1. Capital Gains Rates and Economic Growth

There has been much discussion in the Finance Committee and the Ways & Means Committee about tax reform – both the need for it and what it should look like.

I believe a 21st century tax code must advance America’s security in the global economy. To do this, the code must promote jobs from broad-based growth, competitiveness, innovation, and opportunity.

- Would relatively lower or higher tax rates on capital gains advance those goals?

It is not clear to me whether either relatively lower rates or higher rates on capital gains would advance those goals. I personally believe that the current tax rates on capital gains are too low because I am not comfortable with the distributional consequences of the current rate structure. If Congress moves toward comprehensive tax reform lowering the top rate on ordinary income, I believe it would be advisable to increase the rate of tax on capital gains to compensate for the ordinary income rate cut for upper income taxpayers, but that is primarily because I believe it would be important to maintain a reasonably progressive income tax system and not because I have any particular insights as to the impact of a capital gain rate change on growth, competitiveness, innovation, and opportunity.

While, as noted, I claim no special expertise in regard to the economic consequences of changes in the rate of tax imposed on capital gains, I am skeptical about claims that preferential treatment for investment income has a positive economic impact. Absent clear and convincing evidence to the contrary, I am very reluctant to conclude that individuals earning income from investments contribute more to the economy than individuals earning ordinary income.

In 1996, the top, long term capital gains rate was 28%. Between 1996 and 2002, it was 20%. Since then it has been 15%.
What information do we have that these rate changes changed how investors made investment decisions? How did those rate changes affect economic growth and job creation?

As far as I know, those capital gains tax rate changes had no material impact on the aggregate level of investments in, or performance of, the U.S. economy or job creation. I am not aware that there are empirical studies enjoying consensus academic support that demonstrate any meaningful link between the changes to the individual U.S. capital gains tax rate over that period and the performance of the U.S. or global economy. The increase in the U.S. capital gains tax rates in the 1986 Act did not appear to have an adverse impact on the performance of the economy or on investment decisions apart from curtailing certain investment activities funded through tax shelter syndications. Between 1986 and 2001, the economy performed relatively well, but factors such as the revolution in computing almost certainly had much more impact on investment activity and economic growth than the capital gains tax rate. It escapes me how one could disaggregate the effect of the reduction in the rate of tax on capital gains and in the increase in the top effective rate for ordinary income that occurred in the early 1990’s to claim to know with any confidence which had the dominant effect, if any, on the performance of the economy. Over the past 10 years, the economic performance of the United States, and of the world, has been suboptimal, but I doubt seriously that the low rate of tax on capital gain and dividend income of individual U.S. taxpayers had much to do with the financial collapse beginning in 2007 and its aftermath that continues to affect economic performance today.

2. Capital Gains Taxes and Distributionally Neutral Reform?

In the Tax Reform Act of 1986, we raised taxes on capital gains in order to make sure that we maintained the progressivity of the tax code. We concluded that there was no way to maintain progressivity and cut the top marginal rate to 28 percent without raising taxes on investment income. We also raised taxes on corporations.

- How far can we lower top rates and maintain the progressivity of the tax code without raising taxes on capital gains?

Without raising taxes from the corporate sector or increasing the rate of tax on capital gains and dividend income, I am very doubtful that a significant reduction in the top rate on ordinary income could be made without reducing the progressivity of the individual income tax. It is very hard, however, to have a good sense of maximum cut that could be made to the top ordinary income tax rate with access to the revenue estimating models.

- How else can we make sure that we maintain the progressivity of the tax code as part of tax reform?

Elimination of the preferential rate for dividend income would be one possible change that might be considered as an offset to a cut in the top ordinary income tax rate. Consideration might also be given to placing per-individual dollar limits on the maximum amounts of retirement income and incentive compensation that can qualify for tax preferred treatment. While, as a self-employed taxpayer, I enjoy a deduction for one half
of my medical insurance premiums, it would be a rationalization of the tax system to eliminate that deduction in partial compensation for a rate reduction regardless of whether changes are made to the taxation of employer provided medical care. It might also make sense to consider the imputation of the value of employer-provided medical care to employees with compensation over some level. Limitation on the deduction for state and local taxes of upper-income taxpayers should also be given consideration, but I personally think that the analytical basis for limiting the deduction for state and local income taxes is not all that strong as a matter of tax policy.

- Recent CRS reports have found that changes in capital gains and dividends were the largest contributor to the increase in income inequality in recent decades. Should that conclusion affect how we move forward on tax reform?

Yes. I believe that it is extremely important that tax reform not be structured in a manner that exacerbates the current levels of income inequality.

3. The Lock-In Effect of Capital Gains Taxes

One purpose of having a lower rate for long-term capital gains is to reward investors for investing long-term. However, some economists say that taxing capital gains on realization is inefficient because it encourages investors to hold assets for too long. This is called the “lock-in” effect. The “lock-in” effect is exacerbated by the fact that the tax rate on long-term capital gains is lower than the tax rate on short-term capital gains.

a) Is “lock-in” a drag on economic growth?

Increasing the rate of tax on long-term capital gain income would increase the lock-in effect, and thus it is one consideration to take into account in deciding what treatment to provide for capital gains in comprehensive tax reform. While it seems logical that the lock-in effect would, considered in isolation, be detrimental, it is not at all clear that the lock-in effect has a material adverse macroeconomic impact. Any tax provision on any type of income will have an impact on economic behavior, as will reductions in spending or spending without raising revenues to pay for the spending, so in assessing the ultimate impact of taking steps to reduce the lock-in effect would be a very complex, if not impossible, analysis to undertake.

For example, eliminating the tax on both long and short term capital gain income would eliminate the lock-in effect. It would, however, induce an enormous amount of arbitrage activity, significantly reduce the progressivity of the tax system, and require offsetting tax increases on other types of income, reductions in spending, or increases in the deficit, each with a potentially significant adverse economic effect, etc. My judgment is that the detrimental impact of these other collateral consequences of the attempt to ameliorate the lock-in effect would likely greatly outweigh any advantage gained.
b) Is encouraging longer-term investment an important consideration in setting capital gains tax rates?

I doubt seriously that providing a preferential tax rate for long-term capital gains of individual U.S. taxpayers has a significant positive influence on the aggregate amount of investment in long-lived plant and equipment in the United States.

c) If both are important, how can we square these two goals?

Accept the fact that economists and editorial writers know far less about the ultimate macroeconomic impact of changes to the tax system than they affect to know. With respect, I do not believe that Congress should attempt to optimize aggregate economic performance by codifying permanent preferential tax treatment for particular activities or categories of income.

4. How Much Capital Gains Income is Double Taxed?

Under our current tax code, income from investments in corporate stock is taxed twice: once at the entity level, and once when that income is passed on to investors, either through dividends or through capital gains. However, most capital gains are not from gains in corporate stock.

a) How concerned should we be about this double taxation?

It is very difficult to know how much double taxation of income from investments in corporate stock there is under the current system. Certainly, in many cases, corporate income is taxed at a combined individual and corporate effective tax rate in excess of the top ordinary income tax rate. In other cases, however, the combined effective rate of tax is lower. One can see that the aggregate amount of U.S. corporate income tax actually paid by corporations is relatively low as compared to the aggregate amount of income reported to shareholders. The effective rate of tax on gains on corporate stock is also reduced by the fact that the gains generally are not taxed until the stock is disposed of. I do not know whether there have been any careful academic studies undertaken to determine the net effect of the various favorable and unfavorable tax consequences of operating in corporate form or whether such income is taxed at a higher aggregate effective rate of U.S. tax than compensation income.

b) Should we attempt to remedy double taxation of capital gains? If so, how?

It is worth giving serious consideration to the issue. Some corporate/shareholder integration regime that provides relief for actual double taxation would be the preferable means of doing so. If it is determined that the steps taken to integrate corporate/shareholder taxation would cost significant revenue, that must be weighed against the benefits from providing such relief.
c) Should Congress consider a different capital gains rate for the gain on the sale of C corporation stock than for other capital assets?

I do not believe that a preferential rate for gains on corporate stock is an effective or sensible means of addressing the adverse consequences of the double tax on corporate income.

5. Does the Deferral Benefit Remedy the Double Tax?

Unlike businesses organized as partnerships or other “pass-throughs”, income from corporations is taxed twice. At the same time, corporate investors get to defer paying tax on their capital gains until those gains are realized. This is a significant tax benefit.

• Does the benefit of deferral outweigh the effect of the double tax? Is there a bias towards pass-through entities, or is the tax treatment of pass-throughs and corporations roughly equal?

I suspect that the tax treatment of pass-through entities is preferable to the tax treatment of corporations.

• If there is a bias towards passthrough entities, do you think this is a major problem?

Ideally, the tax treatment of business and investment activity would not depend upon the legal form in which the activities are undertaken. Having said that, it is not clear to me that the different treatment of pass-through entities and corporations is a major problem.

6. Reduced Arbitrage

Would the efforts of taxpayers or their attorneys to reclassify ordinary income as capital gains be eliminated if the rate differential were eliminated?

The efforts would not be eliminated because of the limitation on the deduction of capital losses and the limits on the deduction of investment interest would still motivate a certain amount of arbitrage activity, but they would be very substantially reduced.

Questions from Ranking Member Hatch

1. Under present law, corporations do not receive preferential tax treatment for capital gains. It seems that this would create a “lock-in” effect for corporations as well as possibly imposing an additional level of tax on corporate income. Should corporations also receive preferential tax treatment for capital gains?
Any regime that taxes gains on a realization basis rather than on an economic accrual basis, as is necessary as a practical matter, will create a lock-in effect, and the higher the rate the larger the lock-in effect. I believe that an attempt to deal with this issue by reintroducing a preferential rate of tax for corporate capital gains would be a very inefficient response to this issue and would be a severe step backwards in tax policy. A much better approach to my mind would be to reduce marginal rates on all corporate income, whether ordinary or capital, with the revenue loss offset with broadening the corporate tax base so that the effective rate of tax on corporate income was closer to the reduced nominal corporate income tax rate.

2. As part of Treasury I released in 1984, Treasury proposed a dividends paid deduction to integrate the individual and corporate level taxes. As you know, corporate integration was not enacted as part of the Tax Reform Act of 1986. If, as part of comprehensive tax reform, corporate integration was enacted, maybe a dividends paid deduction, a dividend exclusion or a shareholder credit, how would that affect how capital gains from the sale of stock would be taxed?

Somewhat surprisingly, there was relatively little push from the corporate community at that time for movement toward corporate/shareholder integration. Given that lukewarm response, the Administration and Congress concluded that the distributional impact, revenue cost, and complexity of integration was not justified under the circumstances. Given the erosion of the corporate tax basis since that time, however, the relative cost of corporate/shareholder integration may not be an insuperable burden at this time.

There are technical difference between the various approaches to corporate/shareholder integration, and no method is clearly preferable to the others. I do think that the relief, whichever form it takes, should be limited to situations in which the corporate income would otherwise be subject to U.S. tax at both the corporate and the shareholder level, perhaps by following the model of certain European systems that provide a nonrefundable shareholder credit with a compensatory corporate level tax for distribution that are derived from earnings that have not effectively been subject to tax at the corporate level.

Separate and apart from corporate/shareholder integration for portfolio shareholders in publicly-traded corporations, serious consideration should be given to mandatory integration of corporate/shareholder income for shareholders in closely-held corporations and direct investors with stock interests of more than, say, 10% of the stock of a corporation. The complexities of integration are considerably more manageable in regard to direct investors, and I am doubtful that the current regime of nominal double taxation in such situations raises any particular revenue as to the revenue that would be raised by a pass-through regime. In fact, since taxpayers can generally use self-help to avoid any effective double tax in such situations by operating through a limited liability company and electing partnership treatment under the check-the-box regulations, it is doubtful that the nominal double tax is materially worse for many non-electing closely-held corporations.