Questions for the Record

UNITED STATES SENATE
COMMITTEE ON FINANCE
UNITED STATES HOUSE
WAYS AND MEANS COMMITTEE

Senate Finance Committee Hearing
"Tax Reform and the Tax Treatment of Capital Gains"
September 20, 2012
Questions for Dr. Lawrence B. Lindsey

Questions from Chairman Baucus

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?

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?

Answer: A tax code which is designed to promote jobs from broad-based growth, competitiveness, innovation, and opportunity should not consider the capital gains tax rate in isolation. The tax rates on ordinary income and on corporate income also need to be considered. Obviously, the lower the capital gains rate the better, but this needs to be balanced against these other rates and against the government's need for revenue. Although the issue is complex, on balance I believe that bringing the ordinary income rate down and in line with the capital gains tax rate would be the right mix for a revenue and distributionally neutral tax change.

The capital gain rate reduction of the late 1990s clearly moved investors toward a greater reliance on capital gains as a preferred form of return and was a major contributor to the rise in equity prices in the late 1990s. In concert with an overly loose monetary policy, this became too much of a good thing, creating a bubble, which ultimately popped. The 2002 cuts in dividend and capital gains taxes were designed to restore some growth to equity prices and they succeeded in doing so.

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?

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

- 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?

A: On balance it would be difficult to lower the top rate of income taxation into the mid to upper 20 percent range without raising the capital gains rate if one wished to preserve revenue and distributional neutrality. On the other hand, one could easily design revenue and distributionally neutral tax codes with the top rate in the 25-28 percent range if the capital gains and ordinary rates were identical and other changes were made as well to broaden the base.

I do not concur that the changes in capital gains and dividend taxation were the largest contributor to income inequality. First and foremost I would ascribe that to the low interest rate environment designed to raise asset prices. Second I would point to the enhanced returns to education. In general tax changes have a relatively second order effect on the distribution of income in a society.

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?

b) Is encouraging longer-term investment an important consideration in setting capital gains tax rates?

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

A: The lock-in effect is well demonstrated in the tax literature. It is an indirect drag on economic growth because it inhibits market participants from moving funds from one investment to another – thus slowing the movement of capital to those projects that yield the highest return. I am not certain that taxes are the best way to promote “longer term” investment. We have a political and regulatory process with a decided short term focus. Although our public equity markets have only a slightly longer term perspective than Washington, there are many financial market arrangements that do have a longer term focus. Unfortunately these long term investors and the markets in which they operate are being suppressed by current economic policies – monetary, fiscal, and regulatory.

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?

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

c) Should Congress consider a different capital gains rate for the gain on the sale of C corporation stock than for other capital assets?

A: Double taxation is an inherent byproduct of capital gains taxation. When an income producing entity is taxed on its income and then the owners of that entity are taxed again, double taxation cannot be avoided. One should note that the National Income and Product Accounts do not even consider capital gains as “income” for just that reason – the “income” was generated and taxed at the entity level.

I believe that double taxation should be avoided because it creates a highly distortive environment for economic decision making. But, as I said before the Committee, the best way to do this is to move from income based taxation toward cash flow based taxation imposed exclusively at the entity level and not at the individual level.

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?

- If there is a bias towards pass-through entities, do you think this is a major problem?

A: The "deferral benefit" argument is not a valid one. It is based on the presumption that by leaving funds invested in the company and not realizing the gain that the income on those assets is deferred. In fact, the income continues to be taxed at the corporate level (in the case of stock) as long as the asset is held.

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?

A: On balance, I support the equalization of the ordinary and capital gains rates at a rate in the mid to upper 20 percent range in part for this very reason

7. Reduce Bias for Debt vs. Equity

Dr. Lindsey, in your testimony you say that capital taxation should be as neutral as possible with regard to financial decisions. You also say that the current heavy taxation of equity and the generous taxation of debt helped create an overleveraged economy for which we are now paying a heavy price. You indicate that limiting the favorable tax treatment of debt relative to equity would allow the revenue that would be raised to pay for lower tax rates on equity.

- Can you clarify how you would structure limiting the favorable treatment of debt? Would you propose a straight limitation on interest deductions or use some other mechanism?

- Would you suggest using the revenue raised to help lower corporate tax rates, capital gains rates, or both?

A: As a first best alternative I would recommend moving away from income based taxation and toward cash-flow based taxation. A VAT would be one example of this. In that model it would not matter *how* the income of a firm was allocated – between labor and capital or between debt and equity. These arbitrary distinctions are the reason why our tax code is so needlessly complicated.

However, short of that, if one is interested in taxing capital fairly there is no reason why interest should be treated any differently than dividends as a means of providing capital for firms. Ultimately, eliminating the deduction for interest – or alternatively eliminating the taxation at the corporate level for dividends paid – would accomplish this goal. If this latter approach were used then there would be no need for a separate capital gains rate to be used. If, unfortunately, the Congress were to simply do the former, then the total taxation of capital would rise quite sharply. Obviously a reduction or even the elimination of taxation of interest and dividends and the personal level would be a remedy to this.

Questions from Ranking Member Hatch

1. Much of the literature on the preferential tax treatment of capital gains views capital gains as simply one type of income that should be taxed the same as any other type of income. But our current tax system is not a pure income tax system – it is really a hybrid income and consumption tax system. For example, a large percentage of all savings is held in tax-preferred accounts. So if we look at our tax system from the lens of a consumption tax, would preferential tax treatment of capital gains be consistent with such a system. In fact, should preferential tax treatment be extended to all income from capital, which would be taxed at a zero rate?

   A: Under a consumption tax system there would be no taxation of capital gains or any proceeds from the sale of one asset if that were used to purchase another asset. The other "asset" might even be a cash deposit in an investment fund.

2. 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?

   A: Special treatment of capital gains for corporations is a very complex subject. The reason is that it would be hard to differentiate between assets purchased in the ordinary course of doing business from those held for investment purposes – for which the capital gains rate might apply. This complexity is, in fact, one of the many reasons why the entire income based tax system is so needlessly complicated.