Capital Gains and the Revenue Estimation Process

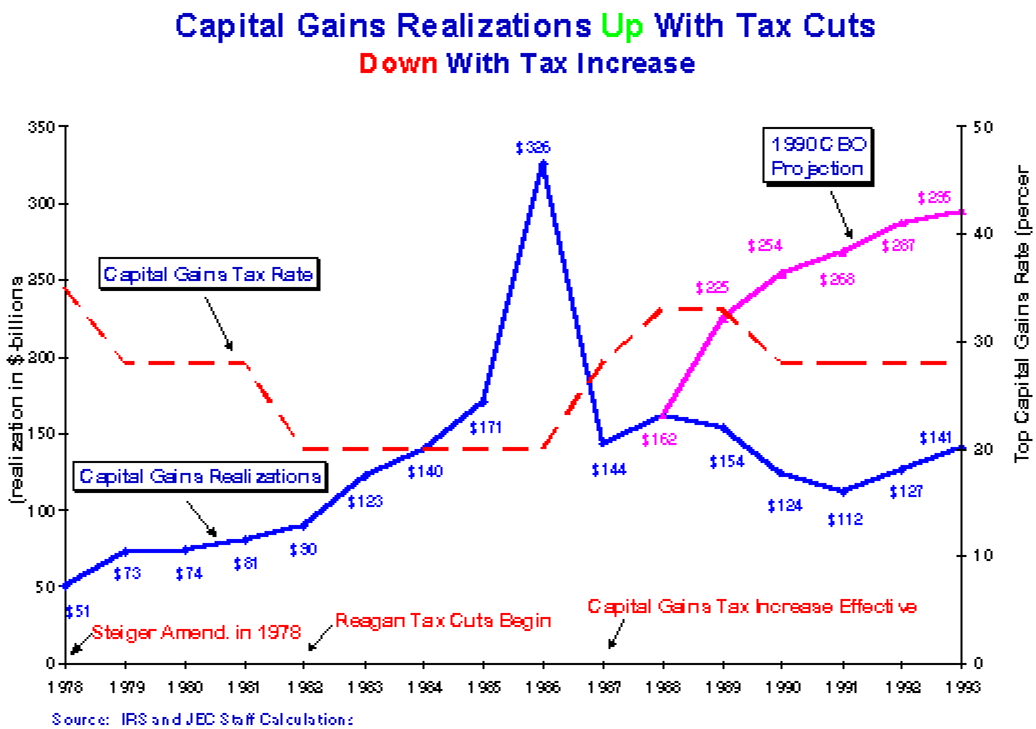
Over the last decade some of the most controversial issues of tax policy have revolved around the treatment of capital gains. These issues include proposed changes in scoring capital gains tax rate cuts, the impact of capital gains rate changes on federal revenues, and related issues regarding the effect of changing capital gains rates on behavior and economic activity. A review of estimation problems in the prior capital gains debate provides an interesting perspective from which to view the revenue estimation process with respect to capital gains.

CBO's Capital Gains Fiasco

In 1990, the then-Democratic controlled Congressional Budget Office (CBO) made a projection of capital gains realizations for the years 1989-1995. This projection was used for constructing the CBO revenue baseline and was also provided to the Joint Committee on Taxation (JCT) as the starting point for estimating the revenue effects of capital gains tax cuts. Early in 1991, JEC Republicans examined these CBO projections and concluded that they were grossly erroneous. The first public disclosure of these huge errors came in a study issued by the ranking Republican JEC member and later republished twice in the tax specialist publication Tax Notes.[1]

A follow up JEC investigation in 1992 using more recent tax data found that the CBO estimates were off by over 100 percent in most cases.[2]

The figure below shows the projected CBO realizations relative to actual realizations. According to newly released IRS data, the amount of the error grew to a level of $154 billion by 1993.



In the 1994 JEC annual report, it was estimated that the annual revenue losses from the CBO mistake had grown to about $40 billion. Over the years 1989-93 capital gains realizations had been overstated by nearly 700 billion dollars, implying a revenue loss of about $150 billion over this period. After a transition period following the 40 percent increase in the capital gains tax rate effective in 1987, real capital gains revenues stabilized at a level lower than that of 1985, before the announcements effects of the tax change became apparent. In other words, the higher capital gains tax rate has produced less annual real revenue in the 1990-1993 time period than under the lower rate of 1985, despite a significantly larger economy.

In other words, the official scoring of the capital gains tax cut, and its portrayal as a huge tax benefit to the rich, was derived from an analysis of CBO baseline realizations that were over 100 percent inaccurate. Moreover, despite the intensely partisan use of this misinformation, and the eventual knowledge by the estimators involved that this was wrong, CBO and others failed to correct the record and acknowledge the mistake.

These mistakes have been serious enough to cause problems even in the projection of the revenue baseline with no policy changes assumed. In 1991, a Republican JEC report warned[3] in publicly disclosing the capital gains baseline problem for the first time, that large revenue losses in coming years would result. Then-CBO director Robert Reischauer flatly denied this, acknowledging the mistake but contending it had been fixed; however, CBO later was forced to make huge "technical reestimates," i.e. corrections, to its revenue projections.[4]

Conclusion

Three main conclusions follow from the data. First, capital gains realizations and revenues are highly responsive to changes in the tax rate. When this sensitivity is ignored or understated by official revenue analysis, huge errors have resulted, as in the previous capital gains debate. Second, there is no evidence from the actual historical data demonstrating that capital gains tax rate reduction would reduce revenues. Third, on the basis of the historical data on capital gains realizations and revenues, it would be reasonable to expect higher revenues to follow a reduction of the capital gains tax rate.

Official analysis of capital gains tax legislation has experienced a number of problems in the past, leading to extremely inaccurate results. Clearly economic and behavioral factors have not been adequately accounted for in evaluation of previous capital gains legislation. Instead of reliance on artificially precise revenue and distribution estimates which are unlikely to be accurate and assume no macroeconomic effects, it would make more sense to provide a range of revenue estimates based on a variety of reasonable economic and behavioral assumptions.

Christopher Frenze
Chief Economist to the Vice-Chairman

Endnotes

1. Armey, Richard, Ph.D., and JEC Republican Staff, Distorting the Data Base: CBO and the Politics of Income Redistribution, Washington, DC, 1991, and Tax Notes, May 20, 1991.

2. JEC Republican staff, Massive Errors in Capital Gains Projections, Washington DC, 1992.

3. Armey, op.cit.

4. The Washington Times, May 1, 1991.