Tax Reform and the Tax Treatment of Capital Gains

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I would like to thank Chairmen Camp and Baucus for holding this very important hearing in a bipartisan and bicameral way. There are probably few issues more central to getting America out of its current fiscal and economic difficulties than fundamental tax reform and the focus of this hearing on capital gains is an important component of that effort.

This is a very complicated issue, but in the interest of time, there are three themes that are critical. First, the key to escaping the economic and fiscal morass in which we now find ourselves is to make America the best place in the world to invest, start a business, and create jobs. This involves a focus on the overall rate of taxation of both capital and entrepreneurship, and not on the capital gains tax rate in isolation. Second, there is a strong relationship between the rate of taxation and the level of the economic activity being taxed, and therefore on the revenue collected from such a tax. This relationship is not as strong as some believe, but it is far stronger than that implied by static revenue models. Moreover, the focus should not be on the revenue maximizing tax rate, but on the additional economic burden created for each dollar of revenue collected. This means that the optimal rate of taxation is well below the revenue maximizing level. Third, the revenue collected from capital gains taxation depends not only on the capital gains tax rate, but on the tax rate on ordinary income as well. A large differential between these rates skews the design of investment and financing just as the current huge differential between the taxation of debt and equity. These are important issues in designing the taxation of capital.

The Taxation of Capital and Entrepreneurship

The capital gains tax rate impacts two key economic drivers: the return on capital and the return on entrepreneurship, but is only part of the calculation on both. Consider first the taxation of the return on corporate capital in its most straightforward form. When a corporation earns a

dollar in profits domestically, it pays a 35 percent corporate rate. The remaining 65 cents is then either retained by the corporation or paid in a dividend. Typically a dollar retained by the corporation raises the value of the company by a dollar which would then be realized and taxed at the capital gains tax rate when the shareholder liquidated his position in the company. At a 15 percent tax rate, this would imply a *total* tax rate on the dollar earned by company of 44.75 percent.

Now, the shareholder might not sell the stock immediately, thus deferring the capital gains tax. But, if he or she makes that choice, the dollar remains in the corporation where it produces a rate of return that is taxed at the corporate rate of 35 percent. Internal compounding of returns by deferring capital gains tax is not particularly tax efficient, so tax calculations that emphasize deferral as a tax preference miss the point.

On the other hand, if the dollar is paid out in dividends, it is taxed at the dividend tax rate which currently is the same as the capital gains tax rate, producing a total rate of tax, again, at 44.75 percent. Some are now advocating raising the dividend tax rate. At the 44 percent rate now being contemplated by some, the effective tax rate on corporate profits paid to shareholders would rise to 63.6 percent.

From an economic point of view such a tax rate is preposterously high. It would not only not make America the best place in the world in which to invest, start a business, and create jobs, it would make it one of the worst. Even a 44.75 percent effective tax rate is far higher than is economically optimal if the objective is to promote growth in America in a very competitive world economy.

Raising the capital gains (and dividend) tax rates will be reflected in share prices. In the preparation for the 2003 tax bill, we estimated that the reduction in the capital gains and dividend

taxes would produce a minimum 8 percent rise in the level of share prices. A recent study by Allen Sinai, one of the leading macroeconomic modelers of the last 40 years, estimated that the elimination of the capital gains and dividend tax changes of 2003 would lead to an 19.6 percent reduction in the S&P 500. Such a change would not only adversely affect the wealth of American consumers, it would also severely damage the already impaired position of America's pension funds.

The capital gains tax rate also has an important effect on the formation of new businesses and entrepreneurship. Increasingly entrepreneurs are not forming traditional corporations, but instead use Subchapter S and similar corporate forms to skip the corporate level of taxation. But the dynamics of capital formation in the small business and entrepreneurial environment are the same. When a dollar is earned by the entrepreneur it is taxed at the current personal rate and is also subjected to both employer and employee Medicare taxes. This makes the effective tax rate on internal buildup within the small business 37.4 percent. Again, some are now contemplating raising this rate to an effective rate of 44 percent. Others are advocating subjecting this income to the full panoply of FICA taxes, thereby driving the rate on small business cash buildup into the mid-50s. It goes without saying that this would not be a good development for small business formation or job creation.

One advantage the entrepreneur has in this model is that the dollar retained in the small business increases his or her basis in the company, and so, if and when the company is sold, that dollar is not subjected to a second round of taxation at the capital gains level. In this sense this makes the capital gains tax rate much less important to the internal buildup of cash within the small business than the ordinary tax rate.

On the other hand, favorable capital gains tax treatment does benefit the company that creates what I think of as "sudden value" without the normal generation of cash. This might come from an invention or an innovation in marketing or being the creative force behind a new industry or business model. This is very powerful stuff in terms of economic growth, and is something that America specializes in. As others on this panel will attest, the capital gains tax rate is an important element of attracting capital to these types of enterprises. But, because this type of "sudden value" is not taxed in the cash-generation process, the capital gains tax is often the only tax on this type of activity. This leads me to conclude that the capital gains tax should not be considered independently of the ordinary tax rate when assessing the tax design that best promotes capital formation and small business creation.

Tax Rates and Tax Revenue

A substantial literature exists on the relationship between capital gains tax rates and capital gains tax revenue. And there is a good degree of disagreement within that literature on the so-called "revenue maximizing" capital gains tax rate. The bulk of the evidence suggests that this rate is probably around 20 percent and, to my knowledge, there simply is no evidence to support a conclusion that the rate is any more than 28 percent. I think this latter figure is used, at least implicitly, by the Joint Committee.

In my view, too much attention is paid to the concept of a "revenue-maximizing" rate. All that means is that the government is wringing as much as it can out of the private sector. It does not take into account the harm being done to the private sector in the process, the impact of this on economic growth, or the effect on job creation. The only point at which the concept of a revenue maximizing rate becomes useful is that higher rates of taxation become a lose-lose

proposition, with no winners. Both the government and the private sector are made worse off from higher rates.

But this does not mean that raising rates to a point below the revenue maximizing rate is necessarily good for the economy or for society. The government may be a winner, but the private economy is still a loser. The key question is one of a tradeoff: how much is the private sector made worse off to transfer each dollar of revenue to the public sector. To care only about getting the most revenue means that the government cares only about itself, and not about the public or the overall economy. This may be an appropriate calculation for a totalitarian state, but it certainly is not appropriate for a country such as America. The simple fact is that the *optimal or efficient rate of taxation is below, and possibly well below, the revenue maximizing rate.* Therefore, the capital gains tax rate needs to be set well below the 28 percent level.

But, as mentioned before, capital gains realizations depend not only on the capital gains tax rate but also on other rates as well. To see this, consider what happened after the increase in the top tax rate from 31 percent to 39.6 percent in 1993. Table 1 shows the percent changes between 1992 and 1994 of capital gains and non-capital gains income for with incomes above $200,000 and those below $200,000, in inflation-adjusted 1990 dollars. There were roughly the same numbers of taxpayers in each group in both years, so this is a like-for-like comparison. Adjusted Gross income rose for all taxpayers between the two years in question. This is consistent with the overall improvement in the economy. The IRS data behind the table is for real, inflation adjusted, income. So the overall 1.9 percent growth in AGI over two years reflects real income growth of approximately 1 percent per year. Note however that income grew much faster for taxpayers reporting income under $200,000 than for taxpayers reporting income over

$200,000. But, the distribution of that income growth, as reported on tax returns, was skewed toward people making under $200,000.

Table 1

Percent Change in Real Income 1992-1994 (in 1990 Constant Dollars)

				Schedule C Income	
Real Income Group	AGI	Cap Gains	Other	Proprietors	S-Corp & Part.
All Taxpayers	1.9%	14.1%	1.4%	2.1%	23.5%
Under $200,000	2.4%	9.4%	2.2%	5.0%	56.7%
Over $200,000	-1.3%	18.3%	-4.6%	-11.0%	16.0%

One possible explanation for this is that overall economic trends were leading to a more equal distribution of income. But careful analysis of income distribution trends throughout this period by the U.S. Census Bureau suggests the opposite was true. Overall income was becoming more skewed toward the top of the income distribution throughout the 1990s, and was particularly sharp in the early part of the decade. So, that thesis has to be rejected.

While the data is not consistent with census bureau information on overall income distribution trends, it is quite consistent with the thesis that there was a behavioral response by taxpayers to changes in tax rates. This is true both overall and given the decomposition of income into capital gains and non-capital gains sources. While all income groups experienced increases in their capital gains realizations during this period as the stock market revived, the percentage gains among higher income taxpayers was nearly twice that for taxpayers earning less than $200,000. So, when capital gains is excluded from income, the percent change in reported income shows an even greater disparity than for overall AGI. Taxpayers earning less than

$200,000 reported a 2.2 percent increase in their non-capital gains income while taxpayers earning over $200,000 reported a 4.6 percent decline in that income. Again, the former group did not see their marginal tax rates increase between the two years taxpayers while the latter group saw an increase of either 5 percentage points or 8.6 percentage points, depending on whether they were going into the 36 percent bracket or the 39.6 percent bracket.

It is also important to bear in mind why capital gains realizations rose so much for the higher income group even though the capital gains tax rate was unchanged. The data confirms the hypothesis that the realization of capital gains depends not only on the level of the capital gains tax rate, but also on the differential between the tax rate on capital gains and the rate on ordinary income. In 1992 the capital gains of 28% was similar to the ordinary income tax rate of 31% for taxpayers earning about $200,000 In 1994 the ordinary income tax rate was raised by 5 to 8.6 percentage points for these taxpayers. The effect of this was to encourage taxpayers to rearrange their portfolio of investments in ways that increased the realization of capital gains and reduced the realization of other forms of income. The reverse effect happened after the 1986 tax reform, when the differential between capital gains and ordinary income was eliminated after having been 30 percentage points.

Further evidence of a strong behavioral response by taxpayers is provided by what happened to Business and Professional Income between 1992 and 1994. This income classification is known as “Schedule C” income because it is reported on that schedule on Form 1040. This is income received by individual sole proprietors. The economy expanded between 1992 and 1994 as did the profitability of businesses rose across the board. The National Income and Product Accounts compiled by the Commerce Department reported that corporate profits surged 25 percent, from $496 billion to $628 billion. The same non-tax measure of profit growth

for the unincorporated business sector rose from $415 billion to $485 billion or 17 percent. The overall tax data also showed growth in the reporting of profits for the unincorporated business sector. The overall income of proprietorships grew 2.1 percent between 1992 while the profits reported by partnerships, LLCs and Subchapter S corporations expanded 23.5 percent. The combined profits of both forms of unincorporated business organization rose 9.9 percent, very much in line with the data compiled by the Commerce Department's Bureau of Economic Analysis that puts together the National Income and Product Accounts.

But when this data is decomposed into the same income classifications described above, the tax sensitivity becomes clear. The income of sole proprietorships rose $6 billion or 5 percent on tax returns with AGI under $200,000 but *fell* nearly $3 billion or 11 percent on tax returns with AGI over $200,000. Either one would have to conclude that well-to-do proprietors suddenly became incompetent and less profitable at a time when all other businesses suddenly got more profitable, or that the same kind of tax responsiveness that was exhibited to other, earlier, tax changes was still in play. As expected, the tax responsiveness at the partnership and Subchapter-S level was less than at the proprietorship level, but was still present. Upper income taxpayers reported a 16 percent rise in their income from these companies while tax returns with AGI under $200,000 saw a stunning 57 percent growth in such income. Again, it seems implausible that firms owned by higher income individuals were only one-third as successful as those of lower income individuals at raising profits during this time period.

To see the effect of this on tax revenue, we used the published data compiled by the Statistics of Income division of the Internal Revenue Service in its annual report on Individual Income Tax Returns. This data is unadjusted for inflation, and so differs somewhat from the previous analysis. We created a standard "counterfactual" to see what would have happened had

the tax rate not been increased, using the growth in income for taxpayers earning less than $200,000, and who did not see a tax rate increase, as a baseline.

Table 2 presents this data for the three major income groups most affected by the tax rate increases: taxpayers with AGI between $200,000 and $500,000, between $500,000 and $1,000,000 and over $1,000,000. The first column shows the amount of non-capital gains taxable income that would be predicted for each group using the counterfactual analysis. The level of non-capital gains income for each group in 1992 was increased by 6.3 percent, the per-return increase in taxable income for taxpayers not affected by the tax rate changes to get the counterfactual level for 1994. The second column shows the actual non-capital gains taxable reported for each group in 1994. The difference between these two columns represents the estimated behavioral response of taxpayers (in terms of taxable income) to the higher tax rates they faced. This calculation suggests that non-capital gains taxable income was about 8.1 percent, or $31.3 billion lower than it would have been without the tax rate hike. The table then extends this analysis of the shortfall in taxable income to tax revenue. The third column presents the Internal Revenue Service's computation of the taxable income that was taxed at the new 36 and 39.6 percent rates. The fourth column simply extends this analysis to compute the *extra* revenue that was collected by taxing this income at 36 percent and 39.6 percent instead of at the old 31 percent rate. As the figure shows, the 36 percent bracket collected an additional $4.2 billion compared to what would have been collected on that income had the top rate remained at 31 percent. The 39.6 percent tax bracket produced an extra $14.17 billion compared to having had that income taxed at 31 percent.

Figure 2
Expected vs Actual Non-Capital Gains Taxable Income in 1994

Income Group	Expected Non-CG Income	Actual Non-CG Income	Taxable Income at 36%	Taxable Income at 39.6%		Extra Tax at 36%	Extra Tax at 39.6%	Foregone 31% Tax at Lower Tax Rate	Revenue Raised
$200k-$500k	179.2	168.9	61.9	21.9		3.1	1.9	3.2	1.8
$500k-$1,000k	77.9	75.1	15.2	45.2		0.8	3.6	0.9	3.5
Over 1 million	129.1	110.8	7.1	100.7		0.4	8.7	5.7	3.4
Total	**386.1**	**354.8**	**84.1**	**164.8**		**4.2**	**14.2**	**9.7**	**8.7**

But those numbers only reflect the higher rate on income that was realized despite the rate being higher. The behavioral response of taxpayers lowered the amount of income that was reported and the IRS would have collected taxes on that revenue at a 31 percent rate. This calculation is provided in the final column. The difference between the counterfactual level of non-capital gains taxable income and the actual level of non-capital gains income is multiplied by the 31 percent tax rate to produce this measure of foregone revenue. By this calculation, the true *net* increase in revenue collected by the IRS was only $8.66 billion, the difference between the extra revenue collected at the higher rate and the foregone revenue that would have been collected at the lower rate on the income that was not produced. On net therefore, the total effect of the higher rates was to add only $8.66 billion to federal coffers, only about 38 percent of what was originally estimated, leaving the behavioral response of taxpayers to offset roughly 60 percent of the static revenue gain from higher rates. Some supply-siders might be disappointed by these figures. It does confirm that the tax rate hikes of 1993 did produce more revenue for the federal government. The more important point is that the dislocating effects of the higher rates were large relative to the extra revenue collected.

Moreover, from the point of view of making America the best country in the world in which to invest, start a business, and create jobs, the adverse effects of higher tax rates is greatest in the entrepreneurial and small business sectors. The revenue maximizing tax rate is not a good target for tax policy to shoot at. Instead, it is the rate at which further tax hikes are totally counterproductive, making both the government and the taxpayer worse off. The key question to decide for public policy is *how much* worse off is it prudent to make the private sector in order to improve public finances. As this analysis makes clear, as taxes approach the 40 percent rate, the

extra burden high rates put on the private sector becomes serious enough to be taken into proper policy analysis. That is true regardless what the capital gains tax rate might happen to be.

Capital Gains, Ordinary Rates, and Economic Distortions

The current tax structure is based on measuring "income", as opposed to broader notions such as revenue or cash flow. It has emerged in an ad hoc fashion, beginning with the taxation of corporate income and then being augmented with personal income taxation. As a result, there are multiple definitions of "income" in the law. Accounting Standards require one measure. The corporate income tax another, the personal income tax yet another and the payroll tax still another. Interestingly, capital gains is not even considered income on the National Income and Product Accounts.

As long as we have an income-based tax system, we will continue to have distortions and unintended adverse incentives created as we try and work around these issues. The fact that the distortions are inevitable does not mean that we shouldn't try to minimize them. Let me suggest three basic rules related to capital gains and the general taxation of capital income and entrepreneurship that should be foremost in minimizing these distortions. In all cases I will presume that we share the common objective of getting America out of its current economic and fiscal mess and that we seek a tax policy that helps to make our country the best place in the world in which to invest, start a business, and create jobs.

First, rates need to be moderate. The current effective tax rate on capital income and entrepreneurship is in the 38 to 44 percent range. That is internationally uncompetitive and raising rates from that level can only be viewed as counterproductive.

Second, capital taxation should be as neutral as possible with regard to financial decisions. The current heavy taxation of equity capital and generous taxation of debt helped

create an overleveraged economy for which we are now paying a heavy price. It also has tended to distort and overly complicate the tax treatment of capital gains since the gains implicit in debt financed capital get doubly preferred treatment. Limiting the favorable tax treatment of debt relative to equity will produce a better tax system while also providing revenue gains that can be used to pay for lower and better designed taxation of equity.

Third, the differences between the ordinary and capital gains tax rates should probably be reduced. As noted above, the incentives provided for both capital formation and entrepreneurship depend crucially on the ordinary rate as well as the capital gains rate. Although there are many competing cross-currents in these issues, on balance, it seems that low-to-moderate rates of taxation of both types of income would be the best approach.

Thank you.