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# The Illusory Rewards of a Capital Gains Tax Cut

*by Dean Baker*

The Congress has returned once again to the question of whether returns to capital should be accorded more favorable tax treatment than returns to labor. The Job Creation & Wage Enhancement Act in the Republicans' "Contract With America" calls for lowering the top rate on capital gains to 19.8% from the current 28% (already a bargain compared to the top income tax rate of 39.6%) and indexing any gains to the rate of inflation. Proponents of the change argue that lowering the rate will lead to increased investment and provide a tax benefit to the broad middle class. Both are far from likely.

## There is no evidence that a capital gains tax cut will have any positive impact on investment and economic growth.

In theory, the only mechanism through which lowering the capital gains tax rate can increase investment, and thereby economic growth, is by raising stock prices. A lower capital gains tax would lead to larger after-tax returns and therefore greater incentives for individuals to purchase shares of stock or other assets that might produce capital gains. This can in principle make it cheaper for firms to raise money for new investment, and thereby increase investment.

In reality, it is all but impossible to increase investment through this route. To begin with, the effect of a tax cut on stock prices is not likely to be very significant, since a large portion of stock holdings (the one-third held by pension funds and similar institutions) is not currently subject to the capital gains tax. Also, since these institutions tend to be the most active traders, they play a disproportionate role in determining share prices. Furthermore, many individuals pay no taxes on capital gains, since stock shares can be passed along to descendants without capital gains liability.

Under the current system, when individuals accrue capital gains during their lifetimes, the gains are effectively taxed at a far lower rate than for other income because the tax can be deferred until the asset is sold. If an individual has a $100,000 capital gain on a stock or small business, he can defer paying

taxes on this money until he sells the asset. On the other hand, if the individual receives $100,000 for working or from interest on savings, he has to pay taxes from the income immediately. This deferral of taxes constitutes a large subsidy to recipients of capital gains. While there is no evidence that this favorable treatment increases the money available for firms to invest, it does provide a large tax break to wealthy shareholders.

It is sometimes claimed that lowering the capital gains tax will "free up" money that is currently tied up by the threat of high taxes. While giving a tax break might free up money for wealthy shareholders, it would do nothing for the market as a whole. The price of stocks is determined by the large numbers of active traders. If a wealthy shareholder decides to unload his holdings of a particular stock, then other money will flow into that stock, leading to little change both in the stock's price and in the amount of money available to be invested elsewhere.

Michael Boskin, President Bush's chairman of the Council of Economic Advisors and a strong proponent of a capital gains tax cut, estimated that a cut of roughly this magnitude would lower the effective rate of interest by only 10 to 15 basis points, or between 0.1% and 0.15%. Interest rates regularly fluctuate this much in a single day. By comparison, in the last year and a half long-term interest rates have risen by over 200 basis points.

## A capital gains tax cut will encourage tax shelters and divert resources from productive uses.

If people pay a lower tax rate on capital gains than on other income, they have an incentive to hide their other income as capital gains. Tax lawyers and accountants will devise methods for highly paid professionals and other wealthy people to have their income taxed at the low capital gains rate instead of the rates that ordinary people pay on their income.

Instead of promoting investment and economic growth, this reaction will take the economy in the opposite direction. Some of the country's most creative people will find that the best way to become wealthy is to outsmart the tax system. In addition, billions of dollars that could have gone to productive investment will be tied up in tax shelters. And, by allowing wealthy individuals who are willing to take advantage of loopholes to pay a lower tax rate than the average working person, the credibility of the tax system will be undermined.

It was for these reasons that President Reagan and Congress eliminated special treatment for capital gains in the Tax Reform Act of 1986. As President Reagan said when he signed the 1986 tax bill:

> By closing loopholes and lowering rates, we're going to bring America's investment money out from under the shelters and back into the productive economy where it belongs. We will no longer use the tax code to make economic and social policy. Instead, we're going to let market forces shape our economy into a sleek and efficient powerhouse of growth.

Bringing back special treatment for capital gains completely subverts the momentous tax reform accomplished in 1986. The only growth it would promote is in the tax shelter industry.

## The loss of tax revenue from a capital gains tax cut is likely to be substantial over the long-term.

In the short term, a capital gains tax cut may have little effect on revenue or may even increase it, as people rush to take advantage of lower rates. In the longer term, the rush will dissipate and the gains will return to their former levels, but the tax rate will be 50% less. This effect will be aggravated by the creation of tax shelters through which much ordinary income will be taxed at the lower capital gains rate. When these dynamic effects are taken into consideration, a capital gains tax cut is likely to lead to a huge revenue loss over the long term.

## The beneficiaries of a capital gains tax cut will be almost exclusively the wealthiest people in the country.

Most working people will never have any capital gains on which to pay tax. The one capital gain that most people receive in their life is on their home, but this gain is virtually excluded from taxation under current tax law. By contrast, the richest 1% of the population typically receive about 90% of all capital gains. Thus a capital gains tax cut would be a huge windfall to the people who need it least.

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***For more information, see:***

Chirinko, Robert S. 1993. "Business Fixed Investment Spending: A Critical Survey of Modeling Strategies, Empirical Results, and Policy Implications" *Journal of Economic Literature,* Vol. 3 1, No. 4, pp. 1875-1911.

Fazzari, Steven M. 1993. *Investment and U.S. Fiscal Policy in the 1990s.* Briefing Paper. Washington, D.C.: Economic Policy Institute.