers inflation on a venture capital investment of $50,000 made in 1987 and sold for $70,000 in 1993, Connecticut's real capital gains tax rate jumps to 11 percent..
>
> In a state with a much higher capitpl gains tax rate, such as New York, where the top rate is 7.875 percent, the real rate on such an investment jumps to over 19 percent.

The combined burden of federal and state taxes on capital gains makes it more difficult to raise capital for the start-up and entrepreneurial activity companies which are the source of much economic vibrancy, innovation, and job creation.

## Q. *Is Capital Gains a Partisan Issue?*

A. No. A reduction in capital gains taxation has not been a partisan issue in the past and should not be a partisan issue now. Capital gains tax reductions enjoyed bipartisan support from the tax-writing committees in all the major debates on this issue for nearly two decades. The real issues are economic: U.S. productivity growth, competitiveness, and job creation. As to fairness, past capital gains cuts have benefited the public generally by strengthening the U.S. economy. In fact, capital gains tax reductions in the Republican "Contract With America" is one of the most progressive measures to be considered by the Ways and Means Committee in many years. It raises large sums from upper-income taxpayers to fund programs for low-income Americans. A number of prominent Democrats have championed lower capital gains taxes over the years. ◆

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
*Washington, DC, February 14, 1995.*

MARK A. BLOOMFIELD, *President,*
*American Council for Capital Formation,*
*1750 K St., NW.,*
*Washington, DC*

Dear Mark: You recently asked me if my views on capital gains had changed since my last research on the subject in 1988. Your question prompted me to review the data on our experience with the capital gains tax rate increase which was part of the 1986 tax bill. That data strongly reinforces my view that the present 28-plus percent tax rate could be reduced without adversely affecting capital gains tax revenue.

Table 1 compares actual capital gains tax revenue with what would have been collected if the growth in revenue had kept pace with the growth in private financial wealth. Absent tax rate changes, capital gains realizations should grow at roughly the same rate as private financial wealth. If the tax rate structure were revenue maximizing, then revenues would also grow at the same rate as wealth. If the prevailing rate was above the revenue maximizing level, then over time, revenues would grow more slowly than private financial wealth as financial arrangements were put in place to minimize taxes.

A few words on methodology are in order. First, I used 1985 as my base year. All of the tax reform proposals on the table in that year maintained a capital gains differential. So, it is unlikely that taxpayer behavior that year was disrupted by expectations of tax changes. Second, the data for 1993 are my estimates based on the reports contained in the Spring 1994 Statistics of Income Bulletin on preliminary capital gains reporting. I assumed that the growth between the preliminary and final figures and the effective tax rate was the same in 1993 as in 1992. Third, I think that real analytic value is added by examining capital gains realizations over an extended period which incorporates financial market ups and downs. Thus, the tables look at the entire period from 1987-1993 which one might describe as up-down-up.

As Table 1 shows, capital gains tax revenues have clearly failed to keep pace with the growth in private financial wealth. Over the 7 year period, revenues fell short of what we might have expected by some $50 billion. As some might prefer other measures of expected growth in the capital gains tax base, I have included Table 2, which contrasts the growth in revenues with the growth in Gross Domestic Product and with the rise in the stock market as measured by the S&P Composite.

Of course, the decline in capital gains realizations was even more precipitous than the decline in revenues. In 1985, realizations were about $171 billion. In 1993, I estimate them at around $144 billion. Thus, realizations fell 16 percent in *nominal* terms at the same time that private financial wealth rose by more than 75 percent. Had there been no behavioral response to the tax rate increase, 1993 capital gains tax revenues would have been roughly $70 billion, more than twice their actual level.

While I think that this data makes clear that the current tax rate is above the revenue maximizing level, there is a great deal of uncertainty regarding what that rate might be. My own expectation, based on the research done to date, is that it is most likely between 15 percent and 20 percent. I would assign a 60 percent probability to this range. Subjectively, there is also probably a 10–20 percent change that the rate is below 15 percent and a 20–30 percent chance that it is in the low 20s.

An important caveat needs to be added to these estimates of the probable revenue maximizing rate. Under no circumstances should the revenue maximizing rate be considered an optimal tax rate. Any economically optimal rate must be well below the revenue maximizing level. All revenue maximization means is that the government has extracted the maximum it can from the private sector. This revenue extraction may be done at enormous cost to the private sector.

To understand the magnitude of this cost, consider the figures cited in a Washington Post editorial and my reply, to the Joint Committee on Taxation's estimates of the effects of an earlier capital gains rate reduction proposal. They estimated that the rate reduction would cost $1) billion in revenue, but reduce the burden to the nation's taxpayers by $100 billion. In effect, collecting each dollar of that $11 billion by keeping the tax rate at 28 percent costs the private sector $9. Surely it would take a rather extreme perception of the public interest to favor impoverishing the private sector by $9 in order to increase tax revenue by $1. Thus, even if the revenue maximizing rate should be in the 20–25 percent range, it would probably still be optimal tax policy to have the actual tax rate be under 20 percent.

In closing, let me add that I am very concerned about the effects of the federal deficit on the U.S. economy. In particular, I am concerned that a potential increase in the deficit might excessively increase aggregate demand in the economy and thus raise interest rates. However, the cause of any deficit change has a dramatic effect on the consequent increase in demand and interest rates. In general, deficit changes which increase either public or private consumption have a much more dramatic effect on aggregate demand than deficit changes which primarily alter the amount of private saving.

In this regard, even if a capital gains rate reduction were to reduce tax revenue, the consequent effect on aggregate demand in the economy and therefore on credit markets would be quite small. In all probability, the great majority of the proceeds from the sale of capital assets are reinvested in other capital assets. Thus, a reduction in the revenue collected from taxation of the gains involved in this process would be largely reflected in a greater amount of private saving, not consumption. So, any potential revenue loss from a capital gains tax reduction would not have to be offset dollar-for-dollar with reductions in direct government or private consumption in order to leave aggregate demand and interest rates unchanged.

I hope this has been responsive to your question.

Sincerely,

LAWRENCE B. LINDSEY.

## Table 1

| Year | Actual Revenue | Revenue Grows as Fast as Private Financial Wealth | |
|---|---|---|---|
| 85 | 26.5 | Revenue | Change |
| 87 | 32.9 | 30.8 | +2.1 |
| 88 | 39.0 | 33.1 | +5.9 |
| 89 | 35.8 | 37.2 | -1.4 |
| 90 | 27.8 | 37.2 | -9.4 |
| 91 | 24.9 | 42.0 | -17.1 |
| 92 | 29.0 | 44.5 | -15.5 |
| 93 | 32.7 | 47.3 | -14.6 |
| Total | | | -50.0 |

## Table 2

| Year | Actual Revenue | Revenue Grows as Fast as GDP | | Revenue Grows as Fast as S&P Composite | |
|---|---|---|---|---|---|
| 85 | 26.5 | Revenue | Change | Revenue | Change |
| 87 | 32.9 | 29.8 | +3.1 | 40.7 | -7.8 |
| 88 | 39.0 | 32.2 | +6.8 | 37.7 | +1.3 |
| 89 | 35.8 | 34.5 | +1.3 | 45.8 | -10.0 |
| 90 | 27.8 | 36.4 | -8.6 | 47.5 | -19.7 |
| 91 | 24.9 | 37.6 | -12.7 | 53.4 | -28.5 |
| 92 | 29.0 | 39.5 | -10.5 | 59.0 | -30.0 |
| 93 | 32.7 | 41.6 | -8.9 | 64.0 | -31.3 |
| Total | | | -29.5 | | -126.0 |



1904655
Rich* and *Poor*.
The Washington Post, February 20, 1990, FINAL Edition
Section: OP-ED, p. a20
Story Type: Editorial
Line Count: 33 Word Count: 352

WHEN DEMOCRATS said last year that a capital gains tax cut would mainly benefit the rich, President Bush said heatedly that they were wrong and were trying to bring about class warfare. Now a new study suggests the Democrats were righter than they knew.

The standard way of measuring how much people save from a tax cut is by the effect it is likely to have on revenues. In the case of a capital gains cut, however, that method masks the full benefits conferred. While the lower capital gains rate that the president proposes would of course reduce taxes per asset sale, economists think that at the same time it would stimulate more sales, since after-tax profits would be higher. The Treasury would lose from the lower rate but gain from the higher volume. But for sellers of assets there would be no such mixed blessing; they would simply gain, relative to current law, on every transaction.

As a partial measure of what the rate cut would mean to asset holders, the staff of Congress's nonpartisan Joint Committee on Taxation was asked to set aside the expected increase in transactions and estimate simply the taxes that would be saved on the transactions that would normally occur. From now through 1995, the staff said, holders of assets would save $100 billion in taxes. More than 80 percent of that money would go to the richest 3 percent of all taxpayers.

At a time when income inequality is already rising in America, a person needs an awful lot of faith in trickle-down economics to back a step such as this. Nor are the objections limited to distributional grounds. While in the short run the lower rate would increase revenues by stimulating sales, the joint committee staff said, in the long run it would reduce revenues, though not by much; the estimate is $11 billion through 1995.

A fairness case can perhaps be made even in a tight budget era for indexing capital gains prospectively to avoid taxing inflation. But the main goals of tax policy just now should be to restore lost revenue and progressivity. A capital gains cut would go in the opposite direction. The president says the step is necessary to increase savings, but the best way the government can increase savings is not to reduce the taxes of the rich but to reduce the deficit.

DESCRIPTORS: Tax system; Tax laws; U.S. Congress
DIALOG (R) File Washington Post Online

909410
*Envy* Is No *Basis* For Tax policy.
The Washington Post, March 20, 1990, FINAL Edition
By: Lawrence B. Lindsey
Section: EDITORIAL, p. a19
Story Type: OP-ED
Line Count: 69 Word Count: 752

In a recent editorial, The Post reiterated its longstanding ideological opposition to a capital gains tax rate reduction, this time seizing upon a staff report of Congress's Joint Committee on Taxation to bolster its position ("Rich and Poor," Feb. 20). But a careful reading of the JCT report and the editorial reveals that The Post's argument is based not on what is best for the country's economic well being but rather on a narrow version of one of the least admirable human emotions: envy.

The JCT finding upon which The Post rested its case showed that the current capital gains tax rate costs taxpayers nine times as much as the government loses in revenue, compared with the lower rate the president has proposed. The JCT study found that cutting the capital gains tax rate would benefit the nation's taxpayers—and the private sector—by $100 billion between now and 1995, while the loss to the U.S. Treasury would be only $11 billion for the same period.

Most people would think that a tax that makes America's taxpayers $100 billion worse off in order to make the Treasury $11 billion better off would be a bad idea. Amazingly, The Post cites those very statistics as the reason for keeping capital gains rates high. The reason? Much of the $89 billion of net benefit would go to the well-to-do. This argument justifies the impoverishment of the U.S. economy in the name of envy. What other reason can there be for a tax that costs the economy $9 for every $1 it produces in tax revenue?

The political manipulation of envy is one reason why America has seen its competitive position in the world economy gradually erode during much of the postwar period. There may have been a time when America could afford to waste its resources in the name of envy, but that is a luxury we can no longer afford.

While we dither over whether we should compete in the global market of the 1990s with a capital gains tax rate of 28 percent or 20 percent, our most successful international competitors have zero or extremely low capital gains taxes. Japan had a zero capital gains tax rate during most of its postwar boom. Even today a Japanese entrepreneur can expect to have to pay only a one or two percent tax on the capital gain on his business. The four dragons of East Asia—Korea, Taiwan, Hong Kong and Singapore—all have zero capital gains taxes. West Germany has a zero capital gains tax on corporate stock.

The $100 billion of private wealth that opponents of a capital gains cut are willing to squander on appeasing their sense of envy could be better used as capital to create jobs and bolster America's competitiveness. If The Post has its way, that $100 billion will largely be made up by Japanese and other foreigners' purchases of American assets. Do the opponents of a capital gains tax really despise American entrepreneurs and investors so much that they prefer equally well-placed Europeans or Japanese to own American assets?

Actually, the cost of envy is even higher than that portrayed by The most or the JCT. The career civil service staff at the Office of Tax analysis estimates that the president's proposal will produce a revenue gain. If this is the case, we are simultaneously punishing the U.S. government and America's economy to make sure that successful investors are also sufficiently punished for their success.

The reason the president supports capital gains tax rate reductions is neither to reward investors nor punish them. The president wants to lower the cost of capital for American businesses, thereby creating jobs, spurring innovation and fostering economic growth. The Council of Economic Avisers estimates that the president's proposal will increase GNP by $61 billion over the next five years and by $274 billion over the next 10 years. Literally tens of thousands of job opportunities are involved.

Economic growth caused by greater productivity and capital formation is the only permanent source of rising living standards. Growth also means more tax revenue. As Martin Feldstein noted in congressional testimony, it would take only an extra four hundredths of one percent extra growth (0.04 percent) to offset even the JCT's estimate of the revenue loss from the president's proposal

The fact that the creation of wealth must precede its redistribution is inescapable. How foolish it would be to make the country's taxpayers $100 billion worse off in a misplaced and counterproductive fit of envy that will produce at most $11 billion in tax revenue. The losers from the pursuit of envy are not only today's wealthy but everyone who benefits from a strong American economy, both today and in the future.

The writer is a special assistant to the president for policy development.

DESCRIPTORS: Tax laws; U.S. Congress

---

## PREPARED STATEMENT OF JANE G. GRAVELLE

Mr. Chairman and Members of the Committee, I am Jane G. Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss capital gains tax cut proposals. While my discussion deals in general with the issues surrounding capital gains tax proposals, at several points it explicitly addresses the proposals in the House Republican Contract with America.

### SUMMARY

The revenue consequences of cutting the capital gains tax may be larger than those currently estimated. Estimates of the taxes lost from lowering the capital gains tax rate include an offset for additional taxes collected on increased realizations that arise from the lower tax rates. Estimates thus depend on the magnitude of this realizations response, which is in turn based on statistical evidence about the relationship between realizations and tax rates. This current offset is substantial relative to the static revenue cost. New evidence on the size of this realizations response suggests that the magnitude used in current revenue estimates may be too large and that the revenue cost of a fifty percent exclusion, for example, may be twice as large as estimated. In addition, the long run cost of the capital gains tax cuts in the Contract will be larger because of the growth in the cost of indexing. Because indexing only applies to inflation occurring after the revision, the inflation component of gains will grow over time. This effect alone could also more than double the cost relative to an exclusion, and the combination of both effects (a smaller realization response and the eventual effect of indexing) could increase the cost of the exclusion by several times. Note, however, that the revenue cost (currently estimated at around $53 billion in the first five years, with $16 billion due to indexation) is small relative to the total U.S. economy.

There has also been some interest in the revenue-maximizing tax rate—the rate that will yield the largest amount of capital gains revenues. This rate depends on the realizations response. Under current estimating assumptions, that rate approximately the same as the current top rate. The new evidence suggests that the revenue-maximizing tax rate is probably higher, perhaps much higher, than current tax rates. It is unlikely that any capital gains tax cut, however small, would fail to lose revenue.

The effects of a capital gains tax cut on the capital stock, labor supply, and output are likely to be modest, particularly in the short run. Even using estimates from the empirical literature favorable to a larger and positive effect indicate very small increases in economic growth arising from the capital gains tax cut in the Contract. This modest effect arises from the small size of the tax change relative to the economy, the evidence of a limited ability of tax policy to influence private savings behavior, and the slow pace of the capital accumulation process. With less favorable assumptions, the effect on economic growth could be negative. Finally, although there is some interest in the capital gains tax rates in other countries, and those rates are generally lower than in the United States, these differences appear to have little explanatory power with respect to differences in economic performance across countries.

An argument made for cutting the capital gains tax is that lower rates would increase economic efficiency, primarily by reducing tax barriers to sale. Capital gains tax cuts could also affect the allocation of capital in other ways. The efficiency effects of cutting capital gains taxes are mixed, although they seem more likely to result from cuts in capital gains taxes on corporate equities than for real estate. Whether indexation rather than an equivalent rate cut leads to greater economic efficiency is not clear. With regard to equity concerns, capital gains are penalized because of the taxation of inflationary gains, but benefit due to deferral and non-taxation of gains passed on at death. Most direct benefits of a capital gains tax cut will accrue to high income individuals. Finally, with respect to administrative issues, indexation will probably complicate administration and compliance.

## REVENUE CONSEQUENCES

Given our current concern for the size of the budget deficit, an important issue is the potential revenue loss from capital gains tax cuts. For example, the Contract proposal, which would allow a fifty percent exclusion for capital gains and allow for indexing for inflation occurring after 1994, is currently estimated to reduce revenues by around $54 billion by the Joint Committee on Taxation (JCT) and by $61 billion by the Treasury Department over the next five years.[1] If tax cuts increase the budget deficit and are not otherwise paid for, the effect will be to reduce the nation's savings. The consequences for the budget deficit may be markedly different from those indicated by the current five year revenue estimates.

There are two reasons to believe that this cost may be larger than suggested by current revenue estimates. First, the revenue cost of the capital gains tax cut is dependent on the size of the realizations response which may be currently overestimated, thereby underestimating the cost of the capital gains cut. Second, the revenue loss associated with the proposal will likely be much larger beyond the 5-year budget window, in part because of the rapid growth of the loss due to indexation, which will cover an increasing fraction of sales.

There has been considerable disagreement over the past few years over the revenue consequences of a capital gains tax cut. Both the Administration and the Joint Committee on Taxation include in their revenue estimates certain behavioral responses. The most important of these responses, by far, is the expectation that individuals will respond to lower capital gains taxes by increasing realizations of capital gains. These increased realizations of capital gains will then produce additional taxable gains and additional revenue which will offset the static revenue loss. (The static revenue loss is the loss arising from the lower tax rate assuming there is no behavioral change.) This projected increase in realizations will be substantial and will lower the static estimate in the 5-year budget window for the fifty percent exclusion by more than sixty percent.

There has been a substantial body of empirical research on the realizations response, which has yielded a wide range of estimates. In particular, studies that estimated the relationships between realizations and tax rates across different taxpayers (micro-data studies) often yielded extremely large responses. These studies were criticized as being severely flawed, in part because the estimates they yielded may have been reflecting responses to temporary rather than permanent tax rates. For that reason, the Joint Committee on Taxation chose to rely on time series evidence (evidence on realizations in the economy as a whole over different time periods), although time series evidence also is subject to a number of serious problems. This empirical research is, for a variety of reasons, very difficult to perform, and all of the studies have been subject to a variety of criticisms. In 1990, there was an extensive public debate about the magnitude of these empirical estimates and

[1] Over ten years, the cost is estimated at $170 billion by the Joint Committee on Taxation and at $183 billion by the Treasury Department.

the merits of the alternative research methodologies employed—an issue which was not resolved at that time.[2]

In recent years, new evidence has been presented that suggests that this realizations response may be smaller than that assumed in the past, especially after the first few years. Because of the wide variation in estimates based on statistical analysis, I prepared an alternative method of assessing the likely size of the realizations response.[3] This analysis is based on a relatively simple observation—in the long run, realizations cannot exceed accruals. That is, realizations would equal accruals over a long period of time (year after year) only if individuals sold all assets after holding them less than a year. Indeed, one would never expect that all gains would be constantly realized, even in the absence of taxes and other transaction costs. The observation of historical ratios of realizations to accruals can be used to measure the upper limit of the realizations response and to suggest a likely size of that response. This analysis suggested a lower, perhaps much lower, permanent realizations response than that measured in most statistical studies. Basically, this type of approach provides a "reality check" on statistical estimates.

This analysis suggested that the very large realizations responses found in most microdata studies lead to implausible estimates of changes in realizations responses—results that are far outside the bounds of historical experiences and far in excess of accrued gains for tax revisions such as those in the Contract.

Most critics believed that a major problem with these studies was that they could not control for timing effects. It is advantageous for individuals whose tax rates fluctuate from one year to the next to realize gains in years when tax rates are low. Thus, the relationships found between low tax rates and high realizations could be reflecting in part, or perhaps primarily, responses to temporary changes in tax rates—responses that would not hold up for a permanent tax rate change. Indeed, the surge in realizations in 1986 when tax rates were scheduled to go up the next year is evidence of the power of this timing effect.

A recent statistical study which used a new approach—variation in tax rates across States—to control for transitory effects that had long plagued microdata statistical studies also found much smaller realizations responses.[4] These results were consistent with the effects that were suggested by the study of the historical measures of realizations and accruals.

If the findings in these recent studies are correct, the revenue estimates for the fifty percent exclusion could be more than twice as large as they would be based on current revenue estimating assumptions.[5]

Secondly, the indexing feature of the capital gains tax cut proposal is a provision that costs much less in the five year budget horizon because it applies only to inflation after 1994. The loss from indexing grows rapidly, however.

On a static basis, this provision might eventually increase the revenue cost associated with the exclusion alone by about fifty percent after it takes full effect. Because of the realizations response, however, adding this provision on top of an exclusion would more than double the revenue loss because it would apply to a much expanded base.[6]

The ten year estimates indicate some of this growth: the Joint Committee on Taxation estimates a $170 billion revenue loss over ten years, while the Treasury estimates a $183 billion loss. The second five year estimates are twice the size of the first five years. Although some of this increase is due to nominal growth in the base-

---

[2] These issues were discussed in a variety of different articles at that time. See, for example, Gerald E. Auten, Leonard E. Burman and William C. Randolph, Estimation and Interpretation of Capital Gains Realizations Behavior, National Tax Journal, September 1989, pp. 353–374; Can a Capital Gains Tax Pay for Itself? by Jane G. Gravelle, Congressional Research Service Report 90–161, March 23, 1990; Gerald E. Auten and Joseph Cordes, Cutting Capital Gains Taxes, Journal of Economic Perspectives, Winter, 1991, pp. 181–192;

[3] See Limits to Capital Gains Feedback Effects, by Jane G. Gravelle, Congressional Research Service Report 91–250, March 15, 1991.

[4] Burman, Leonard E. and William C. Randolph, Measuring the Permanent Responses to Capital Gains Tax Cuts in Panel Data, American Economic Review, September, 1994, pp. 794–809. More recent surveys of the literature cover this more recent research; see George R. Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, In Tax Law Review, Vol. 48, No. 3, 1993, pp. 419–527; Jane G. Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, MIT Press, 1994, p. 143–151.

[5] This calculation assumed a coefficient of 3.5 for prior revenue estimating assumptions and a coefficient of 1 for a revised estimate, using a semi-log estimating function and assuming the reduction in tax rates is 45 percent in the case of the coefficient of 1 and slightly less in the case of the higher coefficient. (If realizations increase a lot, they drive individuals into higher tax brackets, which causes the revenue loss to be even smaller).

[6] This estimate assumes that inflation indexing is roughly equivalent to another fifty percent exclusion.

line, this discrepancy represents a real growth that is associated with indexation. The cost associated with indexation is 29 percent of the total in the first five years, but 43 percent of the total in the second five years.[7]

Both of these effects taken together—a smaller realizations response than that used in the past and the transition to full indexing—could lead to losses several times larger than the cost of the exclusion alone with the current realizations response. It is difficult to be precise about these magnitudes, which are best explored using a micro-simulation technique, but they are large.

If the cost is much larger than budget projections, either the revision will decrease national savings through a higher budget deficit or require larger offsetting changes elsewhere to maintain budget deficit neutrality. Note, however, that although these revenue losses may be significant with respect to the size of the deficit, they are small with respect to national output.

There has been some discussion of the revenue-maximizing tax rate. This tax rate depends, of course, on the empirical question of the realizations response. For the current functional form of response used in revenue estimating (the semi-log form), the revenue estimating tax rate is the inverse of the coefficient in that formula. The coefficient used for current estimating is 3.5, implying a revenue maximizing tax rate of 28.5 percent (1/3.5). This rate is, of course, above rates in current law. If the realizations response is smaller, as suggested by the recent research I discussed, the tax rate would be larger, perhaps much. This research would almost certainly suggest a rate above 50 percent.

SAVINGS AND ECONOMIC GROWTH

It may be surprising to some to learn that we cannot be sure whether cutting taxes on capital income will increase savings. Economists have long recognized that the response of saving to the rate of return is uncertain due to the opposing forces of "income" and "substitution" effects. When the rate of return rises, a substitution effect might cause an individual to prefer more consumption in the future (because the price of future consumption has fallen in terms of foregone present consumption) and increase savings. At the same time, there is an income effect—the higher rate of return can allow savings to be smaller and still increase consumption in the future (and in the present as well). For example, if an individual were saving a certain amount for retirement, he could obtain that objective with a smaller amount of savings when the rate of return goes up.

Because of this theoretical ambiguity, it is necessary to turn to empirical research to determine whether private savings will increase, and empirical evidence would be necessary in any case to determine the magnitude of any effect. While it is very difficult to perform this analysis, this body of research suggests that effects of higher rates of return on savings have small positive effects on savings behavior and, in some studies, negative effects.[8] That is, it is possible that cutting capital gains taxes will reduce savings.

The process of altering the capital stock through a change in the savings rate is a very slow one that takes many years. Even with a large percentage increase in savings, the effect on the capital stock and on economic output will be modest because savings is very small relative to the capital stock.

Finally, it is likely that the effect of the proposed capital gains tax cuts on economic output and growth will be modest, even with a large response, because the tax change itself is not that large relative to the economy. Based on data from 1992, the fifty percent exclusion has the effect of reducing the cost of capital by 9 basis points and the combination of the exclusion and indexation reduces the cost by about 16 basis points. Measures based on this year are probably somewhat understated because realizations have been depressed due to the recession and low real estate values.

To illustrate these points, I present results of a simulation model that traces, over time, the response to a capital gains tax cut of a general magnitude similar to that proposed in the Contract (equivalent to a two percentage point reduction in the capital income tax rate, or a reduction in the cost of capital of 18 basis points), using

[7] The growth over time can also be seen by looking at year to year changes. For example, the sum of the indexing estimate and the interaction term in the Joint Committee on Taxation's estimates (which also results from indexing) rises from $1.4 billion in 1996 to $5.2 billion in 2000 and to $13.4 billion in 2005. Even assuming a fairly high nominal growth rate in the baseline of 8 percent, nominal growth alone would only double the estimate between 1996 and 2005, indicating a constant-income increase of about 5 times. Moreover, by the year 2005, the addition of indexing has come close to doubling the revenue cost.

[8] For a summary of this literature, see Jane G. Gravelle, The Economic Effects of Taxing Capital Income, Cambridge, Mass., MIT Press, 1994, p. 27.

assumptions favorable to a larger positive effect of the tax. A savings response at the upper end of the estimates in the empirical literature is chosen. This response is in the form of a savings elasticity (the percentage change in the savings rate divided by the percentage change in the rate of return), and is set at 0.4. Such a measure implies that a ten percent increase in the rate of return will lead to a four percent increase in the savings rate. The details of the model and the data used are shown in the appendix.

Several aspects of this simulation are chosen to be favorable to a large effect, including not only a larger, and positive, savings elasticity, but also an assumption that any revenue losses are recouped through some mechanism that does not otherwise alter the economy's economic behavior. (Details of data used are presented in the appendix).

The percentage changes in the capital stock, labor supply, and output level are shown in Table 1. This table indicates that, even after five years, the capital stock has increased by less than 2/10 of a percent, the labor supply by 1/100 of a percent, and the output level by 1/20 of a percent. Even after 110 years, output has increased by only one half of one percent. (Eventually, the process reaches a final equilibrium, which results in a 2.25 percent increase in the capital stock, a .07 percent increase in the labor supply, and a 0.62 percent increase in output).[9]

It is relatively straightforward to see why these effects are so small in the short run. Consider the first period after the rate of return rises. Suppose it rises by about 4 percent. That implies an increase in the savings rate of 1.6 percent (4% times the elasticity of 0.4). But savings is about two percent of the capital stock, which implies that the capital stock will increase by only 3/100 of a percent. Finally, given that capital contributes only twenty-five percent of output, the effect on output is less than 1/100 of a percent. After five years, therefore, the effect on output would be about five times as large, or about 1/20 of a percent. Thus, although the estimates are calculated in a more complex general equilibrium model (that allows for labor supply response and feedback effects on wages and rates of return), these results, at least in the first few years, could be approximated with a "back-of-the-envelope" calculation.

TABLE 1.—PERCENTAGE CHANGE IN CAPITAL STOCK, LABOR SUPPLY AND OUTPUT FROM A CAPITAL GAINS TAX CUT

| Year Into Future | Capital Stock | Labor Supply | Output |
|---|---|---|---|
| 5 years | 0.17 | 0.01 | 0.05 |
| 10 years | 0.37 | 0.01 | 0.10 |
| 20 years | 0.71 | 0.03 | 0 20 |
| 50 years | 1.41 | 0.05 | 0.39 |
| 80 years | 1.79 | 0.06 | 0.49 |
| 110 years | 1.94 | 0.07 | 0.54 |

Source: Author's Calculations (see Appendix) The capital gains tax cut is roughly the same magnitude as the cuts in the House Republican Contract with America. Estimates are based on empirical estimates from the literature on savings most favorable to a large effect.

Note that these small effects also indicate that the possibilities of recovering much of the revenue loss through economic growth are extremely limited in the short run. For example, in the first five years, increased taxes on induced income would recoup only one percent of the original revenue loss.[10]

It is important to note that models that have found very large effects on the capital stock of tax cuts, including the capital gains tax cut, use the assumption of an infinitely elastic savings response and a rapid adjustment period. This is an assumption, not evidence from the economics literature.[11]

Under less favorable assumptions (e.g., effects on the budget deficit are not offset and/or the relationship between savings and the rate is return is negative), the capital gains tax cut could contract the economy and slow economic growth by reducing national savings.

[9] In the long run, our concern is about changes in standard of living, that is, available consumption in the steady state. Since the savings rate must be higher to maintain the normal growth of the higher capital stock, the percentage increase in consumption is slightly smaller, at 0.49 percent.

[10] This issue of feedback effects on tax revenues is discussed in more detail in Dynamic Revenue Estimating, by Jane G. Gravelle, Congressional Research Service Report 94–1000 S, December 14, 1994.

[11] Note also that one argument used to justify a large savings response, international capital inflows, is not germane to this issue, since the capital gains tax applies to residents regardless of the location of capital and does not apply to foreign investors.

Finally, attention has often been directed to the differences in capital gains tax rates that apply to different countries. Table 2 summarizes the individual capital gains tax rates in the United States and four other countries. In most cases, gains in other countries are taxed below the rates in the United States, although gains ide of securities are taxed at higher rates in Japan.

This information does not reveal very much about the causes of countries' different economic performances, however. First, the capital gains tax is a relatively small part of the capital income tax structures even in the United States; many other taxes apply and a full comparison of tax systems across countries would require some complex calculations. Secondly, the evidence does not support the notion that capital gains taxes are likely to influence growth rates. Recall that the simulation above suggests that the large percentage reductions in capital gains tax rates (over two-thirds) would increase output by only about 1/100 of one percent a year in the initial years (and less in later years). Thus, our ability to identify any links between capital gains taxes and growth rates would be severely constrained even if such a link existed, simply because it would be too small.

TABLE 2.—COMPARISON OF INDIVIDUAL CAPITAL GAINS TAXES ACROSS DIFFERENT COUNTRIES

| | |
|---|---|
| United States | Capital gains are taxed as ordinary income, but with a 28 percent cap. The maximum tax rate is therefore 28 percent. |
| Canada | Capital gains are subject to a 25 percent exclusion, resulting in a top rate of 22 percent. |
| Japan | Capital gains tax rates vary by asset type. There is an exclusion of 500,000 yen (approximately $5000) per year. |
| | (1) Gains on securities are subject to a tax rate of 20 percent; alternatively a tax of one percent on the entire transaction value may be elected. |
| | (2) Buildings and land held less than ten years are subject to the larger of 40 percent of gain or 110 percent of ordinary tax rate, thus leading to a top rate of 55 percent. |
| | (3) Buildings and land held more than ten years are subject to a 30 percent rate. |
| | (4) Gains from other assets are taxed at ordinary rates (which go up to 50 percent) if held less than five years and eligible for a 50 percent exclusion if held for longer than five years. |
| Germany | No capital gains tax. |
| United Kingdom | Taxable gains pay a separate tax at the taxpayer's highest marginal tax rate. Rates go up to 40 percent. Gains are indexed for inflation. |

Source. Information on capital gains taxes is taken from a series of Congressional Research Service Fact Sheets on Capital Gains And Securities Transactions Taxation, by Gregg A. Esenwein and Philip D. Winters: Report 94-832 (Canada), October 28, 1994; Report 94-891 (Japan), November 17, 1994; Report 94-920 (United Kingdom), November 25, 1994; Report 95-51 (Germany), December 28, 1994.

## OTHER ISSUES ASSOCIATED WITH CAPITAL GAINS TAXES

### *Efficiency*

An argument for reducing the capital gains tax made by some economists is based on the distortions that the tax produces, primarily the barriers it imposes to sale (the lock-in effect). The capital gains tax may also contribute to distortions that disfavor corporate equity investments, and reduce the distortions taxes introduce into savings decisions. How significant these distortions are found to be depends, of course, on the magnitude of empirical measures of realizations responses, investment allocation and portfolio responses, and savings responses. The distortion arising from lock-in could be significant as a fraction of revenue. At the same time, the proposed tax reductions could magnify other distortions, such as the choice of dividend payout ratio and distortions of other taxes if they are used to replace the revenue. Notably, the reduction extends to noncorporate investments (primarily sale of real estate) as well. The lock-in effect is also likely to less serious for real estate because any capital gains tax on the sale is offset by the ability to restart depreciation based on the normally higher nominal value.

Some economists also are concerned about the possibility of low capital gains tax rates playing a role in tax sheltering and avoidance activities. Unfortunately, the role of lower capital gains taxes in increasing or decreasing economic efficiency remains unclear. The case for efficiency gains is probably best made for corporate equity (stocks), but gains on these assets constitute only a fraction of gains (ranging from about 20 percent to 50 percent, depending on the relative performance of the stock market). Much of the remainder is gain on real estate.

Inflation indexing is probably less likely to reduce the lock-in effect than an exclusion of the same average value. The lock-in effect is most serious for assets that have been held a substantial period of time, but these assets will receive a smaller exclusion from indexing than short lived assets. For example, if a corporate stock is appreciating at a three percent annual rate and there is a three percent inflation, indexing for an asset held one year will result in an exclusion of 49 percent of gain, while indexing for an asset held 20 years will result in an exclusion of 36 percent of the gain.[12]

Arguments are also sometimes made that the capital gains tax has an important influence on risk-taking, entrepreneurship, and the availability of venture capital, and hence productivity growth. While such a relationship may exist, there is little empirical evidence of a link between the capital gains tax rate and productivity growth. Also, much of formal venture capital offerings is not subject to capital gains taxation,[13] and the vast majority of capital gains accrue on real estate or sales of stock of long established corporations. As you know, a current tax benefit already exists for gains on new stock issues of small business corporations.

Finally, there is no correct way to provide for an inflation adjustment for capital gain on the sale of depreciable property if tax depreciation is not reflective of economic depreciation.

*Equity Issues*

An important argument for indexing capital gains is that gains include those arising solely from general price changes in the economy. These gains do not constitute real income and it may well be argued that it is unfair to tax them. At the same time, capital gains income benefits from other aspects of the tax law, including the ability to defer taxation of income and the ability of avoid taxation entirely on assets held until death. Higher income individuals also benefit from the current 28 percent cap. In addition, the taxpayer has the advantage of control over the realization of gain, so that he can choose to realize offsetting losses.

Whether, on average, these benefits outweigh the penalties imposed by taxing inflationary gains depends on average holding periods and inflation rates. Currently, it is likely that the average effective tax rate on capital gains is lower than the statutory rate for corporate stock where such effective tax rates can be calculated. This effect varies across individuals and assets, depending on the holding period and the real appreciation rate. The combination of the fifty percent exclusion and inflation indexing will lead to effective tax rates well below the statutory rate.

Vertical distribution effects of the capital gains tax cut may also be of interest to the Committee. A capital gains tax cut will primarily benefit higher income individuals. When a thirty percent tax cut was proposed in 1990, the Treasury department estimated that 64 percent of the direct benefit would have gone to those with incomes over $200,000, a group constituting about one percent of the population.[14] About 74 percent would have gone to the top five percent earning over $100,000.

*Simplicity and Tax Administration*

While, the addition of more tax preferences for capital gains is likely to induce greater efforts to covert ordinary income into capital gains, there is no inherent complication in actually computing capital gains with an exclusion. The proposal from prospective inflation indexing would, however, be more complicated. Unlike an exclusion, an inflation adjustment requires a separate adjustment for each vintage of assets.

---

[12] The value of an asset costing one dollar held for one year is 1.03 times 1.03 and the gain without indexing would be that amount, minus 1, or .0609. If the asset is indexed, the gains will be 1.0609 minus 1.03 (the latter number the basis increased by inflation), or .0309. The gain is reduced by 49 percent. For the asset held for twenty years, the gain is 1.0320 times 1.0320, minus 1; the gain with indexing subtracts 1.0320 and the result is an exclusion of 36 percent.

[13] See James Poterba, Venture Capital and Capital Gains Taxation, in Tax Policy and the Economy, vol. 3, ed. Lawrence Summers, National Bureau of Economic Research, MIT Press, Cambridge, 1989.

[14] Classification was based on five year averages in order to mitigate the problem that individuals would appear in the higher group because of realization of a large gain in one year.

This appendix explains the general equilibrium model that shows the response of the economy to tax changes and the estimates used.

The Model

To simplify, the model is a one-good model. It includes a production function, a labor supply function, a savings rate determinant, and a relationship showing the process of capital accumulation. It is set up to calculate values over time in year one output levels, to simplify calculation of percentage changes. Thus, it measures changes from the normal growth path.

The production function is a Constant Elasticity of Substitution (CES) function:

$$(1)\ Q_t = A\,[aK_t^{(1-1/S)} + (1-a)L_t^{(1-1/S)}]^{(1/(1-1/S))}$$

where $Q_t$ is output at time t, $K_t$ is the capital stock at time t, and $L_t$ is labor at time t. S is the factor substitution elasticity in absolute value (the percentage change in the capital/labor ratio divided by the percentage change in the relative prices of capital and labor). A and a are constants.

The second equation in the model is the labor supply function:

$$(2)\ L_t = b\,[W_t(1-T_L)/P_t]^{E_L}$$

where $W_t$ is the wage rate at time t, $T_L$ is the tax rate on labor income, $P_t$ is the price at time t, $E_L$ is the labor supply elasticity (the percentage change in the labor supply divided by the percentage change in the after tax wage rate), and b is a constant.

There is also a savings rate relationship:

where $a_t$ is the savings rate at time t, c is a constant, $R_t$ is the rate of return at time t, and $E_R$ is the savings elasticity (the percentage change in savings given a percentage change in the real after tax rate of return)

Finally, there is an equation describing the capital accumulation process:

(4) $K_{(t+1)} - K_t = [a_tQ_t(1\text{-}T) - nK_t)]/(1\text{-}n)$

where T is the overall tax rate on income, and n is the steady state growth rate of the economy.

This model now contains eight unknowns: output, capital in two periods, labor, wage rate, rate of return, price, and savings rate.

To complete the model, the profits are maximized; the production function is differentiated to obtain two first order conditions, which can be expressed as:

(5) $K_t/L_t = [(a/(1\text{-}a))(W_t/R_t)]^S$

(6) $K_t/Q_t = [aP_t/R_t)]^S A^{(S-1)}$

The price level is set at 1:

(7) $P_t = 1$

Finally, in each period, the current capital stock, $K_t$, is held constant; once a solution is obtained for all other variables, the new capital stock is found and is then fixed for the next period.

To solve the model, substitute (5), (6) and (7) into (1) to obtain:

$$(8)\quad (1\text{-}a)^{S} W_t^{(1\text{-}S)} + a^{S} R_t^{(1\text{-}S)} = 1$$

Since the price is fixed and only one capital stock is solved for in each round, the model now contains six equations [(2)- (6) and (8)] and six unknowns.

Data Used in the Model

The model is calibrated to reflect measures of the U.S. economy. To calibrate the model, set Q and W equal to 1, labor supply equal to the capital share of income, 0.75. Set the capital stock at 3.5, and set the pretax rate of return at 3.5 divided by capital's share of income, 0.25. Set the saving rate out of after tax income at 0.10, consistent with recent experience, which will yield a growth rate n for any given average tax rate. Tax rates in the model are set to reflect Federal, State and local taxes, (income, property, sales, payroll, excise) and they have different marginal and average rates. The average and marginal tax rates on labor are 0.265 and 0.32; the average and marginal tax rates on capital are 0.382 and 0.491. The marginal tax rates are used in the savings rate and labor supply equations, and the average rates in the capital accumulation equation.

The savings elasticity is set at 0.4, one of the higher values in the literature and one reported by Michael Boskin in his 1978 study ("Taxation, Savings and the Rate of Interest, Journal of Political Economy, vol. 86, January, pp. S3–S27); the labor supply elasticity is set at 0.015 and the factor substitution elasticity is set at one. See Jane G. Gravelle, Dynamic Revenues Estimating, Congressional Research Service Report 94–1000, December 14, 1994, pp. 15–17, pp. 25–28 for further discussion of the derivation of these elasticities.

To calculate the general magnitude of the tax change in the Republican Contract, the change in capital gains taxes from the fifty percent exclusion (the rate falls from 25.1 percent to 15.6 percent) is multiplied by capital gains realizations for 1992 ($127 billion) and in turn divided by capital's share of NNP for that same share (capital share set at 0.25). These calculations indicated that the 50 percent exclusion was the equivalent of a one percentage point change in the capital income tax rate. The indexation provision was assumed to further reduce the effective tax rate by one half; the combination of the 50 percent exclusion and the indexation provision is the equivalent of a 1.6 percent point change in the tax rate. These amounts are the equivalent of a reduction of 9 and 16 basis points respectively, and of a 1.3 percent and 2.4 percent reduction in the cost of capital (net of depreciation) under the assumption of a fixed after-tax rate of return. It seems likely that these effects are somewhat understated, since capital gains realizations were probably still low in 1992 due to the recession and lower real estate values. (Capital gains is, however, a very volatile series that is difficult to predict).

The percentage change in the cost of capital gross of depreciation would be smaller, since, overall, depreciation is about half the size of the return to capital.

An alternative way of measuring this cost of capital change was to calculate its effects on the cost of capital formula for corporate investment. This technique is discussed in the Congressional Research Service Report 90–161, "Can a Capital Gains Tax Pay for Itself?" by Jane G. Gravelle, March 23, 1990. This estimate was modified, based on the realizations to accruals data, by reducing the fraction of capital gains never taxed to 43 percent, by reducing the inflation rate to 3 percent, and by directly calculating the effective real tax rate for a 7 year holding period; otherwise it relies on similar data. This calculation produced a cost of capital (net of depreciation) of 1.2 percent for the fifty percent exclusion and 2.0 percent for the combined effects. These effects are in a similar in general magnitude, although corporate investment probably accounts for somewhat more of the capital stock in the economy than it does of capital gains. Again, these estimates suggest that the calculations of effective tax rate reduction derived from the simple dollar calculation might be somewhat low, but of the same general magnitude. Thus, a reduction in the tax rate of two percentage points was chosen to use in the simulations.

---

## PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

Good morning, Mr. Chairman, and thank you for holding this important hearing today. We are here to discuss the benefits and problems of reducing the current tax on capital gains. This issue is central to our nation's long-term economic growth and prosperity because it affects the very basis of investment and employment in America.

Lowering the capital gains tax rate would offer several important benefits to our economy. First, it would create new jobs. Many respected economists believe that a reduction in capital gains taxes will result in many taxpayers "cashing in" their unrealized capital gains. The resulting "unlocking effect" would free up billions of dollars of new capital, raise stock and real estate values, increase the gross domestic product, and lower the cost of capital. This would lead to increased economic activity and the creation of new jobs.

Second, lowering the capital gains tax rate would remove some of the bias that our current tax system has against saving and toward consumption. As we have heard in hearings in this Committee over the past few weeks, Mr. Chairman, our nation's savings rate is at a dangerously low level. As a nation, and as individuals, we are simply not putting away enough of our current income to secure a prosperous future. One of the reasons for this is that our tax code taxes savers twice and spenders only once. Money saved or invested is taxed when it is earned, and then taxed again when the fruits of the investment are received in the form of interest, dividends, or capital gains. Money spent is only taxed once. Reducing this bias should increase our saving rate.

Third, lowering the tax on capital gains would make us more competitive with our trading partners. In today's increasingly globalized economy, the flow of capital has few boundaries. No longer can we afford to ignore the impact of our tax laws on investors worldwide. The fact is that many of our international competitors tax capital gains to a much lesser degree than we do, if they tax them at all. This puts the U.S. at disadvantage in attracting the capital needed to expand businesses and create new industries.

Finally, there is the issue of fairness. A high percentage of capital gains income reflects gains caused by inflation, not true economic income. It is simply wrong to tax gains caused by inflation.

Mr. Chairman, over the years we have seen a number of different proposals designed to cut the capital gains tax. No one approach is perfect. And, while the capital gains issue has been somewhat partisan, I believe that most members on this committee recognize the importance of having a preferential rate of taxation for at least some capital gains. Where we differ is on how far we should go in creating such a preferential rate.

I have introduced two bills to address this problem this year. These bills represent different paths to the same destination—job creation, long-term economic prosperity, and tax fairness. With your permission, Mr. Chairman, I would like to briefly describe these two proposals.

S. 182, the Capital Formation and Job Creation Act of 1995, is identical to the capital gains bill introduced in the House by Chairman Bill Archer and included in the "Contract With America." The bill would allow all taxpayers a 50 percent deduction of net capital gains. This would create a maximum tax rate on capital gains of 19.8 percent for individuals and 17.5 percent for corporations. For millions of taxpayers, the rates would be much lower. Additionally, the bill would provide for an adjustment for capital assets to reduce the taxation of gains caused by inflation. Finally, the bill would allow losses from the sale of a personal residence to be treated as a deductible capital loss, rather than the present law treatment as a nondeductible personal loss.

Mr. Chairman, enactment of S. 182 would bring a significant amount of the job creation and economic growth benefits I discussed earlier. A study by Dr. Allen Sinai, chief global economist at Lehman Brothers, shows that a 50 percent capital gains exclusion, combined with prospective indexing would, by the year 1999, increase real GDP by 2.3 percent. Such growth would be accompanied by millions of new jobs. Let me emphasize that growth would *increase by* 2.3 percent not *be* 2.3 percent—which is about where we are projected to be for the next few years.

The other bill that I introduced is S. 181. It is called the Small Investors Tax Relief Act of 1995, or SITRA. This bill takes a different approach to reducing the high taxes we place on saving and investing and is specifically targeted to America's small investors. The bill has three simple provisions. First, it would exclude from taxation the first $10,000 of capital gains income for each individual every year. This would be doubled to $20,000 on a joint return. Second, SITRA would exclude from taxation the first $1,000 of interest and dividend income for each individual every year. This would also be doubled to $2,000 for a joint return and these thresholds would be indexed for inflation. Finally, the bill would index the bases of all capital assets, for individuals and corporations, to eventually eliminate the taxation of inflationary gains.

Enacting SITRA would go a long way toward solving our saving crisis, in my view. It would encourage all taxpayers to save more, to invest in or start a small business, or buy some real estate. It would also deliver significant tax relief to the middle and lower income families of America. But, it would deliver this family tax relief in a way that would also increase our long-term competitiveness and economic growth.

These two bills represent different approaches to solving the problems of a capital gains tax that is too high, and I hope that both approaches will be explored by the committee during this evaluative process.

Mr. Chairman, as a leading advocate of the Balanced Budget Amendment, I share your concerns that any tax changes we enact this year must be paid for. Both of these bills have been or will be scored by the staff of the Joint Committee on Taxation as losing considerable revenue to the Treasury over a five year or ten year window. Appropriate offsets would have to be found by the Senate in order for us to responsibly cut the tax on capital gains. Let me just point out, however, that there is a significant body of scholarly research that indicates that a lower capital gains rate would actually result in more revenue to the Treasury when the unlocking effect of the lower rate on unrealized gains and the macroeconomic impact of the change are taken into account. While I do not want to turn this hearing into a debate on dynamic revenue estimation, I simply will note that there is significant evidence to show that lowering the capital gains rate, by unlocking huge amounts of capital and stimulating new economic activity, could actually offset all or some of its own revenue losses.

I thank the Chair and look forward to the testimonies of our witnesses.

---

## PREPARED STATEMENT OF RONALD A. PEARLMAN

Mr. Chairman and Members of the Committee: My name is Ronald A. Pearlman. I am a partner in the Washington, D.C. law firm of Covington & Burling, where I specialize in federal tax matters. I have been engaged in the private practice of tax law for over 20 years. In addition, I have 10 years of tax experience with the federal government, beginning in the mid-1960's with the Office of the Chief Counsel of the Internal Revenue Service; during the mid-1980's, as Assistant Secretary of the Treasury for Tax Policy; and during the period 1988-1990, as Chief of Staff of the Joint Committee on Taxation.

It is an honor to return to the Finance Committee witness table and be afforded the opportunity to appear before so many Members of the Committee with whom I have had the pleasure to work during my days at the Treasury and the Joint Committee.

I understand my role today to be a limited one. I do not appear as an advocate for, or as an opponent of, a decrease in the capital gains rate.[1] Rather, my purpose is to provide some background information that may be of assistance to the Committee as it considers possible changes in the current tax treatment of capital gains. My comments will focus on structural issues involving the capital gains rate; I will not comment on proposals to index the basis of capital assets, nor will I comment on the budgetary or distributional effects of any rate change. The views I express are my own; they do not necessarily represent the views of Covington & Burling or of any of the firms's clients.

### A BRIEF HISTORY OF THE CAPITAL GAINS RATE

Individuals—The current Internal Revenue Code and its predecessors have provided some form of preferential tax treatment for capital gains since 1922. The original preference was in the form of an alternative capital gains tax rate of 12.5 percent at a time when the maximum ordinary income rate was 65 percent (Revenue Act of 1921, § 206). During the ensuing 73-year period, the tax law has included some form of capital gains preference with the exception of the three-year period (1988-1990) following the phase-in of the Tax Reform Act of 1986.[2] This is not to

---

[1] During my discussion, I will refer to the capital gains rate as a preference and to the preferential rate. These references are not intended to be pejorative but, rather, a shorthand method of referring to a rate of tax on capital assets that is lower than the maximum ordinary income tax rate of general applicability.

[2] The 1986 Act did include a maximum capital gains tax rate of 28 percent. However, from January 1, 1987 through December 31, 1990, this provision had no effect because the maximum tax rate on ordinary income also was 28 percent. With the increase in the ordinary income rate to 31 percent in 1991, the 28 percent capital gains maximum rate became a preferential rate and remains so today.

mean that the law was settled during this 73-year period. To the contrary, the capital gains rate or holding period was changed on at least 10 separate occasions.

In addition to the Revenue Act of 1921, the most significant capital gains changes were enacted as part of the following legislation:

- The Revenue Act of 1934, which, for the first time, introduced a capital gains exclusion. Actually, there was a series of exclusions, based on staggered holding periods. See Revenue Act of 1934, § 117.
- The Revenue Act of 1942, which returned to a single (6-month) holding period and established a 50-percent maximum capital gains rate (Revenue Act of 1942, § 150(a)(1)).
- The Revenue Act of 1978, which increased the capital gains exclusion from 50 percent to 60 percent and made certain ameliorative changes to the minimum tax and other provisions that, in combination with the increase in the exclusion, reduced the maximum marginal rate on capital gains from 49 percent to 28 percent. See Report to Congress on the Capital Gains Tax Reductions of 1978, p. i (Treasury Dept., 1985).
- The Economic Recovery Tax Act of 1981, which reduced the maximum ordinary income rate to 50 percent and also reduced the maximum capital gains rate to 20 percent (by reason of the 60-percent capital gains exclusion enacted in 1978).
- The Tax Reform Act of 1986, which effectively repealed the capital gains preference, albeit temporarily. The 1986 Act also substantially reduced the maximum marginal ordinary income tax rate to 28 percent.

There are several other historical notes regarding the individual capital gains tax that may be of interest.

- In 1963, President Kennedy proposed lowering the maximum rate on capital gains to 19.5 percent by means of a 70 percent exclusion. (At the same time he also called for extending the holding period to one year and taxing unrealized gains at death or at the time of gift.) See Tax Reduction and Reform—Message from the President of the United States, 109 Cong. Rec. 962, 969 (1963). None of President Kennedy's proposals were immediately adopted, although his recommendation for a one-year holding period subsequently was enacted as part of the Tax Reform Act of 1976, discussed infra.
- In 1985, as part of his comprehensive tax reform recommendations, President Reagan proposed reducing the maximum marginal rate on capital gains to 17.5 percent. He also proposed an elective capital gains indexing system and a 35 percent maximum ordinary income rate. See The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, pp. 1, 168-69 (1985). None of the Reagan proposals were included in the 1986 Act, although the Act did reduce the maximum individual ordinary income rate to 28 percent.
- In 1989, President Bush proposed a 45 percent exclusion that, if enacted, would have resulted in a 14.9 percent maximum capital gains rate.[3] In 1990, he proposed a series of capital gains exclusions based on staggered holding periods, which when fully phased in, would have ranged from 10 percent to 30 percent, depending on whether an asset was held at least one, two or three years. See General Explanations of the President's Budget Proposals Affecting Receipts, p. 6 (Treasury Dept., January 1990) (hereafter cited as the "Bush 1990 Proposals"). Neither the 1989 nor 1990 Bush proposal was adopted.

*Corporations*—The history of the corporate capital gains rate has taken a different path. A capital gains preference was first made available to corporate taxpayers by the Revenue Act of 1942, when a 25 percent maximum rate was enacted (Revenue Act of 1942, § 150(c)(1)).[4] This rate was increased to 26 percent for a short time in the early 1950's,[5] and to 30 percent in 1969 (Tax Reform Act of 1969, §511(b)). It was reduced to 28 percent in 1978 (Revenue Act of 1978, §403(a)). The Tax Reform Act of 1986 increased the maximum capital gains rate to 34 percent at the same time the regular corporate income tax rate was reduced to 34 percent (Tax Reform Act of 1986, § 311(a)). In 1993, when the corporate tax rate was increased to 35 percent, the maximum rate on capital gains also was increased by one percent-

[3] The 14.9 percent maximum rate calculation was based on a 33 percent maximum ordinary income tax rate resulting from the 31 percent marginal rate plus the phase-out of the 15 percent rate and the personal exemptions for higher-income individuals.

[4] In 1921, when Congress first adopted an individual capital gains preference in the form of a 12.5 percent maximum rate, the maximum corporate income tax rate also was 12.5 percent (Revenue Act of 1921, § 230). This may explain why no corporate capital gains preference was enacted at that time.

[5] Revenue Act of 1951, §123. The rate was returned to 25 percent by the Internal Revenue Code of 1954, effective for years beginning after March 31, 1954 (Internal Revenue Code of 1954, §1201(a)(2)).

age point to 35 percent. Thus, at the present time, corporations enjoy no reduced rate on capital gains. (See Sections 1201(a)(2) & 11(b)(1)(D)).[6]

STRUCTURAL ISSUES

A. *Exclusion or deduction versus an explicit preferential rate*—Assuming that the Committee decides to increase the current capital gains preference, it must decide the form of the increase. Technically, the Internal Revenue Code does not include a capital gains rate. Rather, current law subjects long-term capital gains to tax at full ordinary income rates and then imposes a maximum rate—or ceiling rate—of 28 percent on such gains (Section 1(h)). This structure has two important consequences:

First, it requires a somewhat complex calculation. A taxpayer whose maximum marginal ordinary income rate exceeds 28 percent must make the following three calculations:

(1) The tax on income other than capital gains must be calculated using the appropriate ordinary income rate.

(2) The capital gains tax must be computed using the 28 percent ceiling rate.

(3) The two calculations must be combined to arrive at total tax liability for the year.

In order to avoid unduly lengthening the tax return, the Internal Revenue Service includes a worksheet in the instructions to the Form 1040 tax return for use in completing these calculations. I have attached a copy of the 1994 worksheet, located at page 25 of this year's instructions. As you can see, it complicates the calculation of an individual's income tax.

Second, and more importantly, the 28 percent maximum rate provides *no* preferential rate benefit to those taxpayers whose regular tax rate is 28 percent or less—which represents by far most individual taxpayers. Unless an individual who normally is in a lower tax bracket recognizes an extraordinary gain in a particular year, such as from the sale of a residence or business, that would push the individual into the 31, 36 or 39.6 percent bracket, capital gains are taxed at the individual's regular ordinary income tax rate.

There is another way to provide a preferential capital gains rate that will eliminate the multiple calculations required under current law *and* will extend the preference to all taxpayers, without regard to their marginal ordinary income tax rate. This alternative would entitle the taxpayer to exclude some portion of taxable capital gains in calculating his or her regular tax.[7] For example, if the Committee were to decide to adopt a maximum rate on capital gains equal to 50 percent of the maximum ordinary income rate, it could produce this result by providing that 50 percent of taxable capital gains is to be excluded in calculating adjusted gross income. There is substantial historical precedent for this manner of according capital gains relief; in fact, the law included exclusions of varying amounts during the entire 53-year period from 1934-1986.

One word of caution. Should the Committee expand the current capital gains preference in the form of an exclusion, it should be aware that this approach likely will indirectly affect the tax revenues of a number of States whose income taxes are based on federal adjusted gross income (so-called "piggyback" jurisdictions). In these States, income subject to tax is reduced by any change in the Internal Revenue Code that reduces "adjusted gross income." Therefore, enactment of a capital gains exclusion, which will reduce federal adjusted gross income, in turn will reduce the beginning point for calculating state income tax in States that have adopted "piggyback" systems. Of course, these States recognized this exposure when they adopted their "piggyback" systems and, if a particular State does not approve of the reduction in the state tax revenues that may result from a change in the federal income tax law, it is free to change its law.

B. *Provisions directly affected by the specific rate selected*—The Internal Revenue Code includes two provisions that create special capital gains rates for particular assets. Under Section 1256, gains on certain regulated futures, foreign currency and certain options contracts currently are taxed on an accrual basis under "mark-to-market" principles. The resulting gain is divided into two parts: 40 percent of the gain constitutes short-term gain taxable at ordinary income rates and 60 percent of the gain constitutes long-term capital gain taxable at capital gains rates. Section

[6] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended.

[7] An exclusion also could be designed as a deduction. I am aware of no difference between the two approaches and, therefore, for convenience, I will hereafter refer only to an exclusion.

1202, enacted in 1993, provides a special 50-percent exclusion for gain on the sale of so-called "qualified small business stock" issued after August 10, 1993 and held by a taxpayer other than a corporation for more than five years.

The Committee may wish to review these existing special provisions and determine whether any change is appropriate as a result of an overall increase in the capital gains rate preference. Does the 60 percent-40 percent split applicable to certain regulated futures, foreign currency and certain options contracts remain appropriate? Likewise, will there be any need to retain the special rule for "qualified small business stock" contained in Section 1202?

C. *Holding Period*—Assuming that the Committee chooses to increase the current capital gains preference, it must determine how long an asset must be held in order to qualify for the expanded preference.

Throughout the history of the capital gains tax, there has been some minimum period during which an asset must be held in order to qualify for the preferential rate. Initially, the required holding period was two years (Revenue Act of 1921, §206(a)(6)). In 1934, a system of staggered holding periods was enacted (a 20 percent exclusion applied to assets held for more than one year and less than to two years, a 40 percent exclusion applied to assets held more for than two years and less than five years, a 60 percent exclusion applied to assets held for more than five years and less than 10 years, and a 70 percent exclusion applied to assets held for more than 10 years.)[8] In 1942, the staggered holding periods were replaced with a single six-month holding period (Revenue Act of 1942, §150(a)(1)). This holding period was increased to nine months for 1977 and one year beginning in 1978 (Tax Reform Act of 1976, § 1402(a)). Currently, an asset must be held by the taxpayer for more than one year in order to qualify for the 28 percent maximum rate (Section 1222(3)).

Some supporters of a capital gains preference have suggested that the amount of the preference should increase in proportion to the length of time that an individual holds an asset.[9] Staggered holding periods are thought by these people to discourage short-term speculation and reward those individuals who hold assets over the longer term. You also may hear advocates of staggered holding periods maintain that the effect of inflation on accrued gains increases with the period of time an asset is held and, therefore, to the extent a preferential rate is intended to compensate for the taxation of inflationary gains, staggered holding periods are appropriate.

Opponents of multiple holding periods maintain that they would complicate recordkeeping and the calculation of an individual's capital gain tax liability, increase the number of "cliffs" that may artificially interfere with an individual's decision to sell or retain an asset as he or she approaches the end of each holding period, and are unnecessary to compensate for inflation because recognition of capital gain is deferred under our realization system until the asset is sold.[10]

In selecting the appropriate holding period(s), the Committee should evaluate the economic arguments, the behavioral implications, and the relative complexity of differing structures.

D. *Definition of capital asset*—Current law defines "capital asset" by excluding certain categories of assets from the definition. These categories are inventory and certain other property held for sale in the ordinary course of business, real property or other depreciable property used in the taxpayer's trade or business,[11] certain intellectual property, accounts and notes receivable, and certain U.S. Government publications (Section 1221).

In addition, certain assets are accorded special treatment under current law. In some cases, income that might otherwise constitute ordinary income is recharacterized as capital gain (certain patent sales (Sections 1235 and 1249)), and in other cases, income that otherwise might constitute capital gain is recharacterized as ordinary income (certain gain on the sale of foreign stock (Sections 1246 and 1248) and income attributable to certain corporate stock or partnership interests referred to as "collapsible assets" (Sections 341 and 751)).

As the Committee considers the possibility of expanding the capital gains preference, you must determine what assets will qualify for the preference. Some argue

---

[8] Revenue Act of 1934, § 117(a). This structure was slightly modified in 1938 to reduce the number of holding periods (Revenue Act of 1938, § 117(b)).

[9] Bush 1990 Proposals, p. 6; S. 2565, 102d Cong., 2d Sess. (1992) (Senator Breaux); S. 1938, 101st Cong., 1st Sess. (1989) (Senator Graham).

[10] For a general discussion of holding period requirements, see Repetti, "The Use of Tax Law to Stabilize the Stock Market: The Efficacy of Holding Period Requirements," 8 Va. Tax Rev. 591 (1989).

[11] Depreciable property used in a trade or business is accorded capital gains treatment under Section 1231.

that assets other than those which are considered to contribute directly to the productive capacity of the Nation should be excluded from characterization as "capital assets." These assets might include undeveloped land or collectibles such as art, antiques, precious metals, gems, coins, and stamps.[12] Conversely, others maintain that some types of investments should receive a disproportionately more generous preference, such as stock in a start-up company or high risk venture or an investment in an enterprise zone.[13]

In considering the possibility of excluding one or more assets, such as land or collectibles, from classification as a "capital asset," or in seeking to craft a special incentive for one or more particular types of desirable entrepreneurial activities, it is important to realize that taxpayers will respond to any attempted statutory differentiations by creating legal structures that will permit ownership of disfavored or less favored assets in a form that will qualify for the most favorable tax treatment. For example, if art were to be excluded from the definition of "capital asset," a collector may be able to transfer an art object to a corporation and effect future transfers of the art by means of the sale or other disposition of the corporate stock, thereby enabling the transferor to enjoy the capital gains preference. Therefore, you must consider whether it is possible to effectively draw additional meaningful distinctions among assets without also substantially complicating the law.

E. *Taxpayers eligible for preferential rate*—Current law limits the rate on net capital gain to 28 percent in the case of individuals (including sole proprietors, partners and shareholders of so-called S Corporations). The 28-percent maximum rate is not available to regular taxable corporations (so-called "C Corporations"). As I previously indicated, individuals and corporations historically have been subject to different capital gains rate regimes. The Committee must determine whether an expansion of the current individual capital gains preference also should be extended to corporations and, if so, in what form. In considering this issue, it is appropriate to determine whether there is a tax policy rationale for a distinction. The only one of which I am aware is that corporate capital gains tend more generally to be recognized in the ordinary course of the corporation's trade or business.

F. *Capital losses*—I do not intend to discuss the tax treatment of capital losses, except to point out that issues involving the deductibility of certain capital losses not currently deductible, the permissible carryover period for unused capital losses, and the extent to which unused capital losses may offset ordinary income are issues that properly might be considered by the Committee during its capital gains rate deliberations.

G. *Foreign investors*—Under current law, gain on the sale or exchange of U.S. securities recognized by a foreign investor is exempt from tax in the United States, even if the sale transaction occurs in the U.S., for example, on a domestic securities exchange. This exemption has been criticized as being unfair to U.S. investors and may serve as an encouragement to some U.S. citizens or resident aliens to illegally place assets offshore with a foreign fiduciary to avoid U.S. tax.[14]

The current law exemption is premised in large part on practical considerations.[15] First, the imposition of a tax on capital gains may discourage foreign investment in U.S. equities, thereby making a very large pool of investment capital unavailable to finance U.S. businesses. Second, collection of the tax in many instances is doubtful. If a securities transaction occurs wholly offshore, on a foreign securities exchange, for example, there is no way in which the United States could collect a tax, even if jurisdiction to tax could be established. If the transaction is undertaken in the United States, presumably the tax could be collected by withholding, as our law currently attempts to do with certain dividends and interest. However, because the current dividend and interest withholding systems are considered by many to be flawed, it is questionable whether either should be applied to an additional set of transactions with any likelihood that additional revenue in fact would be collected.[16]

In considering whether an expansion of the current capital gains preference is an appropriate time to change the law applicable to foreign investors, it also should be noted that any expansion of the preference serves to reduce the relative benefit of

---

[12] President Bush's 1990 capital gain proposal excluded collectibles from the definition of capital asset. See Bush 1990 Proposals, p. 6.

[13] See S. 467, 102d Cong., 1st Sess. (1991) (Senator Kerry); see also statement of former Senator Kasten on the introduction of the Plant Opening Act of 1988, 134 Cong. Rec. S6634 (1988).

[14] See, e.g., Lamp, "Financial Competitiveness," 66 Tax Notes 875 (1995).

[15] See Surrey, "The United States Tax System and International Tax Relationships—Current Developments, 1965-66," *Taxation of Foreign Income* 256, 296-97 (Tax Institute of America, 1966).

[16] Even if a U.S. transaction were subject to tax, it is likely that an entirely foreign secondary market in depository receipt-type interests would be established offshore to avoid any contact with the United States.

the current exemption enjoyed by foreign investors, since the difference between the preferential rate and a zero rate of tax presumably will be less after Congressional action than under current law.

H. *Depreciation recapture*—Gain on the sale of a capital asset is calculated by comparing the sales price with the asset's adjusted tax basis. "Adjusted tax basis" generally is the original cost of the asset plus improvements and other expenses related to the asset that are required to be capitalized minus periodic depreciation or amortization deductions.

An asset's "adjusted tax basis" is reduced dollar-for-dollar by the amount of allowable depreciation or amortization deductions. Therefore, on the sale or other taxable disposition of the asset, the portion of the asset's basis that has been depreciated or amortized is subject to tax to the extent the sales price of the asset exceeds the date-of-sale basis. This is so even if there is no economic profit (that is, even if the sales price does not exceed the asset's original cost). Absent a specific statutory provision, the gain resulting from the difference between the asset's depreciated basis and its original cost is not distinguished from any real economic gain (i.e., profit on the sale of the asset over an above its original cost); both would be taxable at capital gains rates.

Because depreciation and amortization deductions offset ordinary income, the applicability of a preferential capital gains rate to the gain resulting from these deductions results in a "conversion" of ordinary income into capital gain. As a result, since the 1960's, the tax law has contained specific provisions designed to recharacterize as ordinary income either all or some portion of the gain on the sale of an asset that is attributable to prior depreciation or amortization deductions. These rules are based on the so-called "tax benefit principle," which in turn is based on the proposition that if on the sale of an asset it appears that the taxpayer did not suffer the economic loss represented by prior deductions, the deductions should be recovered or recaptured. Cf., Nash v. United States, 398 U.S. 1 (1970) (application of tax benefit rule to bad debt reserve).

The current law depreciation recapture rules are as follows:

- Gain on the sale of tangible personal property, such as machinery or equipment, is taxed as ordinary income up to the amount of all prior depreciation deductions (Section 1245).
- Depreciable real property (Section 1250):

Real property that is depreciable under the straight line method under the current Modified Accelerated Cost Recovery System is subject to no depreciation recapture (cf., Section 1250(b)(1)).

Other real property (i.e., property eligible for pre-1986 accelerated depreciation) is subject to depreciation recapture to the extent of the excess of accelerated depreciation over straight line depreciation (Section 1250(a)(1)(A), (b)(v) & (b)(1)).

Certain federally-insured and low-income housing property are subject to varying, less stringent recapture rules (Section 1250(a)(1)(B)(i)-(iv)).

- Natural resources property (oil, gas, geothermal and other mineral property) is subject to full recapture of gain equal to previously deducted intangible drilling and development costs, mining expenses, and depletion (Section 1254).

Because the scope of Section 1250, relating to depreciable real property, is limited, current law does not fully require recapture of gain that results solely from previously claimed depreciation deductions. The Committee might consider whether the existing recapture rules are appropriate or whether the current system should be replaced with a more comprehensive set of recapture rules,[17] whether any distinction between the recapture rules applicable to machinery and equipment on the one hand and improved real property on the other is appropriate, and whether the distinctions in recapture rules among classes of real property are appropriate.

"Full recapture" might be justified on the basis that a rate conversion from ordinary income into capital gain is not appropriate. If an asset is sold at an amount in excess of its depreciated basis, the prior depreciation or amortization deductions could be considered to have been overstated and, thus, appropriately subject to recapture. The Finance Committee Report relating to the Revenue Act of 1964, which first contained real property depreciation recapture, pointed out that the rate conversion issue is magnified in the case of real estate by the fact that real estate usually is acquired through debt financing. See S. Rep. No. 830, 88th Cong., 2d Sess. 132 (1964).

Opponents of "full recapture" likely would argue that current-law straight-line depreciation over 39 years in the case of nonresidential real property (Section 168(c)(1)) merely compensates for the inflationary gain inherent in a long-held asset

---

[17] President Bush's 1990 capital gains proposal included full Section 1250 depreciation recapture. See Bush 1990 Proposals, p. 7.

and, therefore, is not a tax benefit that should be subject to recapture at ordinary income rates. Cf., letter to Treasury Secretary Nicholas F. Brady from the National Realty Committee, dated March 19, 1992; see also S. Rep. No, 830, supra at 133, which indicates that if property is sold in excess of straight line depreciation, the gain is likely to be attributable to a rise in price levels rather than real appreciation in the value of the property. "Full recapture" opponents also may point out that any increase in the tax on the gain from the sale of a depreciable real property will inhibit real estate sales and capital mobility.

I. *Alternative minimum tax*—The Tax Reform Act of 1986 included comprehensive alternative minimum tax systems applicable to both individuals and corporations. The stated purpose of the AMT is to assure that virtually every taxpayer pays at least some minimum federal income tax (General Explanation of the Tax Reform Act of 1986, p. 432 (Staff of the Joint Committee on Taxation, 1987)). Under the individual AMT, so-called "alternative minimum taxable income," less an exemption, is taxable at a 26 percent rate up to $175,000 and thereafter at a 28 percent rate. The alternative minimum taxable income of a corporation is subject to tax at a 20 percent rate, after application of an exemption and a limited foreign tax credit.

Both the individual and corporate AMTs subject certain enumerated "tax preferences" to tax. Prior to the Tax Reform Act of 1986, the untaxed portion of capital gains was a "preference" under both the corporate and individual minimum taxes (Section 57(a)(9) of the Internal Revenue Code of 1954)). This preference was deleted in 1986, presumably because the 1986 Act contained no capital gains preference. In 1990, as part of his individual capital gains proposal, President Bush recommended that the untaxed portion of capital gains again be included as a preference under the individual minimum tax.[18] It should be noted that the AMT rate applicable to individuals at the time President Bush put forward his recommendation was 21 percent (Section 55(b)(1)(A), prior to amendment by the Omnibus Budget Reconciliation Act of 1990, § 11102(a)).[19]

J. *Tax Arbitrage*—The ability of a taxpayer to deduct against ordinary income the interest expense on indebtedness incurred to acquire a capital asset and be subject to tax on the profit on the sale of the asset at a lower capital gains rate creates what is referred to as "tax arbitrage." In addition to the ordinary income/capital gain "rate conversion," the investor also benefits from deferral, that is, the ability to defer tax on the accrued gain in the asset until the asset is sold.

Deferral is a basic feature of our income tax system. It enhances the desirability of investing in a capital asset, even if the gain on the sale of the asset is not eligible for a preferential rate—a "time value of money" benefit exists if one can borrow to purchase an asset, deduct the interest expense currently, and defer the gain until the asset is sold. This benefit is substantially increased, however, when in addition to deferral, the gain on the disposition of the asset is taxed at a preferential rate. This benefit is present in current law because interest expense is deductible at a maximum 39.6 percent ordinary income rate and gain on the sale of a capital asset is taxable at a maximum 28 percent rate. Thus, under current law, there is an incentive to invest borrowed funds in capital assets. However, this incentive will increase if the current capital gains rate preference is further expanded, and if the capital gains preference is increased significantly, the incentive to engage in tax arbitrage also will increase significantly.

As tax lawyers, we know that rate conversion is a powerful incentive and will encourage tax planners to seek to design transactions that will take advantage of the current deductibility of interest expense against ordinary income, the deferral of gain until the asset is sold, and the tax on the gain at a substantially lower capital gains rate. It is for this reason that the Tax Section of the American Bar Association, in technical comments submitted with its recent testimony before the House Committee on Ways and Means, stated:

A fifty percent [capital gains] deduction would be a powerful incentive to convert ordinary income into capital gains. Our experience suggests that taxpayers would engage in tax planning to take advantage of this differential. ABA Tax Section Statement, p.17 (February 1, 1995)[20]

---

[18] Bush 1990 Proposals, p. 7.

[19] At the same time, President Bush also recommended excluding the untaxed portion of capital gains in calculating investment income for purposes of the investment interest limitation of Section 163(d). This recommendation was adopted as part of the Omnibus Reconciliation Act of 1993, § 13206(d)(1). See Section 163(d)(4)(B); see also Bush 1990 Proposals, p. 7.

[20] Similarly, in a May 14, 1990 letter to former House Ways and Means Committee Chairman Dan Rostenkowski, the Council on Taxation of The Association of the Bar of the City of New York stated "Lawyers and investment bankers will devise elaborate techniques to produce ordi-

Continued

The Code presently contains a number of provisions designed to discourage tax shelter activities and other transactions either motivated in part by the capital gains preference or improperly taxed under a capital gains regime.[21] In addition, in 1993, Congress specifically addressed the "rate conversion" issue by recharacterizing capital gain recognized in a "conversion transaction" as ordinary income and by granting the Treasury Department broad regulatory authority to identify conversion transactions in addition to those specifically enumerated in the statute (Section 1258). To date, the Internal Revenue Service has provided only limited guidance under Section 1258 (See Prop. Reg. § 1.1258-1).

Any substantial increase in the capital gains preference will bring with it a significant added incentive to design transactions intended to convert ordinary income into capital gain. I know of no advocate of an expanded capital gains preference who endorses any uneconomic transactions. Thus, the Committee may wish to consult with its staff and the staffs of the Joint Committee on Taxation, the Internal Revenue Service and Treasury's Office of Tax Policy in an attempt to identify potential tax avoidance transactions that have little or no economic substance but that appear not to be adequately covered by the tax avoidance provisions of current law. In doing so, I urge you to direct the staffs to take into consideration and make the Committee aware of the resulting complexity of any additional legislative safeguards.

K. *Effective date*—Generally, when Congress adjusts an overall tax rate, it does so for any income earned or recognized on or after some relatively contemporaneous date, such as the date of Committee action or the date of enactment, without regard to the date the income producing activity was entered into or the date that the asset was acquired.[22]

Of course, it would be possible to limit any increase in the capital gains preferential rate to newly acquired assets, that is, assets purchased after some current date. If the Committee were to do so, presumably the rationale would be to use the rate reduction to encourage new investments rather than reward previously accrued profits. However, such a decision would introduce significant complexity in the law, arguably would discriminate against old investments, and would substantially affect the revenue estimate of a rate change.

The Committee also must consider the appropriate effective date for any other change in provisions prompted by a change in the capital gains rate. For example, in 1993, Congress added a special preference for so-called "qualified small business stock" held for more than five years (Section 1202). If this provision were to be repealed because it were deemed to no longer be necessary following a capital gains rate reduction, it will be important to assure that appropriate transition relief is provided to anyone who relied on Section 1202. Similarly, if the Committee were to expand the category of depreciable real property subject to full depreciation recapture, appropriate transition relief for owners of existing property should be considered.

Finally, I would like to make one recommendation regarding effective dates that hopefully will not be controversial. Should the Committee choose to recommend to the Senate a change in the current law capital gains rate or in related provisions, I hope that you will specify an effective date that is not later than the date of Committee action. By doing so, investors may be under less pressure to defer transactions that they otherwise would undertake until later in the year, although obviously they will not be certain that a change in the law ultimately will be enacted.

* * * *

Capital gains tax policy is a very important subject. Not only are the broad economic and behavioral issues significant, but the issues surrounding the structure of any capital gains preference—the actual rules by which people and businesses will conduct their affairs—also merit careful consideration. Mr. Chairman, thank you for

---

nary loss and capital gain from a series of related transactions * * * ." Letter reproduced in Tax Analysts and Advocates Highlights and Documents, Doc. 90-3548.

[21] Section 163(d) (investment interest limitation), 263(g) (interest and carrying costs related to certain straddle transactions), Section 469 (passive loss rules), Section 1092 (straddle rules), Section 1256 (regulated futures, foreign currency and certain options contracts), and Section 1276 (gain on market discount bonds). The recapture rules of Sections 1245, 1250 and 1254 previously mentioned also restrict rate conversion.

[22] The Revenue Act of 1978 often is cited as one of the most important recent legislative actions reducing the rate of tax on capital gains. This legislation adopted an effective date (November 1, 1978) that preceded the date of enactment (November 6, 1978) by five days. However, the Act also required calendar year taxpayers to prorate gain for the year (Revenue Act of 1978, § 402(a)).

the opportunity to discuss some of these structural issues with the Committee this morning. At the appropriate time, I will be pleased to attempt to respond to your questions.

**Capital Gain Tax Worksheet—Line 38 (keep for your records)**

Use this worksheet to figure your tax only if (a) you are filing Schedule D and both lines 17 and 18 of Schedule D are gains, or (b) you reported capital gain distributions on Form 1040, line 13, and:

| Your filing status is: AND | Form 1040, line 37, is over: | Your filing status is: AND | Form 1040, line 37, is over: |
|---|---|---|---|
| Single | $55,100 | Head of household | $78,700 |
| Married filing jointly or Qualifying widow(er) | $91,850 | Married filing separately | $45,925 |

| | | | |
|---|---|---|---|
| 1. Enter the amount from Form 1040, line 37 | | | 1. ______ |
| 2. If you are filing Schedule D, enter the smaller of Schedule D, line 17 or line 18. Otherwise, enter the capital gain distributions reported on Form 1040, line 13 | 2. ______ | | |
| 3. If you are filing Form 4952, enter the amount from Form 4952, line 4e | 3. ______ | | |
| 4. Subtract line 3 from line 2. If zero or less, stop here; you cannot use this worksheet to figure your tax. Instead, use the Tax Table or Tax Rate Schedules, whichever applies | | | 4. ______ |
| 5. Subtract line 4 from line 1 | | | 5. ______ |
| 6. Enter $38,000 ($22,750 if single; $19,000 if married filing separately; $30,500 if head of household) | | | 6. ______ |
| 7. Enter the greater of line 5 or line 6 | | | 7. ______ |
| 8. Subtract line 7 from line 1 | | | 8. ______ |
| 9. Figure the tax on the amount on line 7. Use the Tax Table or Tax Rate Schedules, whichever applies | | | 9. ______ |
| 10. Multiply line 8 by 28% (.28) | | | 10. ______ |
| 11. Add lines 9 and 10 | | | 11. ______ |
| 12. Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies | | | 12. ______ |
| 13. Tax. Enter the smaller of line 11 or line 12 here and on Form 1040, line 38. Check the box for Capital Gain Tax Worksheet | | | 13. ______ |

## PREPARED STATEMENT OF SENATOR LARRY PRESSLER

Thank you, Mr. Chairman. I commend you for holding this series of hearings to analyze the various proposals for increasing savings and investment in the United States. In particular, I believe that cutting the capital gains rate is one of the most important issues that our committee will consider this session.

As we have heard today from the panelists, and I think most of my colleagues would agree, cutting the capital gains tax rate is one of the most effective ways that we can stimulate investment in the U.S. There are those in my party who would argue that we could have an effective economic stimulus with just a prospective capital gains reduction, and I think that this is probably true. However, I cannot support such a proposal.

While a prospective reduction in the capital gains rates would help stimulate investment on Wall Street, it would hurt our farmers, ranchers, and small businesses. In South Dakota, we have people who have given their whole lives to creating a successful farm or small business. Most often, the income that they receive from their labors is plowed back into the family business to make it more successful, leaving little room for retirement savings.

These people depend upon the final sale of their farm, ranch or small business for the vast majority of their retirement income, and they are punished by the current capital gains tax system. The lump sum capital gains tax payment that is due when the farm or small business is sold, after a lifetime of work, threatens to wipe out the income that they have come to depend on for their later years. In fact, I have constituents in South Dakota who have been unable to sell their property at the time that they want to because they could not possibly have been able to afford the capital gains taxes.

If we are to reduce the capital gains tax rates, which I strongly support, we must reach back and include previously-owned assets so that our efforts to stimulate savings reach all the way from Wall Street to the main streets of our farms and small businesses across the country. I cannot support a proposal that does not include our family farmers, but I will fight to pass one that does.

The business of farming is an unpredictable one. It changes from year to year, and is subject to more uncontrollable factors that most any other business. We have all seen the devastation that floods have caused in the Midwest in recent years, and my Colleagues on the Committee from Kansas, Iowa, North Dakota and other states know first hand how drought and disease can have the same devastating impact. We must give our farmers and small business people something that they can count on.

That something is dependable retirement income free from an onerous capital gains tax burden.

I think that we are already familiar with the proposal in the Contract With America relating to this issue. Many of my colleagues have problems with the cost in these tough budget times—an estimated $53 billion over five years—and frankly I am concerned with this as well. I want to make sure that we are able to pay for whatever tax cut initiatives we approve here because, as important as this proposal is, it is equally important to our economic strength that we bring down our deficit.

I am intrigued by the comment in Dr. Gravelle's testimony that while the cost of the capital gains cut seems large, that in fact, "the revenue cost is small relative to the total U.S. economy." I want each of you to please comment on the effectiveness of including previously-owned assets in the capital gains cuts to stimulate savings, and to share with us your thoughts on how this will help farmers, ranchers, and small business people to save for retirement.

FACT SHEET

* **CURRENT CAPITAL GAINS RATES:**
  **28% FOR NON-CORPORATE TAXPAYERS**
  **35% FOR CORPORATE TAXPAYERS**
* NET CAPITAL GAIN
  —Is the excess of net long-term capital gain for the taxable year over the short-term capital loss for the year.
* LONG-TERM CAPITAL GAIN
  —Is defined as gain from the sale or exchange of a capital asset held for more than one year.
* CONTRACT WITH AMERICA PROPOSAL
  —The Job Creation and Wage Enhancement Act of 1995 (H.R. 9) would allow all taxpayers (individual and corporate) a deduction equal to 50% of net capital gain for the taxable year.
  —The bill would **repeal** the present-law maximum 28% rate.
  —Thus, the effective rate on the net capital gain of an individual in the highest rate bracket (39.6%) would be 19.8%, and the effective rate for a corporation in the 35% bracket would be 17.5%.
  —The Joint Tax revenue estimate for this proposal is roughly $52 Billion over five years.
* FARMERS/RANCHERS
  —current capital gains treatment hurts farmers who sell their farms/ranches to retire because they must pay an immediate capital gains tax, in lump sum, on the appreciation of the property while they have held it.
  —this hurts them in that it substantially cuts into the amount left from the sale that they have for retirement.

---

PREPARED STATEMENT OF JUDE WANNISKI

I can not begin to tell you, Mr. Chairman, how thrilled I am to be before this committee to address the topic of capital gains taxation—especially having been informed by staff that you had requests for my testimony from both sides of the aisle. As you know from personal experience, I have been a "nagging wife" on the critical importance of this issue for several years, to the point where members of Congress or the Executive Branch cross the street when they see me coming. If you will recall, Mr. Chairman, I had you in my clutches in 1989, in the earliest days of the Bush Administration, at a point where you were dead set against any change in capital gains taxation. I would like to think I had something to do with having you reverse yourself to the point where you are now as persuaded as I have been that there is no single thing we could do in fiscal policy that would energize our economy as much as a lower, indexed capital gains tax.

Since that milestone conversation I had with you in 1989, in Boca Raton, Fla., I've had a further epiphany on this issue, which I will make the centerpiece of my testimony today. It began with a conversation I had four years ago with Alan Greenspan, who told me of his belief that the correct tax on capital gains is zero. His position, which he has since made parenthetically to the banking committees of this body and the other when testifying on monetary matters, is that a tax on capital gains is a tax on the national standard of living. My epiphany was completed a few weeks later, in a conversation with Ted Forstmann, who may well be the most successful entrepreneurial financier of our time. It was Forstmann, now a man of immense wealth who began his career with nothing more than a good education at Yale and a trust fund that provided him $500 a month, who let me in on a secret.

Men of wealth, he told me, are not interested in a lower capital gains tax, *because their gains are behind them*. The people who benefit most from a lower capital gains tax, he said, are those who have no wealth, but aspire to it. Independently of Greenspan, Forstmann told me the correct tax on capital gains is zero. What we are talking about here is the essence of capitalism, which is why this has become the defining economic issue of the Republican Party.

In the kind of capitalism we have here in the United States, people invest in each other. People with capital invest it in people without capital. Old people invest in young people. Rich people invest in middle-class people and the middle class invests in poor people with promise. People in cities invest in country people, and farm people in town people. When all this activity is at a high level, the economy is too.

When Wanniski invests in young Forstmann—directly or through a bank, a credit union, a stock market, a thrift, an insurance company or a pension fund—and Forstmann succeeds, I get to share in the fruits of his success. The more successful he is, the more I get in return. If he loses, I lose. Now, if the government tells me that if Forstmann succeeds, I have to pay Internal Revenue a high percentage of my share of his success, I will think twice about making the investment in the first place.

If Forstmann Inc. looks like a sure thing, I might invest in it anyway, but if he does not have a proven track record in business, I will pass and Forstmann, Little & Co., may not get off the ground. I will invest in a blue chip company, or a government bond, or a municipal bond, something safe.

When the capital gains tax is high, riskier investment in the young and the small and the promising, aspiring poor will dry up. People will stick close to home, which they know best. City people will not invest in country people and vice versa. And because there are fewer people able to try for success, there will be less success for the country as a whole.

When the capital gains tax is low, and there are more people encouraged to invest in each other, there is also a lot of employment. People who start a new enterprise with new capital hire helpers, and whether the enterprise eventually succeeds or not, the workers are earning weekly wages and paying taxes—not only income taxes to the federal government, but taxes of all kinds to state and local governments.

People on unemployment benefits and welfare rolls are employed and begin adding tax revenues to City Hall and the county and the state, instead of living on public welfare.

All of this activity, remember, is occurring because someone with capital—by which we mean surplus energy, talent and time—is willing to bet on another person, who is temporarily short of either energy, talent or time or all three. The payoff for success in the venture is called a capital gain. Failure is termed a capital loss.

It's bad enough when the government puts a high tax on capital gain, because the people who lose the most from a high rate are the poorest, the youngest, those at the beginning of their careers, those who are furthest from sources of capital.

But when the government also taxes gains that arise from inflation, not real gains, then the flow of fresh capital from those who have it to those who need it really dries up. If the rate is 28% on a capital gain, but it takes five or ten years for an enterprise to know whether it is a success or not, the investor must consider the inflation rate *compounded* over those years and add it to the 28%. The rate then becomes confiscatory.

Inflation is a direct result of the monetary or fiscal irresponsibility of government. To penalize participants in the private economy for the mistakes of government seems to me to be the height of arrogance and irresponsibility, In my home state of New Jersey, almost everyone who owns property now has to consider that if they sell that property—the farm, the home, the business—they have to pay capital gains tax on what is for the most part an inflated gain.

The price of their property has gone up in the last 25 years, but the value is about the same, in terms of other goods and services that have also risen in price. So they don't sell the property, unless they are forced to sell in distress. The capital is "locked in." It can't be sold to someone who could make better use of the farm or home or business, with the proceeds to the current owner then invested in a new enterprise.

In the entire United States, which is worth about $30 trillion altogether, lock, stock and barrel, about $7.5 trillion—one quarter of all—is in value that is pure inflation. The federal government would grab 28% of that if it were sold tomorrow, and state and local governments would grab their pieces too. But because it is almost all "locked in," the government gets almost none of it.

If the government decided tomorrow that it wasn't fair to tax all that inflated gain, it would immediately come unlocked. As it changed hands, governments at all levels would be able to get their share of the real gains. Not only would capital become more efficient, as the economists say. People everywhere would be happier with this great burden lifted from them, economic activity would increase, and governments would find their budgets going from red ink to black.

Imagine you had a race track, where purses were so high for winning races that fine horses came from near and far to enter, and bettors came from near and far to watch and wager on these fine horses. Imagine, then, the government announcing it would tax away most of the purse, and you will quickly see the destruction that is done by the current federal capital gains tax of 28% as it applies to inflated as well as real gains.

This is why both political parties should be dedicated to at least reducing the rate and removing the tax threat on inflated gains. Almost everyone in the country would benefit immediately and for generations to come. The only losers would be those who are now betting on the nation's continued decline and failure.

Why is there such ideological opposition to this idea from the Democratic side? It is because the Democratic Party is the party of security, the party of fairness and compassion and equality. It is like the mother in a family, whose role is to question risky enterprise. The Republican Party must play the role of risk-taker, the traditional husband and father role of enterprise. President Clinton and the Democrats of this committee will naturally be skeptical of ideas that increase the levels of risk-taking in our society. It is up to the Republicans of the committee to persuade them that without risk-taking, there can be no economic growth. I say that again: Without risk-taking, there can be no growth.

All growth is the result of risk-taking, all success is the result of failure. The dynamism of our national economy is dependent upon people who are secure in their wealth, investing portions of it in men and women who have get-up-and-go and a can-do attitude, but no capital. The Majority Leader of the other body, Dick Armey, born in Can-Do, Okla., would eliminate the tax on capital gains altogether in his flat-tax proposal. He is in agreement with Alan Greenspan and Ted Forstmann.

I bring up Congressman Armey at this point of my testimony because of his well-known desire to change the method of scoring capital gains taxation by the Congressional Budget Office and the Joint Committee on Taxation. The reason is not that he would like the computers that do the scoring to be programmed by optimists instead of pessimists. It is rather that they should be programmed by supply-siders instead of demand-siders, as they are now.

In a demand-model, whether Keynesian or Monetarist or a combination of the two, there is no such thing as risk-taking. "Demand" means consumption, just as "supply" means production. All the computers in the legislative and executive branches at the present moment are programmed in the consumption mode, which assumes production is automatic. You have heard the expression many times, "Demand creates its own supply." If all growth is the result of risk-taking and our national policies of public finance are routinely ignoring risk-taking, inevitably all growth will stop.

Can the computers be programmed by supply-siders? Not really. The fact is, risk-taking cannot be converted into mathematical notation. In 1936, the great Princeton mathematician, John von Neuman, one of Albert Einstein's close friends, demonstrated that risk-taking could not be converted into mathematical notation. This meant that economics could not be converted into a mathematical science. It would have to remain a behavioral science. Unhappily, the departments of economics throughout the country, including those at Princeton, chose to ignore Professor von Neuman. This is one important reason why our national economy has become so sluggish, why our national standard of living has been in decline for more than a generation. And here, I quite agree with Labor Secretary Robert Reich when he points to the discouraging decline in real wages over the last two decades. But where Secretary Reich would get us moving again by spending more federal money on training workers for jobs that do not exist, would eliminate the capital gains tax, stand back, and watch the boom unfold.

Now do not get me wrong. Cutting or eliminating or indexing the capital gains tax is not the magic bullet that solves all problems. It is, as Jack Kemp has been saying for years, "the bone in the throat of the national economy." Unless that bone is removed, no amount of pills or surgery aimed at treating the rest of our body politic will do much good. As long as risk-taking is punished, growth will be smothered.

In 1989, I was invited to Moscow by the central bank of the Soviet Union, to advise them on how to convert to capitalism. The bone in their throat is not excessive taxation, but the absence of a reliable money, which is a prerequisite to a financial industry and a market economy. They took the shock therapy advice of the IMF and are still experiencing economic and political chaos. In my several visits, I would use the following metaphor to give them a feel for capitalism:

Imagine three countries in the world, each of which produces all its GNP by digging holes in the ground. In the first, the workers dig with backhoes, in the second with spades, in the third with sticks. I would ask in which country will the workers have the highest wages. Obviously, the difference is capital. You can take a 25-year-old man in the United States or one in Polandor one in Ethiopia and give them a shovel and they will dig approximately to the same depth in the same amount of time. Capital makes the difference. Secretary Reich can train all our young men to work backhoes, but if all that is available are sticks, the market will pay them the minimum wage.

This, though, is why I would happily support an agreement with the President, to raise the minimum wage at the same time we index and reduce the capital gains tax. Real wages would rise without an increase in the minimum, but if the administration insists on the tradeoff, I would see almost no harm in it. The only serious damage would occur in Puerto Rico, which has its own tax structure, but which is obliged to meet the mandates of our minimum wage law. This could be resolved by suggesting to Puerto Rico that it match our adjustments in capital gains taxation, something I have been trying to get them to do anyway.

These are broad, general observations, Mr. Chairman, as I can only hit high spots in the time I was alloted for a prepared statement. As you well know from my nagging, I could sit here until the cows come home answering questions about this issue. I would be happy to supply the committee with answers to any questions you may have. I would be surprised if you come across a question or criticism that I have not confronted in the last several years. I genuinely believe we will open the 21st century without a tax on capital gains, as we opened the 20th century. The only question is what path we will take to get there and how fast we will travel it. Thank you again for the invitation to testify on this most important issue before this most important committee.

## COMMUNICATIONS

### STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commercially-grown commodity in this country. Our policy is developed by producer members at the county, state and national levels of our organization. Farm Bureau appreciates the opportunity to comment on needed changes in capital gains tax laws.

Farm Bureau supports elimination of the capital gains tax. If elimination of this tax cannot be achieved, Farm Bureau would support setting the maximum tax rate for real capital gains at 15 percent and indexing capital gains for inflation, both retroactively and prospectively.

In most instances, the capital gains tax is not a tax on income, but rather a tax on transferring capital from one asset to another. The tax creates a disincentive for farmers to upgrade farm operations because capital gains tax must be paid on land and other farm assets sold to finance improvements. Unimproved farm businesses are less efficient, which reduces agriculture's competitiveness in world markets. These farms are also less profitable, creating a disincentive for young farmers to pursue a career in agriculture.

Farming and ranching are extremely capital intensive businesses. Even a part-time, beginning farmer who owns little or no land can easily have more than $100,000 of investments. When land is added to an operation's assets, capital needs can quickly reach $200,000 to $300,000, at a minimum. Capital gains tax relief is needed to facilitate the movement of agricultural capital assets to the next generation of America's farmers and ranchers and to improve the economic viability of existing farm operations.

The U.S. Department of Agriculture estimates that between 1992 and 2002, about 500,000 older farmers will leave production agriculture to be replaced by about 250,000 new, young farmers. Many older farmers and ranchers who would like to transfer land and other capital property to some other assets for retirement income are prevented by the high taxes on inflationary gains in asset values. This delay in the sale of farm assets is a hindrance to young farmers trying to obtain land and equipment necessary to begin a farming operation.

Even though land prices declined in many eras of the country during the 1980s, in both real and nominal terms, they have recovered in recent years in most areas. Farmers hold land an average of 28.6 years. In the past 28.6 years the value of total farm real estate in the United States has increased 4.27 times. Much of this increase in value has been due to nothing more than inflation. Farm Bureau believes that taxes on capital should be assessed only on the real increases in the value of property and not on nominal gains caused by inflation.

Many farm commodities, such as timber, Christmas trees, breeding livestock, dairy cows and equine animals, have extended production cycles. These extended production cycles merit capital gains tax treatment of income when the commodities are marketed. Taxing capital gains on slow-maturing commodities at ordinary rates reduces the profitability of these operations.

Tax policies that are fair and equitable promote both the economic well-being for farmers and our nation's food supply. Thank you for the opportunity to present the views of the American Farm Bureau Federation on this matter of importance to our nation's farmers and ranchers.

STATEMENT OF THE AMERICAN HOTEL & MOTEL ASSOCIATION

Hon. BOB PACKWOOD,
*Chairman, Committee on Finance,*
*U.S. Senate,*
*Washington, DC*

Dear Chairman Packwood: The American Hotel and Motel Association (AH&MA) is a federation of state and local lodging associations representing over 10,000 properties. The lodging industry employs over 1.5 million people and has annual sales exceeding $60 billion. Our association represent all of the major lodging chains and also contains a significant number of smaller properties. On behalf of our member properties we offer the following comments and request they be made a part of the record of the hearings on capital gains tax reform held February 15 and February 16, 1995.

AH&MA supports the provisions in the Contract with America to reduce the capital gains tax and index the value of assets to eliminate taxing "illusory gains" and applauds this committee's efforts in focusing on the advantages to the business community of a capital gains reduction. We believe that many hotels, including our smaller properties, may benefit from this change in several ways.

Firstly, it is likely that some investors already in the industry are holding hotels out of a reluctance to face the current level of taxation upon their sale. This reluctance to sell can artificially reduce normal turnover of property ownership and can act as a drag on our industry which is just beginning to recover from one of its worst downturns. A capital gains reduction would encourage investors to turn over appropriate properties and may even have a salutary effect on the sale price. At the same time, a capital gains tax reduction would encourage those investors to make upgrades to their properties prior to sale, knowing that their return on that additional investment would not be unduly penalized.

For those investors outside the lodging industry who are able to have capital freed by sales or dispositions of other assets, we believe investment in the lodging industry will be an increasingly attractive consideration. As our industry continues its recovery and experiences modest expansion, a change in capital gain rates along with indexing of asset value should help ensure solid growth for hotel and motel owners. The freeing up of capital both inside and outside our industry should help to stimulate the market for hotel properties.

We believe these benefits are not limited to the lodging industry and that many other industries could likely experience similar favorable results from the capital gains tax change under consideration. We look forward to final action by the Congress on this tax change.

Sincerely,

JAMES E. GAFFIGAN, *Vice President,*
*Governmental Affairs.*

---

STATEMENT OF THE NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

[SUBMITTED BY MARK O. DECKER, PRESIDENT AND CEO]

We appreciate the opportunity to comment on capital gains reduction proposals such as S. 182 and H.R. 9. The National Association of Real Estate Investment Trusts ("NAREIT") represents over 240 real estate investment trusts (known as "REITs"), about 200 of which trade on the New York Stock Exchange, the American Stock Exchange, or the National Market System of the NASDAQ. In addition, NAREIT represents over 1,600 lawyers, accountants, analysts, investment bankers, and others who provide services to the REIT industry.

Congress established REITs in 1960 to allow small investors to obtain the diversification and professional management of real estate that beforehand were only available to large, sophisticated investors. Capital formation has been essential to the growth and success of REITs ever since, and the promise of a large scale, widely held real estate capital market has begun to become a reality. The market capitalization of publicly held REITs has blossomed from under $9 billion at the beginning of 1991 to about $45 billion today. This success story is due in large part to the tax modernization reforms adopted by Congress over the years.

The maturation of the REIT industry would not have been possible without capital formation. Thus, NAREIT applauds the intent of legislation such as S. 182 and H.R. 9 to create further incentives for the public to invest in the stock market. Specifically, NAREIT wholeheartedly endorses the proposal to reward the entrepreneurial risks of investing in stock by reducing the capital gains tax.

In addition, NAREIT supports the intent of S. 182 and H.R. 9 to index the tax basis of investors' stock to avoid taxing the noneconomic increase of value attributable to inflation. However, there appears to be some provisions in S. 182 and H.R. 9 that could deny such indexing to investors in REIT stock. Such a result would be terrible for the REIT industry because investors would have an incentive to invest in other companies for which they could receive the benefits of indexation.

S. 182 and H.R. 9 would allow stock in a REIT to be fully indexed only if 90% of the REIT's assets are "indexed assets," that is, corporate stock or tangible property. I will briefly summarize the three major technical provisions in S. 182 and H.R. 9 that could disqualify REIT shares from full indexation.

First, S. 182 and H.R. 9 exclude as an "indexed asset" any "net lease property." The nature of the real estate business is such that this definition could easily prevent more than half of today's REITs from qualifying for indexation. For example, many of our shopping center, health care, industrial, hotel, and net lease REITs own and operate portfolios of properties that fall under the net lease definition in S. 182 and H.R. 9. These REITs are in the ongoing real estate business and are completely different from the single shot, financing vehicles that the original net lease definition was meant to encompass.

Second, many REIT investments are made through partnerships. However, S. 182 and H.R. 9 could be interpreted to exclude as "indexed assets" properties held through a partnership. Such an interpretation would be contrary to the tax Code's usual rule of treating a partnership as an aggregation of the partners rather than as a separate entity.

Third, the 90/10 safe harbor is a good idea because the administrative complexity of requiring REIT shareholders to adjust only a portion of their tax basis is not justified when most of the REIT's assets qualify as indexed assets. However, we recommend that the 90% threshold be reduced to provide REITs with greater flexibility in conformity with the REIT asset tests.

NAREIT urges the Committee to enact these capital formation incentives after making our suggested technical changes to allow REITs to raise capital on an even playing field. Thank you once again for the opportunity to comment on this important legislation.

---

## Statement of the National Center for Policy Analysis

[BY JOHN C. GOODMAN, PRESIDENT & CEO]

The 1986 Tax Reform Act increased the maximum tax rate on capital gains income from 20 percent to 28 percent. This 40 percent tax hike has reduced government revenues, discouraged entrepreneurship and caused many investors to hold on to assets they would prefer to sell. The proposal to reduce capital gains tax rates by 50 percent and to index capital gains for inflation, if enacted into law, would benefit both taxpayers and the government.

The tax rate reduction would help businesses of all sizes by "unlocking" investments and freeing up the venture capital market—which provides funds for small business expansion and entrepreneurial activity. It would make it possible for business owners who retire and sell their businesses to enjoy more of the fruits of their years of labor. It would benefit all income groups. It would result in stronger economic growth. And that economic growth, as well as the growth in the realization of capital gains that would result, would increase the amount of revenue collected by the government.

*The Case for Indexing.* Because tax brackets and the personal exemption are indexed to inflation, people who receive wage income cannot be pushed into a higher tax bracket by the effects of inflation alone. But people who receive investment income have no similar protection. When investors have to pay taxes on gains that merely reflect the effects of inflation, the effective tax rate on their real gains can be extraordinarily high.

Suppose someone invested in common stock in 1970, saw the same appreciation as the Dow Jones Industrial Average, and sold the stock in 1980 with a capital gain of 18.4 percent. Because the price level more than doubled during that period, the nominal gain of 18.4 percent represents a real loss of 44 percent. Despite this loss, the investor would have been assessed a capital gains tax based on the nominal gain. The purpose of indexing is to ensure that only real gains are taxed.

*The Case for Lower Tax Rates.* The vast majority of assets have value only because they are expected to produce future income. For example, bonds will produce interest income and stocks will produce dividends and retained earnings. As a result, the present value of the asset today is totally determined by the income stream it will generate. Since all of this income will be taxed as it is realized, there is no need to tax the owners of these assets at the time the assets are bought and sold. Further, even without a capital gains tax, sellers of assets indirectly pay taxes on the future income of those assets. For example, a 28 percent income tax reduces the value of the asset by 28 percent, because the asset will generate an income stream that is 28 percent less than it would otherwise be. The owner who sells the asset will pay this income tax indirectly through a lower sales price for the asset.

A capital gains tax, therefore, is not needed in order to insure that all income is taxed at the same rate. Indeed, such a tax is not really a tax on income at all. It is instead a transfer tax. It impedes the efficient transfer of assets from those who value them less to those who value them more, and it makes investments in all income-producing assets less attractive.

*Economic Effect: "Unlocking" Investments.* When the taxing of inflationary gains is combined with the high capital gains tax rates, the result is a powerful "lock-in" effect. Since selling is taxed and possessing is not, high capital gains taxes encourage investors to hold rather than sell—thereby avoiding the tax indefinitely. Assets that are held until death avoid capital gains taxes altogether.

When investors lock in their assets this way, the capital market becomes inefficient, because the flow of assets to those who value them the most is impeded, and government loses revenue it would have gotten if tax rates had been lower.

*Economic Effect: More Revenue for Government.* Historically, there has been a negative relationship between capital gains tax rates and capital gains revenues collected by the federal government: Whenever tax rates have been increased, tax revenues have dropped, and vice versa. Investors are highly sensitive to the tax on capital gains. As Figure I illustrates, investors rushed to sell assets in advance of increases in the capital gains tax in 1969 and again in 1987. This led to a bulge in sales in 1968 and again in 1986. After the tax increase, however, asset sales fell. Conversely, cuts in the capital gains tax in 1978 and 1981 led to increased sales, as the lock-in effect abated.

This history has been repeatedly ignored in Washington. In 1986, both the Congressional Budget Office and the Joint Committee on Taxation misled many members of Congress by predicting that the increase in the maximum capital gains tax rate from 20 percent to 28 percent would not deter asset sales and would increase government revenues. Following the selling spree that preceded the tax hike, capital gains income went down, not up.

- Capital gains realizations in 1992 (the latest year for which statistics are available) were $116.5 billion, far lower than the $165.5 billion in 1985.
- After adjusting for inflation, the government collected 13 percent less in capital gains tax revenue in 1992 than it collected in 1985, even though the tax rate was 40 percent higher.

*Economic Effect: More Investment.* Capital gains taxes affect investment decisions. In particular, they reduce the amount of capital available for investments with higher risk potential, such as new startups and companies in emerging sectors. As a result, the capital gains tax tends to be a direct tax on entrepreneurship, which all economists recognize as essential to growth. This is especially injurious to small businesses, so many of which are started and built by entrepreneurs.

*Economic Effect: Economic Growth.* All Americans would benefit from the stronger economic growth that would result from lower taxes on capital gains. NCPA Senior Fellows Gary and Aldona Robbins predict that:

- The proposed 50 percent capital gains exclusion and inflation indexing would lower the cost of capital by 5 percent, thereby inducing investors to increase the capital stock by $2.2 trillion by the year 2000.
- This larger stock of capital would create 721 new jobs and increase total GDP cumulatively by almost $1 trillion by the year 2000.

*Economic Effect: Benefits for All Income Groups.* Despite the strong evidence that lower capital gains tax rates buoy the economy, proposals to cut the rates are labeled as cutting taxes only for the wealthy. However, the bulk of taxpayers realizing capital gains are those with middle incomes.

- Well over half of all taxpayers with capital gains in 1992 had adjusted gross incomes of less than $50,000.
- Over 73 percent had incomes of less than $75,000.

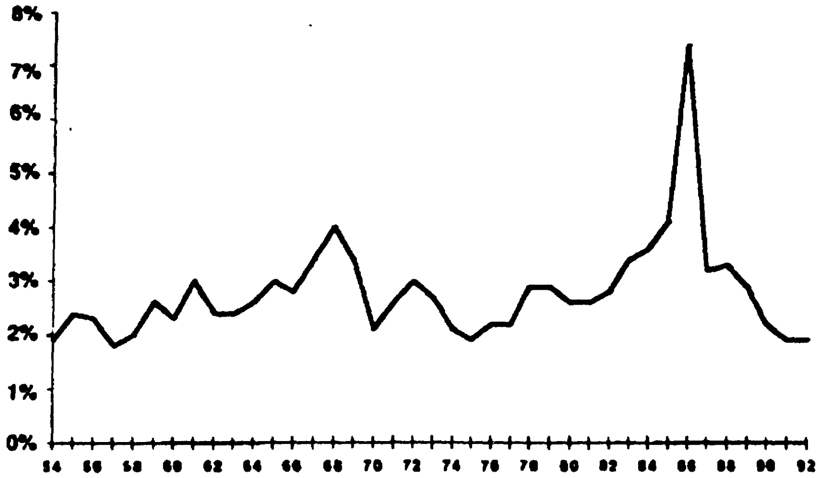
The small business owner who is not rich and who needs funds to invest in the business usually cannot hold assets until there is a more favorable tax rate. Neither can the small business owner who wants to sell the business and retire for age or health reasons.

Moreover, the claim that the tax cut would primarily benefit the wealthy ignores the benefits that flow from new investment. On the average, wage earners receive $12 after tax for every $1 of after tax income received by investors. Thus, more than

90 percent of the benefits of new investment would flow to wage earners rather than owners of capital.

*Financing the Tax Cut.* Expansion of economic activity would increase the overall tax base of the economy by more than enough to compensate for any loss in federal revenue from the tax changes described. Indeed, the indexing feature alone is probably enough to ensure that the proposal increases revenue. Since only new investments would be indexed, most taxpayers would want to realize their existing gains and invest in new inflation-indexed assets.

**Capital Gains Realizations as a Percent of GDP**




Source: Congressional Budget Office and Internal Revenue Service.

STATEMENT OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

The National Multi Housing Council and the National Apartment Association represent the preponderance of the nation's firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the development and operation of multifamily housing, including ownership, construction, finance, and management of rental properties.

There are approximately 15 million multifamily units, defined as part of a complex of five or more units, in the United States. A study by Regis J. Sheehan & Associates for the U.S. Departments of Labor, Commerce, and HUD showed that in 1993 "the rental housing industry's contribution to the Gross Domestic Product was about $153.2 billion dollars representing 2.3% of our economy." In normal economic times, rental housing is the fifth largest contributor to the United States economy.

The National Multi Housing Council and National Apartment Association are dedicated to providing clean, safe, affordable living for millions of Americans. Because our industry is so competitive (just look at any metropolitan apartment guide), federal and state tax policies have a direct and substantial impact on the livability as well as rent levels that are enjoyed by occupants.

SUPPORT FOR REDUCTION IN THE CAPITAL GAINS TAX

We strongly support a significant reduction in the capital gains tax rate and indexing the basis of assets beginning in 1995. We believe that a reduction in the capital gains rate will actually bring in more money to the U.S. Treasury as real estate capital assets are unlocked by existing investors and new money is brought in for investment and modernization by new investors.

REAL ESTATE MUST BE INCLUDED

Real estate is emerging from one of its worst periods in history. After several years of a severe economic period for real estate and many foreclosures, only recently have we begun to see the cost and availability of credit for purchase or development of multifamily housing return to somewhat normal conditions. Even today, credit for the construction and modernization of multifamily housing is not as broad as for many other areas of investment.

Any broad-based capital gains legislation that omits real estate will cause a tremendous amount of disintermediation in the capital markets as money flows away from real estate and to those investments that benefit from a reduction in the tax. The resulting scarcity of credit for real estate will drive our industry into another extraordinarily difficult period. This in turn will lead to fewer federal income and payroll taxes being collected from real estate companies and their workers, foreclosures, pressure on the banking and financial system, a reduction in property values, and finally a reduction in tax revenues to state and local governments who rely on property taxes for a majority of the money they receive to fund school systems, police and fire departments, and other essential services.

Any reduction in capital gains rates must include real estate.

## THE DEPRECIATION RECAPTURE ISSUE

In 1992, President Bush proposed a reduction in the capital gains rate. Unfortunately, he coupled this reduction with an onerous provision that required full recapture of all previously taken depreciation at ordinary income rates. The theory was that since the basis of a real estate asset had been reduced by depreciation which taxpayers had deducted from their ordinary income, recapture was necessary in order to be "fair" when lowering the capital gains rate. In practice, nothing could be further from the truth.

There is nothing wrong with depreciation recapture as long as it does not affect the economic rate of depreciation that has been taken in the past. The fact is that real estate is subject to economic depreciation, especially in the case of multifamily housing.

In addition, recapture would be both punitive and confiscatory vis-a-vis other investments. For example, if a taxpayer invests in the stock of a manufacturing company, that taxpayer will benefit from the cash flow that company is able to attain as a result of good operations and depreciation deductions. When the stock is subsequently sold, the seller is not assigned a pro rata portion of the depreciation that the company took to enhance its overall cash flow. Likewise, taxpayers should not have to incur an onerous provision for recapture of depreciation on real estate investments at ordinary income levels. Real estate assets do depreciate at an economic rate and recapture is not necessary to bring "fairness" to a reduction in the capital gains rate.

If an onerous recapture requirement is included in any capital gains reduction, then real estate will experience the same capital disintermediation that was outlined above. The net result of the 1992 proposal, which would have lowered capital gains tax rates but required full depreciation recapture, was to actually bring in more revenue from real estate under static revenue scoring. The reason? The recapture provision resulted in a confiscatory tax and the likely result was that real estate assets would continue to be "frozen" in existing investor accounts. Much needed new capital investment would not occur and, in fact, capital markets would once again shun real estate credit advancement.

## A LOWERING OF THE CAPITAL GAINS TAX WILL BRING IN MUCH NEEDED FUNDS FOR MODERNIZATION OF TENS OF THOUSANDS OF APARTMENT UNITS

A meaningful reduction in the capital gains rate that does not include onerous depreciation recapture provisions will lead to new investment in tens of thousands of existing apartment units across America whose present owners have no financial incentive to invest in needed capital improvements. This new investment is badly needed and will result in the creation of many new jobs for carpenters, painters, electricians, plumbers, appliance makers, and others.

For example, Drever Partners of San Francisco, California has acquired over 18,000 units during the past 7-1/2 years with investment groups comprised primarily of tax-exempt investors. The capital improvements have averaged $4,000 per unit, or a total of more than $72 million for improvements alone. A reduction in the capital gains rate would attract similar private investors willing to make the improvements necessary for capital appreciation.

Numerous examples of this potential unlocking effect have been brought to our attention. For example, a major apartment owner in New Jersey would invest $1.5 million into modernization of a building that would cost $23 million. But at this point, the existing owner cannot sell the property because of capital gains tax ramifications.

This type of anecdotal evidence does not even scratch the surface. In the case of apartments, a meaningful lowering of the capital gains tax rate would result in thousands of new, good paying jobs here in America.

### THE "EXIT TAX" PROBLEM

Little, if any, of this new investment will occur under the present capital gains rate of 28% because of something referred to as the "exit tax." Capital gains tax proposals such as those contained in S. 182 would be a step in the right direction toward solving the exit tax problem for properties that have substantial negative capital accounts by their partners. Under current law, most dispositions of older properties would result in huge gains on paper for tax purposes without enough actual cash from the sale to pay the taxes. At present, existing partners are unable to sell these properties for a sufficient amount of cash to pay the taxes that would be due. Therefore, these investments will remain frozen for many years with no incentive for existing owners to put in capital to preserve and modernize the units for tenants. This problem will become even more critical considering the millions of units that will be affected as HUD Section 8 contracts expire over the next few years.

Some estimate that a more likely figure of $7,000 to $10,000 per unit would be invested by new partners in the modernization of existing apartment units. There are estimates that more than one million units are in need of capital improvements, but existing owners do not have the financial incentive to spend the money.

Speaking for the multifamily housing industry, we believe that a significant reduction in the capital gains tax will result in thousands of new high-paying jobs for modernization of more than one million apartment units here in America. To accomplish this, the Committee may have to look at bringing negative basis in apartment investments to zero when applying the new capital gains rates.

The U.S. Treasury stands to receive a large increase in revenues from capital gains taxed at a significantly lower rate. You have heard this before and it is true: the great reservoir of fixed investments that are "locked" for many years to come would, in short order, be freed and new money brought in that is vitally needed. In the case of multifamily housing, thousands of new jobs would be created as new investors spend money to modernize existing apartment units. Modernized apartments will enhance both federal and state and local taxes and greatly improve living conditions and neighborhoods.

### OTHER BENEFITS

Other benefits will also accrue to federal, state and local economies from the unlocking of investments in multifamily housing. An estimated additional 10–20 percent of the sales price of a multifamily property is spent on appraisal fees, legal fees, title services, transfer taxes, and other items directly related to the sale. These expenditures will mean added revenues to all levels of government.

Local property tax valuations will also be increased, bringing additional revenues to local governments for schools and other essential services; not to mention the improvement in neighborhoods that will result from modernization of existing living units.

### CONCLUSION

The National Multi Housing Council and the National Apartment Association strongly support a reduction in the capital gains tax rate. We want to commend the Committee for considering legislation that reduces capital gains rates, brings in the concept of indexing for inflation, and rejects onerous depreciation recapture provisions.

For further information or questions contact:

Jim Arbury, Vice President, National Multi Housing Council-National Apartment Association, 1850 M Street, N.W., Suite 540, Washington, DC 20036, 202/659-3381.

O

90-210 (128)