U.S. SENATE COMMITTEE ON
Finance
SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN
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Grassley Rebuts Claim of No Link Between Capital Gains Activity, Rate Cuts

WASHINGTON – Sen. Chuck Grassley, chairman of the Committee on Finance, is urging his colleagues to reconsider a claim from a fellow senator that the Congressional Budget Office (CBO) is "debunking" the value of continued capital gains relief. Grassley said the correlation between lower capital gains tax rates and higher capital gains realizations is undeniable, according to the same CBO document cited by Sen. John Kerry.

"I say all the time that CBO is god around here, because policy lives and dies by CBO's word," Grassley said. "Like the Bible, a CBO document can mean different things to different people and it's easy to pull things out in isolation to justify a position. I hope everyone will take the full picture into account before rushing to judgment."

Grassley sent a "Dear Colleague" letter outlining his views. The text follows here.

March 1, 2006

CBO CAN'T EXPLAIN HALF OF THE GROWTH IN CAPITAL GAINS REALIZATIONS, BUT REDUCED TAX RATES HAD A BIGGER IMPACT THAN EXPECTED

Dear Colleague:

This letter is in response to a "Dear Colleague" letter, dated February 28, 2006, sent by the junior senator from Massachusetts, in which he characterized a letter to me from the CBO as "debunking the main selling points" for extending the reduced rates on dividends and capital gains. [1]

In a letter dated February 10, 2006, I asked the CBO to explain how it projects capital gains realizations and the reasons for recent changes in their projections, as reported in CBO's *The Budget and Economic Outlook: Fiscal Years 2007 to 2016*. For example, according to the CBO's response to my inquiry, capital gain realizations in 2004 alone exceeded expectations by $98 billion and "added about $19 billion in tax receipts for fiscal year 2005."

In a letter dated February 23, 2006, Donald B. Marron, Acting Director at the CBO, responded to my inquiry. To no one's surprise, the response confirms that projecting capital gains realizations is a difficult process, because many factors affect whether there are gains to realize and whether taxpayers choose to realize them. The "important lesson" that CBO points out – that "projections of a revenue source characterized by high volatility are bound to be uncertain" – is not news to me. Neither is the conclusion that "much of that volatility seems unrelated to changes in capital gains tax rates."

However, the letter does not "debunk" the point that lower tax rates on capital gains result in an increase in capital gains realizations. In fact, the CBO confirms this point in several parts of its letter:

Lower tax rates lead to higher realizations. The CBO explains how taxpayers respond to changes in capital gains tax rates. "In analyzing the relationship between capital gains tax rates and capital gains realizations, it is important to distinguish between the temporary and permanent effects of tax rate changes. Investors can generally choose when to realize their gains; if they believe that tax rates will change in the future, they may try to time their realizations to occur during a period with lower tax rates. . . . Such timing effects are, by their nature, temporary. Over longer periods, the pace of capital gains realizations is also influenced by capital gains tax rates; *realizations are higher when tax rates are lower*." (emphasis added).

Lower tax rates caused realizations to be higher than expected. In its 2004 baseline, CBO projected that the reduced tax rate on capital gains caused a 14.9 percent increase in capital gains realizations between 2002 and 2004. With new information on realizations through 2003 and preliminary data through 2004, CBO adjusted its January 2006 baseline because it now estimates "that the tax reductions in JGTRRA caused gains to increase by 18.0 percent between 2002 and 2004." So, according to the CBO, the impact of lower tax rates on capital gains realizations was more than 20 percent higher than expected.

Capital gains tax rates contribute to volatility in realizations. The CBO attributes the volatility in capital gain realizations to two principal factors: "household decisions about the amount of assets to sell in a given year and the underlying accrual of capital gains in those assets." The CBO goes on to note that "[b]oth those factors, in turn, are influenced by changes in asset prices, individual circumstances, and *capital gains tax rates (both current and anticipated)*." (emphasis added). Thus, according to the CBO, capital gains tax rates are one factor that affects capital gains realizations by influencing asset values and taxpayers' decisions about whether to sell those assets.

The bottom line is that capital gains realizations and related tax receipts have been higher than the CBO expected since the lower tax rates on capital gains have been in place. As illustrated by the attached charts, each January, the CBO has revised its projections upward, with the biggest increase coming in 2006 after taking into account available data for 2003 and 2004. The correlation between lower tax rates and higher realizations is undeniable, even if, according to the CBO "[r]oughly half of the growth in realizations between 2003 and 2004 remains unexplained."

Sincerely,

Charles E. Grassley
Chairman

(1) The letter also states: "As you know, these lower rates do not expire until January 1, 2009, which occurs during the *next* President's term." (emphasis in original). For the sake of clarity, note that the *next* President's term would actually begin at noon on January 20, 2009. *See* U.S. Const. amend. XX, § 1.