BROADENING THE TAX BASE
AND RAISING TOP RATES ARE
COMPLEMENTS, NOT
SUBSTITUTES

1986-style tax reform is a flawed template

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The Tax Reform Act of 1986, with its basic structure of “broadening the tax base and lowering rates,” has become the lodestar for bipartisan tax reform. The Moment of Truth report by National Commission on Fiscal Responsibility and Reform Co-Chairs Erskine Bowles and Alan Simpson, the report of the Bipartisan Policy Center’s Debt Reduction Task Force led by Alice Rivlin and Pete Domenici, and the U.S. Senate “Gang of Six” budget blueprint have all proposed variations of the “broadening the tax base and lowering rates” reform framework.

But it’s time to move past 1986. Economic research and trends over the past quarter-century make clear that the “broaden the base and lower rates” blueprint is flawed. The right mantra should be “broaden the base and raise top rates.” More precisely, policymakers should broaden the base by repealing tax preferences for capital income and—instead of raising the current 39.6 percent top stat-
Enthusiasm for lowering marginal tax rates is based partly on the false idea that lower marginal tax rates are a powerful spur to economic growth. Recent research on behavioral responses to taxation, as well as historical and cross-country regression analyses of top tax rates and macroeconomic performance, strongly suggest that these growth effects are substantially overstated.

Also contrary to a popular myth, raising current top tax rates on high-income households would not sharply reduce productive economic activity. While tax increases do decrease upper-income households’ reported taxable income more than they decrease moderate-income households’ reported income, it is not because upper-income households choose to work less, but because they take advantage of their greater capacity to shift income from one category to another or one time period to another to reduce their taxes. Thus raising tax rates while broadening the tax base (by eliminating or curbing tax expenditures such as deductions, exclusions, credits, exemptions, and preferential treatment of capital income over labor income) and improving tax enforcement to minimize this avoidance thus could deter inefficient allocations of capital that are made simply for tax purposes.

There is a revenue-maximizing tax rate (i.e., the tax rate associated with top of the Laffer curve), which is estimated as a function of behavioral responses to top tax rates. The U.S. top statutory federal income tax rate of 39.6 percent is still well below that “revenue-maximizing” rate based on best estimates of behavioral responses to the existing tax structure, by roughly 26 percentage points, according to some estimates.

Tax reform that broadens the tax base and minimizes tax-avoidance opportunities would actually further increase that revenue-maximizing top statutory federal income tax rate, by as much as an additional 10 percentage points. Simply put, high-income households would have less ability to avoid taxes by shifting the form or timing of their compensation, and this would decrease their overall behavioral response of reported income to top tax rates.

In the current top tax bracket, roughly the top 1.0 percent of households, income has become increasingly skewed toward the top. Therefore, rather than raising the top tax rate on married joint-filers making just above the $450,000 threshold, new tax brackets should be created; for example, a 45 percent tax bracket for joint-filers with taxable income above $2 million and a 50 percent tax bracket for joint-filers with taxable income above $10 million.

One of the best base-broadening policies would be to end tax treatment of capital gains, which are now taxed at a top statutory rate of 20 percent, well below the 39.6 percent top statutory rate on ordinary income for taxpayers in the top tax bracket. Many highly compensated workers have the ability to reclassify labor income as capital income, and avoid taxes by shifting the timing of realizing income for tax purposes; they also access tax shelters that inefficiently reallocate capital from more productive uses. Base-broadening should therefore include reducing the gap between tax rates levied on wage income versus capital gains and other sources of investment income.
In addition to tackling the preferential capital gains tax rate, policymakers should consider repealing two preferences that increase avenues for tax-avoidance and amplify the overall behavioral response of capital gains realizations with respect to capital gains tax rates: the “step-up basis of capital gains at death” (which allows for taxes to be avoided on inherited capital assets, particularly stocks) and the “carryover basis of capital gains on gifts” (which allows for taxes to be avoided on capital assets given as gifts). Repealing these preferences would decrease efficiency losses from capital gains taxation and increase the revenue-maximizing capital gains tax rate.

The fallacy of broadening the tax base and lowering tax rates

Broadening the tax base simply means subjecting more gross income to taxation by eliminating or curbing tax expenditures such as deductions, exclusions, credits, exemptions, and preferential treatment of capital income over labor income. Such reforms have value beyond raising revenue; they would help the tax code adhere more closely to the principle of horizontal equity, a core public finance and taxation theory concept stating that two people with the same income should not pay significantly different effective tax rates based on the ability to exploit tax code preferences or loopholes. As explained below, these base-broadening reforms should be complemented by higher top rates—not lower top rates, as was the case in the 1986 tax reforms—in order to restore lost tax progressivity and ensure revenue adequacy for the future.

Why the 1986 tax reforms are a poor template

The Tax Reform Act of 1986 broadened the tax base, most notably by repealing the preferential treatment of capital gains, and lowered the top individual income tax rate from 50 percent to 28 percent. Policymakers intended the 1986 model to be both revenue neutral and distributionally neutral (Shaviro 2011), meaning that effective tax rates would remain roughly unchanged across incomes. This mandate for revenue and distribution neutrality was also later incorporated in the recommendations made by President George W. Bush’s Advisory Panel on Federal Tax Reform, although the Bush-era tax cuts themselves violated this spirit by lowering overall effective tax rates, disproportionately so for high earners (Fieldhouse and Pollack 2011).

Targeting these objectives today would imprudently disregard economic and budgetary shifts over the past quarter century. The Bush-era tax cuts significantly shrunk projected future budget surpluses—helping turn them to structural budget deficits—and left revenue short of what is needed to fund the projected rapid growth of federal health programs in coming decades. (This outlook is essentially unchanged by the lame-duck budget deal.) Meanwhile, rising income inequality—exacerbated by reductions in top tax rates (Hungerford 2011; Hungerford 2012)—has surpassed Gilded Age levels, and will continue to be exacerbated for some time by the sustained, depressed demand for labor and ongoing jobs crisis (Bivens, Fieldhouse, and Shierholz 2013).

Furthermore, to the degree that many tax expenditures are most accurately viewed as government spending programs administered through the tax code (Marron and Toder 2012), New York University School of Law professor Daniel Shaviro rightly notes that “a revenue neutrality norm in which the budgetary gain from their repeal ostensibly needs to be offset by rate cuts is intellectually incoherent” (Shaviro 2011).

Despite the fact that revenue neutrality and distributional neutrality are clearly inappropriate goals for tax reform today, the 1986 reforms are viewed as a template largely because they succeeded politically, passing a divided Congress and enacted by a lame-duck president. Similarly, comprehensive reform today would have to overcome major political hurdles, particularly Republican intransigence over raising revenue.
But there is an additional economic dimension that drives enthusiasm for the "broadening the tax base and lowering rates" formulation: Many believe that low marginal tax rates are a powerful spur to economic growth. However, recent research on behavioral responses to taxation, as well as historical and cross-country regression analyses with respect to top tax rates and macroeconomic performance, strongly suggest that these growth effects are substantially overstated (Fieldhouse 2013).

Moreover, cleaning the tax code of exemptions and credits and other tax expenditures will decrease efficiency losses from the existing structure of the income tax code by subjecting more gross income to higher tax rates both through mechanical channels (i.e., reduced revenue loss from tax expenditures, ignoring behavioral effects) and behavioral effects (i.e., reduced avoidance).

**Behavioral responses of upper-income households indicate that broadening the tax base is complemented by higher marginal tax rates**

The bottom-line parameter for assessing the economic effects and desirability of tax changes is the “elasticity of taxable income” (ETI), which is simply the change in reported taxable income (and hence revenue) that accompanies changes in marginal tax rates. The higher the ETI (in absolute-value terms), the more distortionary the changes in tax rates. Simply put, if taxable income is very elastic with respect to tax changes, then small increases in marginal rates will cause large decreases in reported income. If this elasticity is greater than one, then raising tax rates will actually decrease total tax collections—the famous phenomenon of being on the wrong side of the “Laffer curve.”

Over the last half century, much policymaking toward top marginal tax rates took for granted that high-income households were very responsive to tax changes, and could well be close to the wrong side of the Laffer curve. New evidence demonstrates that this is not true. In a review of the literature, McClelland and Mok (2012) conclude, “There is little compelling evidence that high-income taxpayers have substantially higher elasticities with respect to their labor input than lower-income taxpayers.”

Further, much of the measured responsiveness of high-income households to tax changes is not a function of them reducing productive economic activity (i.e., working less or saving less) in response to higher tax rates. Instead, this responsiveness largely reflects these households' ability to avoid taxation through income-shifting or income-timing (i.e., strategically reclassifying the form of income or timing the realization of income for tax purposes). As McClelland and Mok (2012) find, “Higher estimates of the elasticity of broad income among high-income taxpayers appear to reflect their greater ability to time their income rather than greater changes in their labor supply.”

This key finding indicates that policymakers need not worry that potential economic output will be affected by upper-income households’ predominant behavioral responses to changing top rates, as shifting the form or timing of their compensation has a negligible effect on long-run potential growth.

As evidence of this finding, upper-income households’ taxable income (after deductions) is empirically more responsive to tax rate changes than their broad income (before deductions). Gruber and Saez (2002), for example, have found a higher 0.57 ETI after deductions and a lower 0.17 elasticity of broad income before deductions. This important finding implies that reported taxable income becomes less responsive to tax rate changes when the tax base is broader—i.e., when avoidance strategies are minimized through stricter tax enforcement and/or a cleaner tax code with fewer deductions, exemptions, and exclusions, as well as tax neutrality between capital and labor income.

This result also strongly indicates that tax reform that broadens the tax base is actually complemented by higher
marginal tax rates, as the ETI is the principal economic parameter determining the revenue-maximizing tax rate (Saez, Slemrod, and Giertz 2012). That is, the broader the tax base, the lower the behavioral responses to taxation (the lower the ETI), and thus the higher the revenue-maximizing top tax rate. In current tax policy debates, however, raising top rates and broadening the base are generally treated as substitutes.

Research by Saez, Slemrod, and Giertz (2012) and Diamond and Saez (2011) suggest that top tax rates are currently well shy of revenue-maximizing levels, and that broadening the tax base and minimizing avoidance would even further increase the revenue-maximizing rate. Based on a preferred estimated ETI of 0.25, Diamond and Saez (2011) estimate the revenue-maximizing top income tax rate is 73 percent (combining federal, state, and local taxes). This implies that policymakers could raise the top statutory federal income tax rate to roughly 66 percent—more than 26 percentage points above the prevailing 39.6 percent rate (see Fieldhouse 2013 for details on these calculations).\(^7\)

But Diamond and Saez (2011) also note that Gruber and Saez’s (2002) pre- and post-deduction elasticities for the top of the income distribution, ranging from 0.17 to 0.57, imply a revenue-maximizing total top income tax rate of between 54 percent and 80 percent, depending on how narrow or broad the tax base is. This range of estimates would imply revenue-maximizing top federal income tax rates between 37 percent and 76 percent (Fieldhouse 2013).\(^8\)

Again, the important takeaway from this range of estimates is that base-broadening (i.e., eliminating exclusions, deductions, credits, and preferences) increases the revenue-maximizing tax rate. This is to suggest that base-broadening tax reform is complemented by a higher top tax rate, but not necessarily by raising the current 39.6 percent top statutory income tax rate. That rate is applied to taxable income above $450,000 for married joint filers, a threshold that has been reduced precipitously from roughly $1 million in the early 1970s and roughly $3 million in the early 1950s (adjusted to 2012 dollars), as discussed in Fieldhouse (2013). The growth and distribution of income within the top 1.0 percent of households by income (those in the top tax bracket, roughly speaking) is also quite skewed; better policy would add higher tax rates to better match the skewed distribution of income. For instance, EPI’s most recent progressive budget blueprint proposed adding a 45 percent income tax rate above $2 million in taxable income and a 50 percent income tax rate above $10 million in taxable income, both for joint filers (Bivens et al. 2012).

Conversely, base-broadening tax reform is all too often focused on reducing top marginal tax rates already below best estimates of the revenue-maximizing rate.

**The most important base-broadener: ending the preferential tax treatment of capital income**

Much of upper-income households’ greater ability to minimize tax liability stems from the capacity to time, shift, and shelter income afforded by the preferential treatment of capital income over labor income, particularly the preferential tax rates on capital gains. The equalization of tax rates on capital gains and ordinary income from the Tax Reform Act of 1986 has long been ended, and the Bush-era tax cuts created a new preferential rate on dividends (previously taxed as ordinary income). Indeed, the American Taxpayer Relief Act (ATRA) of 2013 (i.e., the lame-duck budget deal) made permanent preferential 20-percent top statutory rates on both long-term capital gains and qualified dividends for taxpayers in the top 39.6 percent tax bracket.\(^9\) Thus, for upper-income households, capital income is taxed at substantially lower rates than ordinary income.

Capital income is heavily concentrated at the top of the income distribution, with roughly 75 percent of the bene-
of the preferential rates on long-term capital gains and qualified dividends accruing to the top 1.0 percent of households ranked by income (Toder and Baneman 2012). Economist and tax policy expert Leonard Burman (2011) concluded in testimony before the Senate Finance Committee that “the biggest loophole is the lower tax rate on capital gains,” adding later that “lower capital gains tax rates fuel inefficient tax shelters that entail a significant economic cost” (2011).

Many highly compensated workers have the ability to reclassify labor income as capital income, famously in some cases through “carried interests” in partnership profits (the “carried interest” loophole). This loophole allows much of the compensation of some financial-fund managers to be taxed at the preferential capital gains rate, as opposed to the higher ordinary income tax rate, and thus additionally avoiding uncapped Medicare payroll taxes on wages and salaries. Other capital income preferences, notably the tax exclusion for interest on municipal bonds, allow households to shift income or wealth into assets whose returns are excluded from taxable income.

Further, unlike dividends payments subject to annual taxation when disbursed, tax filers have discretion in determining when to realize capital gains (or losses) and subject them to taxation (or deduct losses). Capital gains taxes are assessed on the difference between the sale price and the purchase price of an asset, which is known as the basis for capital gains. For assets that are bequeathed, the basis price for heirs is reset to the value at the time of transfer rather than at the time of purchase (this is known as the “step-up basis of capital gains at death”). In other words, families can avoid capital gains taxation altogether by never realizing capital gains until shortly after assets are bequeathed, thereby minimizing intergenerational tax liability. For example, if an heir inherits a stock portfolio valued at $1 million, she could immediately liquidate it to pay zero income tax (assuming there has been no subsequent appreciation or depreciation). Sufficiently large bequests would be subject to some estate tax liability (indeed, the step-up basis is intended to avoid double taxation of intergenerational transfers), but the estate tax has been deeply hollowed out over the past 12 years, and a historically high exemption and low top rate were made permanent by ATRA. The step-up basis of capital gains would be repealed statutorily if the estate tax were repealed (TPC 2013), and, interestingly, would on net likely generate substantial revenue because projected estate tax receipts have fallen so sharply. The tax code also enables households to avoid paying taxes on capital gains accruals by allowing them to transfer the donor’s basis valuation to a donee along with appreciated assets given as gifts—the “carryover basis of capital gains on gifts.” Many recipients of such gifts are tax-exempt institutions, so these accruals will likely never be subject to any taxation.

In discussions with Economic Policy Institute staff about the revenue-maximizing capital gains tax rate, Leonard Burman noted that the capital gains realization elasticity is raised by the step-up basis of capital gains. Essentially, the additional option this step-up basis affords taxpayers for intergenerational avoidance of capital gains taxes means they have another avenue through which to respond to higher capital gains tax rates. Consequently, repealing the step-up basis would decrease efficiency losses from standing capital gains taxation and push up the revenue-maximizing long-term capital gains tax rate. The carryover basis of capital gains on gifts almost certainly elevates the capital gains realization elasticity as well, although the elasticity, revenue, and progressivity implications are much more modest.

More broadly, the preferential tax rate on capital gains opens a host of income sheltering and tax arbitrage opportunities. In testimony before the Senate Finance Committee, Burman (2012) noted “the difference in tax rates between capital gains and other income is a prime factor behind individual income tax shelters,” and that tax code arbitrage was distorting investment decisions away from more productive uses of capital.
Broadening the tax base by repealing the step-up basis of capital gains and the carryover basis of capital gains on gifts would make raising the capital gains tax rate more efficient and would also increase the revenue-maximizing tax rate. Improving tax neutrality between income forms by more closely harmonizing the tax rates on capital gains and wages and salaries—or better yet by repealing the capital gains and dividends preferences altogether—would in turn decrease the ETI with respect to marginal ordinary income tax rates.\(^{14}\) Again the lesson is clear: Base-broadening (in this case minimizing the opportunity to exploit different tax rates applying to different legal classifications of income sources) increases revenue-maximizing top rates. Therefore, a broader base and higher rate should be seen as complementary, not substitutable.

The preferentially low 20 percent top statutory tax rate on qualified dividends has much less of a justification than the capital gains preference, notably because there are fewer avenues for tax avoidance behavioral responses since dividends are taxed annually as they are disbursed.\(^ {15}\) And prior to the 2003 Bush tax cuts, qualified dividends were taxed as ordinary income. In discussions with Economic Policy Institute staff about the revenue-maximizing capital gains tax rate, Tax Policy Center staff suggested that behavioral responses to the tax rate on qualified dividends are close to negligible.\(^ {16}\) From a corporate finance perspective, there is some merit in horizontally equitable tax treatment between capital gains and dividends to avoid distorting firm payout strategy, such as tilting the balance toward share repurchases (passed on to shareholders as capital gains) over dividends payments because of tax reasons. But there is also a strong revenue and equity argument for again taxing qualified dividends as ordinary income and simultaneously raising the capital gains rate—or better, repealing the capital gains preference entirely—which, by decreasing or eliminating this tax wedge, would mitigate concerns about tax arbitrage driving corporate payout strategies.

**Conclusion**

Put simply, if the aim of tax reform is to generate revenue and restore lost progressivity, lowering top income tax rates as the 1986 framework did would be a step in the wrong direction. And this is true even if reform leads to a broader base. Lowering top marginal rates on labor or capital income would decrease the progressivity of the tax-and-transfer system and likely exacerbate market-based income inequality growth (Fieldhouse 2013).

Short of reneging on the nation’s commitments to ensuring health care for the elderly, poor, and disabled, Congress must raise substantially more revenue than projected under current policy. To do that, we don’t need a repeat of 1986-style reform. Instead, we need a context-based overhaul that eliminates some of the more regressive tax preferences and decelerates income inequality growth. This overhaul should also heed lessons from recent public finance research and begin viewing a broader base as an opportunity to raise rates while decreasing efficiency losses.

And the greatest opportunities for base-broadening with respect to decreasing tax avoidance and income sheltering, as well as increasing progressivity, are the tax preferences for investment income, including the “carried interest” loophole, preferential rates on capital gains and qualified dividends, step-up basis of capital gains, and tax exclusion for municipal bond interest.

In short, we need tax reform that ensures revenue adequacy for the future, restores lost tax progressivity, and treats raising top marginal rates and broadening the tax base as complements rather than substitutes.

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Endnotes

1. The corollary principle of vertical equity states that taxpayers with greater resources should pay a higher share of their income in taxes than those with fewer resources, or that effective tax rates should rise with income. As this paper discusses, tax preferences for capital income undermine both vertical and horizontal equity principles at the top of the income distribution.

2. The statutory preferential rate on long-term capital gains was 20 percent prior to reform, which repeal effectively raised to 28 percent.

3. Most of the base broadening in the Tax Reform Act of 1986 was actually on the corporate income side, although distributional analysis of tax changes typically assigns the incidence of corporate income tax changes to individual shareholders. On the individual income tax side, the biggest base-broadening reforms were repealing the preferential tax rate on capital gains and establishing limits on contributions to tax-preferred retirement plans, both of which were reversed in 1997 (Gravelle and Hungerford 2012). Most itemized deductions were left untouched, although the mortgage interest deduction was capped (at high levels), and deductions for sales taxes and consumer interest were repealed (Gravelle and Hungerford 2012).

4. The Bush-era tax cuts generally refer to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 and Jobs and Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, although there were a number of tax changes over 2001–2008. Subsequent tax changes primarily accelerated the implementation of provisions in the 2001 and 2003 tax cuts.

5. ETIs can be estimated with respect to any marginal tax rate, but much of the public finance literature is concerned with the ETI with respect to the net-of-top-marginal tax rate (i.e., \(1-\tau\), where \(\tau\) is the top marginal tax rate), the most policy-relevant variable for comprehensive tax reform and its revenue implications. Note that economic distortions from tax rate changes can influence both productive and unproductive economic activity.

6. More accurately, if the absolute value of the point elasticity of taxable income with respect to the marginal tax rate is equal to 1, then the top of the Laffer curve has been reached. If the absolute value of the point elasticity of taxable income with respect to the marginal tax rate is greater than 1, then top tax rates are higher than the revenue-maximizing rate—that is, the tax structure is “on the wrong side” of the Laffer curve. Note also that elasticities are dependent on both the starting marginal tax rate and tax avoidance opportunities afforded by tax enforcement and preferences.

7. Their preferred ETI estimate of 0.25 is based on best estimates of the long-run elasticity, ranging between 0.12 and 0.40, reported in Saez, Slemrod, and Giertz (2012).

8. While a small part of this range of estimates falls below the prevailing top tax rate, it is important to remember that both the 1) revenue-maximizing federal income tax rate given a revenue-maximizing total income tax rate and 2) revenue-maximizing total income tax rate given a specified elasticity are nonlinear relationships, and their preferred estimate from the midpoint elasticity of 0.25 is strong evidence that the revenue-maximizing top tax rate is on the high end of this range. See Fieldhouse (2013) for calculations of the revenue-maximizing top federal income tax rate from this range of top total income tax rates.
As a result of the Affordable Care Act, investment income for households with adjusted gross income above $200,000 ($250,000 for joint filers) is additionally subject to a 3.8 percent Medicare Hospital Insurance surcharge as of January 1, 2013.

This compares with 26.4 percent of the benefit of itemized deductions, 15.9 percent of the benefit of exclusions, 8.3 percent of the benefit of above-the-line deductions, and 8.3 percent of the benefit of nonrefundable tax credits, all for the top 1.0 percent of households by income (Toder and Baneman 2012).

EGTRRA repealed the estate tax for 2010, and in that year replaced the step-up basis of capital gains at death with a modified carryover basis for capital gains bequests. The estate tax and step-up basis of capital gains were reinstated in 2011. The Office of Management and Budget (OMB) Federal Receipts Analytical Perspective from the president’s fiscal 2014 budget request estimated that the step-up basis of capital gains would result in $149.8 billion of revenue loss over fiscal 2014–2018. Extrapolating from this score for economic growth, we estimate that repealing the step-up basis would save $337.7 billion over fiscal 2014–2023. Conversely, the Congressional Budget Office projects that only $197.6 billion will be collected from estate and gift taxes over fiscal 2014–2023 (CBO 2013). The Bush-era tax cuts gradually hollowed out the estate tax from an exemption of $675,000 ($1.35 million for married couples) and top rate of 55 percent in 2001 to an exemption of $3.5 million ($7 million for married couples) and top rate of 45 percent, before repealing the tax entirely for 2010. The estate tax was reintroduced for 2011 and 2012 at an inflation-indexed exemption of $5 million ($10 million for married couples) and top tax rate of 35 percent—the least progressive structure of the most progressive federal tax since the 1930s. ATRA permanently set an inflation-indexed exemption of $5 million ($10 million for married couples) and top tax rate of 40 percent, at a cost of $369.1 billion relative to current law (JCT 2013).

This conversation was regarding elasticity assumptions in the Urban-Brookings Tax Policy Center’s microsimulation tax model, but it was suggested that the same would hold true of elasticity estimates used by other official scorekeepers, notably the Joint Committee on Taxation. For more on capital gains realization elasticities and revenue modeling, see Gravelle (2010).

The OMB Federal Receipts Analytical Perspective from the president’s fiscal 2013 budget request estimated that the step-up basis of capital gains would result in $149.8 billion of revenue loss over fiscal 2014–2018, roughly six times the $24.5 billion cost of the carryover basis of capital gains on gifts (OMB 2013).

Saez, Slemrod, and Giertz (2012) note that raising the top income tax rate while holding the top capital gains rate fixed at lower levels could increase the ETI with respect to marginal ordinary income tax rates (as increased tax arbitrage incentives fueled greater tax avoidance). See footnote 70 in Saez, Slemrod, and Giertz (2012).

See endnote 9.

See endnote 12.

References


