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Joint Economic Committee Staff Report
Office of the Chairman, U.S. Senator Connie Mack

EXECUTIVE SUMMARY

- Federal spending as a share of the economy has fallen during the 1990s, primarily because of positive demographic factors and reductions in defense spending in the aftermath of the Cold War. At the same time, federal taxes as a share of the economy are at an all-time peacetime high.

- Demographic factors underlie the current highly favorable budgetary picture. The baby boomers are in their prime earning years. Their high incomes generate substantial tax revenues, while their demands on existing government programs are relatively low.

- The current debate between President Clinton and the Congress is mainly about spending, rather than taxes or debt retirement. The President wants to use the $1 trillion of on-budget surpluses projected for the next ten years to increase spending. The Congress would use the money to provide tax relief. There is little difference between the two with regard to the retirement of debt.

- It is important to distinguish between the optimal tax rate and the revenue-maximizing rate. As tax rates increase toward the revenue-maximizing point, they distort prices and eliminate so much productive activity that they raise little additional revenue. Thus, the revenue-maximizing rate is very bad for the economy. The optimal tax rate—the rate that is best for the economy—will always be substantially lower than the revenue-maximizing rate.

- A tax system should be consistent with both fairness and economic growth. The following would improve the current system: (a) reducing or eliminating the double taxation of corporate income, (b) eliminating the "earnings test" imposed on Social Security recipients and the double taxation of Social Security benefits, (c) reducing or eliminating the estate and gift tax, (d) eliminating the marriage penalty, (e) making health insurance premiums for individuals fully tax deductible, and (f) indexing capital gains for inflation or eliminating the capital gains tax entirely.

CONTENTS

FOREWORD

When Adam Smith wrote *The Wealth of Nations* in 1776, he sought to explain why some nations prospered while others stagnated. Just as in Smith's time, growth and prosperity are the central issues of our day. After all, improvements in our standard of living are dependent on sustained growth. This series reflects the importance of economic growth.

Building on the initial volume of the series, this report focuses on the budget and the structure of taxation. During the decade immediately ahead, the "baby boom" generation will be in its peak earning years. The high earnings of this huge proportion of the population will generate huge revenues for the government. The central political issue—one that will return in various forms again and again—will be what to do with the revenues. Many will want to use them to enlarge the size and scope of government. Others will want to return them to the taxpayer and use them to retire debt.

The outcome of the debate will determine the future health of the American economy. If we take on new obligations, the size of government in the United States will look much like that of Europe when the baby boomers retire. So, too, will our growth rate. While it will be tempting to take on new obligations, they will lead to stagnation. Section 1 focuses on this topic. Section 2 focuses on taxation and considers five of the least defensible features of the current tax structure. Section 3 analyzes the unique nature of capital gains and explains why this influences how they should be taxed. Section 4 summarizes the principal policy recommendations for increasing economic growth and prosperity. I hope that you will find this report both interesting and informative.

Senator Connie Mack, Chairman
Joint Economic Committee

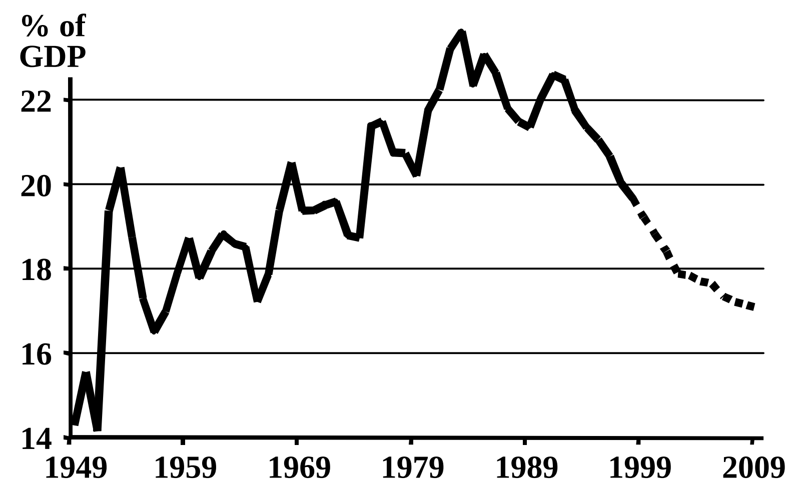
1. THE FEDERAL BUDGET

From 1961 to 1997, the federal government ran a budget deficit every year except 1969. The era of persistent deficits gave way to surpluses starting in 1998. If there are no major changes in fiscal policy, budget surpluses are projected throughout the next decade even if the average growth rate of real GDP is only 2.3 percent to 2.5 percent, which is lower than the current rate. If the growth of the economy is stronger, the surpluses will be exceedingly large, particularly if there is no major reduction in taxes.[1]

Both more rapid growth of revenue and slower growth of spending have helped bring about the fiscal turnaround of the 1990s. Pushed along by favorable demographics—the increasing share of the population in their prime-age earning years—income has grown rapidly during the last five years. With progressive taxation, federal tax revenue rises as a share of the economy concurrently with growth in real income. During the current expansion, it has risen to a peacetime high of 20.6 percent of GDP. In the aftermath of the Cold War, certain expenditures, particularly those for defense, have fallen as a share of the economy. In 1997, the Congress and the President agreed to limits on discretionary spending (roughly speaking, the portion of the federal budget that does not consist of income-transfer programs such as Social Security and Medicare). At present the limits are due to expire after fiscal 2002. If they are adjusted for inflation after 2002, government spending is projected to fall to 17.1

[1]During the 1960s and 1970s, the fiscal policy ideas of John Maynard Keynes and his followers exerted a major impact. Keynesians believed that fiscal policy exerted a strong effect on total demand and that budget deficits could be used to stimulate output and employment. During the 1970s, expectations and the crowding out of private spending as the result of higher interest rates accompanying budget deficits were integrated more fully into macroeconomics. As economists became more aware of the offsetting effects accompanying budget deficits (and surpluses), the popularity of the deficits and the Keynesian view waned. The almost total absence of criticisms of the large budget surpluses projected for the upcoming decade is a reflection of the change in views among economists concerning the potency of fiscal policy.

Figure 1.1: Federal Spending as a Share of GDP*



Sources: Haver Analytics; Congressional Budget Office, *The Economic and Budget Outlook: An Update* (July 1999); *Budget of the United States Government, F.Y. 2000, Historical Tables.*

Notes: *Data are nominal figures for fiscal years. Federal spending is outlays. Years beyond 1998 are Congressional Budget Office projections.

percent of GDP by 2009. That would be the lowest level since the mid 1950s, when Dwight Eisenhower was president.

I. Federal Spending Over the Last Two Decades

As Figure 1.1 shows, there was an upward trend in federal spending as a share of GDP from 1950 to 1983. In 1983, federal spending reached 23.6 percent of GDP, its highest level since World War II. Much of the growth of federal spending in the early 1980s resulted from the Reagan Administration's buildup of the U.S. military. Defense spending rose from 5.2 percent of GDP in 1981, the last budget of the Carter Administration, to 6.1 percent in 1983. When the Reagan Administration took office, the tide of Communism was at its high-water mark. Soviet troops were occupying Afghanistan, and Soviet-supported regimes in Nicaragua, Angola, and Mozambique threatened neighboring countries. In Europe, France and Italy had large, powerful Communist parties; Soviet propaganda had briefly threatened the stability of the North Atlantic Treaty Organization (NATO); and the suppression of Poland's Solidarity movement made it seem that Communism's grip on Eastern Europe was unyielding. The Reagan Administration's response was decisive in turning the tide of the Cold War, ending the threat of Soviet Communism and making it possible to reduce defense spending as a share of the economy in the 1990s.[2]

II. Federal Taxes Over the Last Two Decades

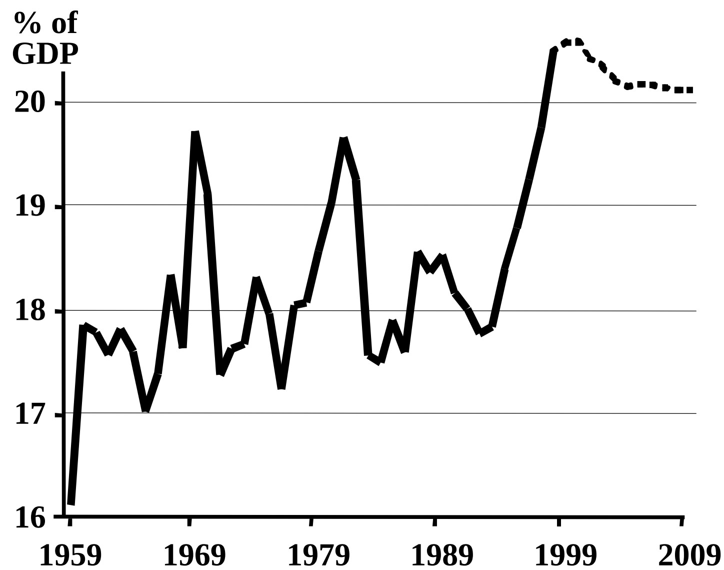
When President Reagan and the 97th Congress took office, federal taxes were 19.7 percent of GDP, equalling the highest level since World War II.[3] Marginal tax rates as high as 70 percent and expansionary monetary policy combined to cause stagflation. President Reagan's tax cuts reduced marginal tax rates by 25 percent across the board. At a time when many in the West were losing confidence in capitalism, the Reagan tax cuts reaffirmed faith in the creative powers of a free people in a free economy. Lower tax rates restored incentives to work and invest, liberating the economy. Once fully implemented, the tax cuts reduced federal receipts to 17.5 percent of GDP, 2.2 percentage points lower than in 1981. Real GDP grew rapidly following the 1982 recession.

Figure 1.2 presents data on tax revenues as a share of the economy. During the last 40 years, taxes have generally ranged from 16.1 to 19.7 percent of GDP, usually falling below 18.5 percent. Prior to the current period, there were two peaks: 1969, due to the Vietnam War surcharges on income taxes; and 1981, just before the

[2]The explosion in nondefense spending, which began in the 1970s, was not so easily contained. Falling inflation also contributed to high levels of federal spending in the 1980s. As inflation fell from 13.5 percent in 1980 to 3.2 percent in 1983, spending was often based on projections of inflation that proved too high.

[3]This matched the 1969 level, under the Johnson Administration's last budget.

Figure 1.2: Federal Receipts as a Share of GDP*

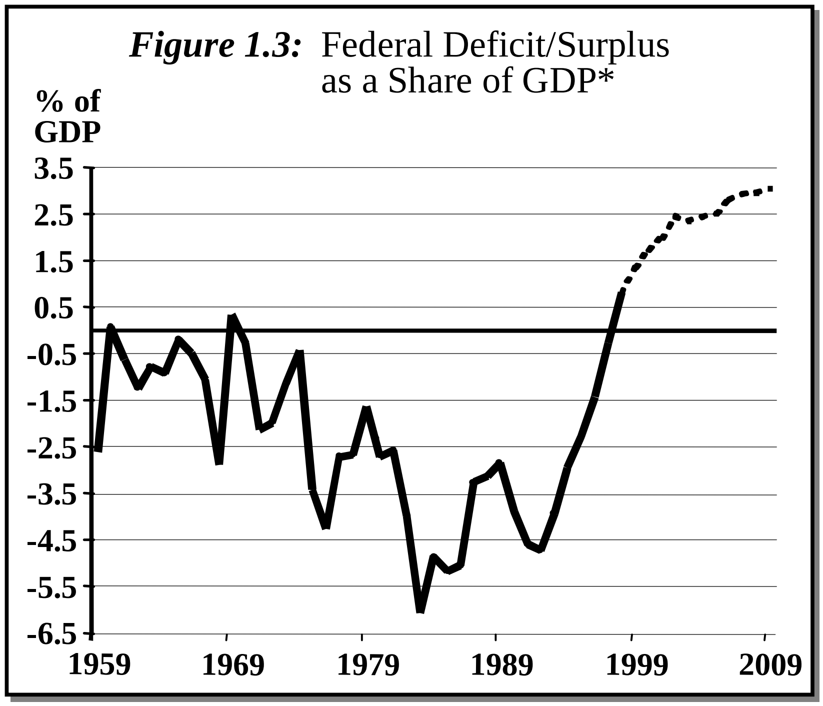


Sources: Haver Analytics; Congressional Budget Office, *The Economic and Budget Outlook: An Update* (July 1999); *Budget of the United States Government, F.Y. 2000, Historical Tables.*

Notes: *Data are nominal figures for fiscal years. Federal spending is outlays. Years beyond 1998 are Congressional Budget Office projections.

Reagan tax cuts. Within two years of each peak, the fiscal pendulum swung back and taxes were reduced by over 2 percentage points of GDP.

Under the Clinton Administration, taxes as a share of GDP have climbed each year, from 18.4 percent of GDP in 1994 (the year of the first Clinton budget) to the current peacetime record of 20.6 percent. This is partly a result of President Clinton's 1993 package of tax increases, which raised the top marginal rate from 31 percent to 39.6 percent. It is also a consequence of two other factors. First, as economic growth enables taxpayers in general to earn more, they are pushed into higher tax brackets ("real bracket creep"). Second,



Sources: Haver Analytics; Congressional Budget Office, *The Economic and Budget Outlook: An Update* (July 1999); *Budget of the United States Government, F.Y. 2000, Historical Tables.*

Notes: *Data are nominal figures for fiscal years. Federal spending is outlays. Years beyond 1998 are Congressional Budget Office projections.

capital gains tax revenue is included in taxes even though the capital gains on which they are based are not included in GDP

III. The Coming Decade: Cutting Taxes, Retiring Debt, and Bolstering Retirement Security

Figure 1.3 shows the pattern of budget deficits and surpluses as a share of GDP during the last 40 years. Deficits were present throughout the 1960s (except 1969), and increased in the 1970s and 1980s. Following the recovery from the 1990 recession and one-time expenditures due to the savings and loan crisis, the situation changed dramatically. The increase in economic growth of the last five years has accelerated the shrinkage of the deficit.

With taxes exceeding 20 percent of GDP, and spending below 20 percent of GDP and falling, budget surpluses are projected for the next ten years and beyond. If limits on discretionary spending are extended beyond fiscal 2002 and adjusted for inflation, revenues are on a path to exceed expenditures by a total of $2.9 trillion over the next ten years, with surpluses totaling $1.1 trillion during 2000-2004 and $1.8 trillion during 2005-2009.[4]

The budget for fiscal year 2000 passed by the 106th Congress provides for tax cuts totalling $792 billion over ten years, which will come from the $996 billion of on-budget surpluses.[5] The entire amount of the Social Security surpluses will be set aside in a "lockbox" to provide for greater retirement security. The surpluses in the lockbox will be used to retire publicly held debt by as much as $1.9 trillion.[6] The tax cut still leaves $254 billion of on-budget surpluses that can be used for further debt reduction or increased spending on Medicare reform, national defense, or other priorities.[7]

The Congress and the Clinton Administration have developed contrasting proposals for using the on-budget surpluses projected to accumulate over the next decade. Figure 1.4 compares the proposals.

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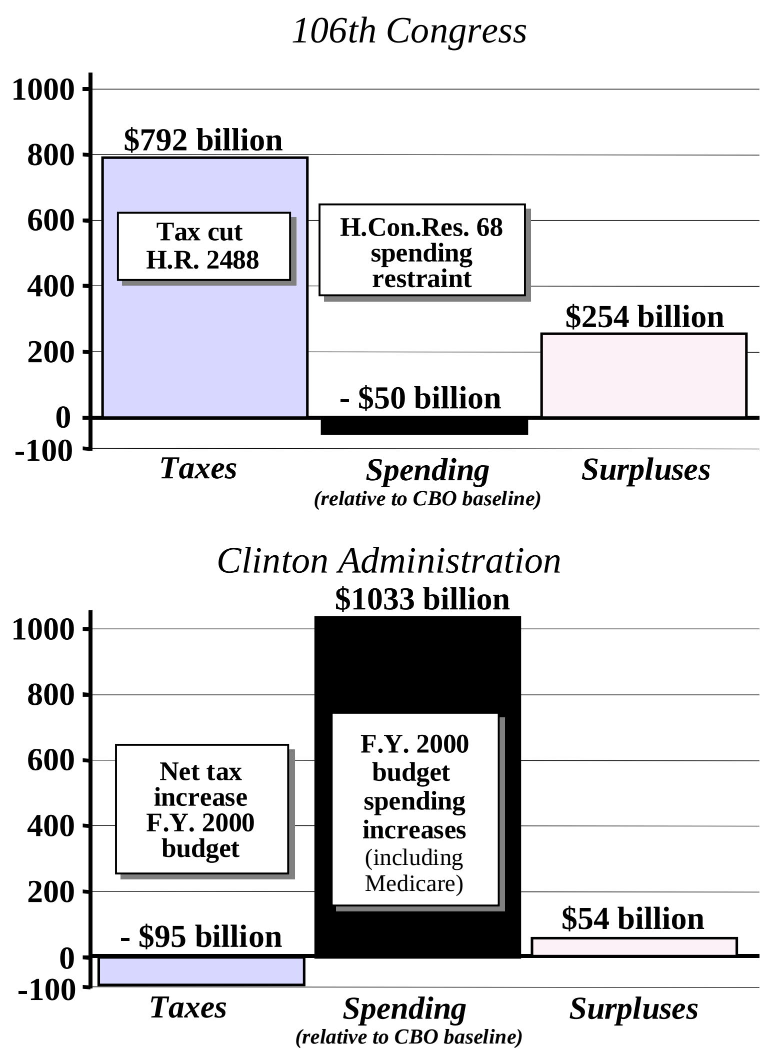
[4] Congressional Budget Office, "The Economic and Budget Outlook: An Update," July 1, 1999.

[5] H. Con. Res. 68, conference report agreed to by the House of Representatives on April 14, 1999 and the Senate on April 15; H.R. 2488, the Taxpayer Relief and Refund Act of 1999, conference report adopted by both Houses of Congress on August 5, 1999.

[6] One method of strengthening Social Security would be to allow future recipients to invest a portion of their payroll tax in personal savings accounts in exchange for lower future benefits. This would have the twin virtues of increasing personal savings and reducing future demands on the Social Security system. However, a way must be found to shift toward an "investment-based" system without endangering the benefits promised to current and future retirees.

[7] This figure also takes into account the effect of the 1999 supplemental appropriations bill and contingent emergencies. Statement of Dan L. Crippen, director of the Congressional Budget Office, to the Senate Budget Committee, July 21, 1999.

Figure 1.4: Opposing Proposals for On-Budget Surpluses, 2000-2009



Sources: Congressional Budget Office, Joint Committee on Taxation, and Joint Economic Committee.

Note: F.Y. denotes fiscal year.

As the figure shows, *the federal government does not have to choose among significant tax cuts, deep debt reductions, or maintenance of entitlement spending levels. Under current budget projections, it can accomplish all of them.* Specifically,

- Taxes can be cut by $792 billion.
- Publicly held debt of $1.9 trillion can be retired.
- Mandatory entitlement spending can increase by 73 percent over 1999 levels, from $977 billion to $1.69 trillion.
- Discretionary spending can increase (as provided in the fiscal 2000 budget resolution) by $222 billion more than if the current limits were left in place and not adjusted for inflation.[8]
- Even with all these other activities, $254 billion will be left over for other purposes.[9]

In contrast, the Clinton Administration has proposed to raise taxes above the current all-time high-level, increase spending, and retire less of the outstanding debt. Over the next 10 years, President Clinton's proposals

- Increase taxes by $95 billion.
- Increase spending by $1.033 trillion.[10]
- Provide for on-budget surpluses totalling only $54 billion.

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[8]All the figures here are calculated using the assumptions of the nonpartisan Congressional Budget Office. The figure of $222 billion is $197 billion below the CBO baseline, which assumes inflation adjustments from 2003 to 2009. Taking into account increased interest payments, and the net increase in mandatory spending under the budget resolution, total spending would be $50 billion less than the CBO baseline.

[9]If some of this remaining surplus is used to retire debt, there will be additional savings due to reduced interest payments.

[10]These numbers are from the CBO's analysis of the Mid-Session Review, contained in CBO Testimony, Statement of Dan L. Crippen to the Senate Budget Committee, July 21, 1999. They are relative to the CBO baseline, and include the proposed expenditures for Universal Savings Accounts.

The Clinton Administration has endorsed the idea of a "lockbox" for off-budget surpluses, so both the Congress and the President would reduce publicly held debt by $1.9 trillion. As Figure 1.4 clearly illustrates, *the tax cut debate is not about taxes and debt retirement. It is about spending!* The President wants to use every penny of the $1 trillion in on-budget surpluses (plus a tax increase) to increase spending. The Congress would use these surpluses to reduce the tax burden of the American people. There is little difference between the two with regard to the retirement of debt. In fact, the Congressional plan provides a slightly larger amount for this purpose.

IV. Does the CBO Underestimate Future Revenue?

If the spending caps are maintained through 2002 and thereafter adjusted for inflation, the Congressional Budget Office's revenue projections indicate that $2.9 trillion will be available for debt retirement, tax cuts, or spending increases. There are two major reasons to believe that the CBO's calculations underestimate the growth of federal revenue. First, the CBO assumes federal tax revenues will increase less rapidly than nominal income. Under a progressive tax structure, the opposite is true. According to CBO's projections, nominal GDP will increase by 53.1 percent during the next ten years but federal revenue will increase by only 49.6 percent. This implies that for every 10 percent of growth in nominal GDP, federal revenue grows only 9.4 percent. Under progressive taxation, this forecast does not make sense. While federal income tax brackets are indexed for inflation, they are not indexed for growth in real income. Thus, a larger and larger share of income will be taxed at higher rates as real income grows. Most observers agree that federal revenue grows 10 to 30 percent faster than nominal GDP, rather than 6 percent slower than nominal GDP as the CBO estimates. If federal revenue grows 10 percent faster than nominal GDP, during the next ten years it will be $966 billion more than the CBO forecast.

Second, the CBO assumes real GDP will grow an average of less than 2.5 percent a year during the next decade. This is exceedingly conservative. During the last five years, real GDP grew at an annual rate of 3.4 percent a year, and during the last 15 years it has averaged 3.1 percent a year. Given the high percentage of the work force that will be in its prime earning years in the decade ahead, the CBO's projection is too low. Even if real GDP growth is only 2.8 percent a year, federal revenues will exceed the CBO forecast by $385 billion over the ten-year period.

Thus, the CBO's projections underestimate federal revenues, and therefore budget surpluses. It is highly likely that federal revenues during the next ten years will be around $1.3 trillion more than the CBO forecast.[11] Attractive growth and favorable demographics will make it possible to initiate new programs and expand spending as the President proposes. But it would be a mistake to do so. Following such a plan during the next decade will plant the seeds of big government and slow growth when the baby boom generation retires during the subsequent decade.

V. Why Tax Relief Is Necessary

Americans are not under-taxed. As Figure 1.2 showed, taxes are currently at a peacetime high. Without a major tax cut, they will remain at or near that level during the next decade. If anything, the tax cut proposed by Congress was too small. Of the $792 billion in tax reduction, only $156 billion would have taken effect during the first five years. The Congressional tax cut was only 0.7 percent of GDP during the ten year period—0.4 percent during the first 5 years and 1.0 percent during the last five years. After the tax cut was fully phased in, tax revenues would still have taken 18.8 percent of GDP—a level that is still higher than 40 of the last 50 years. There are several reasons why taxes should be reduced.

1. It will be tempting for Congress and the President (regardless of party) to spend the surpluses. Given the current structure of the U.S. economy and the favorable demographics that will continue until the baby boom generation starts retiring around

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[11]For additional details, see the testimony of James Gwartney at the Joint Economic Committee Hearing on Tax Cuts and the Budget Surplus, September 13, 1999, online at <http://www.senate.gov/~jec/gwartney.htm>.

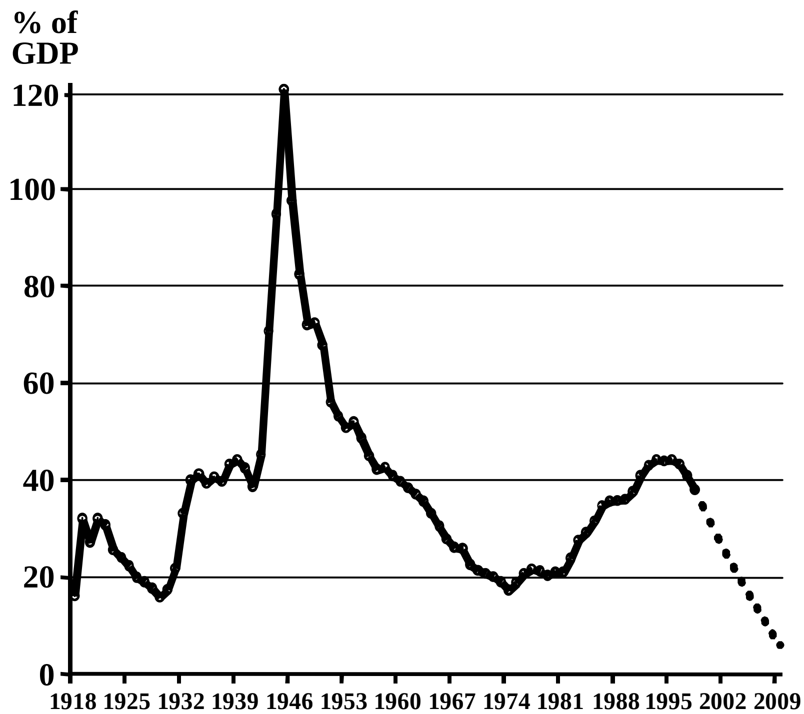
2010, economic growth is almost certain to generate sizeable surpluses. It will be tempting to spend the surpluses. President Clinton has already proposed $1.03 trillion in new spending initiatives. High levels of taxation that bring in more revenues will lead to more spending. But it would be a mistake to follow this course. Big government leads to slower growth, so spending increases financed by the surpluses of the next decade would retard future growth.

2. A tax cut is an insurance policy against a future recession. Critics of a tax cut argue that future surpluses will be sharply reduced or even eliminated if the economy goes into a recession. The projected surpluses are based on a modest long-term annual growth rate (2.5 percent a year), which is less than the decade average achieved during the 1960s, 1970s, 1980s, and the 1990s so far. The actual growth rate during the next decade is far more likely to exceed 2.5 percent than it is to fall short of it. However, suppose the economy does fall into a recession. Taxes reduce the efficiency of resource use and incentives to produce and generate income. Thus, a tax cut—particularly one that reduces the highest effective tax rates on investment income—will make a future recession both less likely to occur, and less severe if it does occur.

3. Even if only the Social Security surpluses are used to retire outstanding debt, the federal debt will fall rapidly–perhaps too rapidly. Even if just the funds in the Social Security lockbox are used to pay down debt, by the end of 2009, publicly held debt will fall from its current level of $3.6 trillion to $1.7 trillion. However, some of the publicly held debt is needed by the Federal Reserve to conduct monetary policy. Assuming that the Federal Reserve's holdings of debt increase at the same rate as during the last decade, it will need $870 billion in national debt in 2009. That means that net *privately* held debt will fall from $3.1 trillion currently (40 percent of GDP) to just $826 billion in 2009.[12] Figure 1.5 shows the path of the privately held debt as a share of GDP during the last 80 years and

[12]Only privately held debt creates an interest liability for the federal government. The government both pays and receives the interest on debt held by government agencies and by the Federal Reserve (after the Federal Reserve deducts its operating expenses).

Figure 1.5: Privately Held Federal Debt



Sources: U.S. Census Bureau, *The Statistical History of the United States from Colonial Times to the Present; Historical Tables, Budget of the United States Government, Fiscal Year 2000;* Congressional Budget Office.

projects the ratio for the next decade under these assumptions. *Privately held federal debt will fall to 6 percent of GDP in 2009, its lowest level since before World War I.*

Rapid retirement of debt could exert a destabilizing influence on financial markets and jeopardize the dollar’s role as the world’s preferred reserve currency. Dollar-denominated, risk-free Treasury bills and bonds currently play an important role in financial markets. They are widely held by central banks and currency boards around the world. They are also widely held by state and local government pension funds and private funds seeking secure assets. Paying down the debt to very low levels would force holders of Treasury securities to search for other highly secure interest-earning assets, perhaps bonds denominated in euros or yen.

VI. Fiscal Policy and America's Future

With the bulk of the baby boomers in their peak earning years, income should grow rapidly and federal spending should decline as a share of the economy during the next decade. It will be important to restrain federal spending during this period because the situation will change dramatically starting around 2010. Currently, persons age 65 and over are approximately 12 percent of the U.S. population. Federal spending on health care, social security and other entitlements targeted toward the elderly consume roughly 8 percent of GDP. When the baby boomers retire between 2010 and 2025, persons 65 and over will increase to 18 percent of the total. Under current law, this factor alone will push federal spending up by more than 4 percentage points as a share of GDP by 2025.

The role of government in the provision of retirement security and health care needs to be re-evaluated. The current Social Security system discourages savings, investment, and work. It also promotes dependency. A system that placed less reliance on pay-as-you-go funding and more on investment could encourage both a higher rate of economic growth and greater financial security for elderly Americans. In recent years, Roth IRAs and similar modifications have moved us in this direction. Other options that would allow individuals to channel more of their earnings into personal retirement savings accounts should be pursued.

Currently, government involvement in health care reduces the incentive of individuals to choose among health care providers and shop for providers that supply the most value per dollar of expenditure. The current system also reduces the incentive of suppliers to economize. This perverse structure helps explain why costs of medical services have risen almost twice as fast as the general level of prices during the last three decades.

The favorable budgetary situation during the years immediately ahead may actually make it more difficult to undertake meaningful reforms in these two areas. The easy option will be to simply pour more funding into existing programs. Doing so, however, would be shortsighted. Unless Social Security and health care are restructured, total government spending (federal, state, and local) will almost certainly rise to 40 percent of GDP when the baby boomers retire. No country has been able to sustain real growth above 2 percent a year with government spending of this magnitude. A European-style, big-government economy will lead to European-style growth rates of just 1 percent to 1.5 percent per year. If, on the other hand, Social Security and health care are reformed in a sensible manner and government spending in other areas is restrained and reduced as a share of the economy in the decade ahead, the future of the U.S. economy is exceedingly bright.

2. FIVE INDEFENSIBLE FEATURES OF THE TAX SYSTEM

As the U.S. economy heads into the next century, federal taxation will continue to be a dominant policy issue. It is not hard to understand why: the federal government will collect an enormous $1.9 trillion in taxes in 2000. Measured as a share of GDP, federal taxes now stand at a peacetime high of 21 percent, up from just 3 percent 100 years ago.

The extraction of $1.9 trillion each year from workers, retirees, business owners, consumers, savers, and investors imposes substantial costs on taxpayers over and above the revenue transferred to the government. In the long run, comprehensive tax reform could greatly reduce the harmful side effects caused by the federal tax system, benefitting taxpayers and encouraging economic growth.

Reforms can be made to both the *tax base* and *tax rates*. The tax base is the items and transactions that are taxed; the tax rate is the percentage of the tax base that the taxpayer has to pay the government. Much of the trouble with the tax code results from the overly complicated definitions of the tax base. The federal income tax code contains confusing rules regarding the “income” to be included on the numerous tax forms, while certain types of income face multiple layers of taxation. For example, corporate profits distributed to shareholders in the form of dividends are taxed at both the business level and the individual level, biasing taxpayers against investment and encouraging businesses to take on debt.

I. The Optimal and Revenue-Maximizing Tax Rates

In the case of each tax, it is important to recognize the distinction between the optimal tax rate and the revenue-maximizing rate. Taxes provide the government with revenue, but they also squeeze out productive activity. At the optimal tax rate, the government’s use of the additional tax revenue provides net benefits to citizens that are sufficient to cover the cost of the productive activity squeezed out by the tax. The optimal tax rate balances the value of the lost output against the value of what might be provided with the additional revenue; it is the best rate for the economy.

In contrast, the revenue-maximizing rate ignores the cost of the lost output accompanying the higher tax rate. It focuses only on whether a higher rate will generate additional revenue.[13] The revenue derived from a tax is equal to the tax rate multiplied by the tax base. Higher tax rates cause the tax base to shrink. At the revenue-maximizing tax rate, the revenue reduction due to the shrinkage of the tax base exactly offsets the revenue gain due to the higher rate.

Figure 2.1 illustrates the revenue-maximizing tax rate and its relationship to the optimal tax rate. As the tax rate (measured on the vertical axis) increases, tax revenue (measured on the horizontal axis) initially expands. However, as the tax rate continues to increase, the tax base (productive activity) declines, causing revenue to increase less than proportionally. Eventually, at the revenue-maximizing rate (point A), the shrinkage in the tax base is so large that a higher tax rate fails to generate any additional revenue. Still higher rates actually reduce revenue.

Think of what is happening as higher tax rates eventually extract the maximum amount of revenue. As the revenue-maximizing rate is approached, output declines and the tax base shrinks by such a large amount that a higher rate fails to raise additional revenue. Economists refer to the loss of output accompanying the imposition of a tax as the "excess burden" of taxation. Because the excess burden is so large relative to the revenue raised, tax rates at or near the revenue-maximizing point harm the economy. The optimal tax rate is always lower—generally substantially lower—than the revenue-maximizing rate. In Figure 2.1, the optimal rate is a point such as B, C, or D rather than point A.[14]

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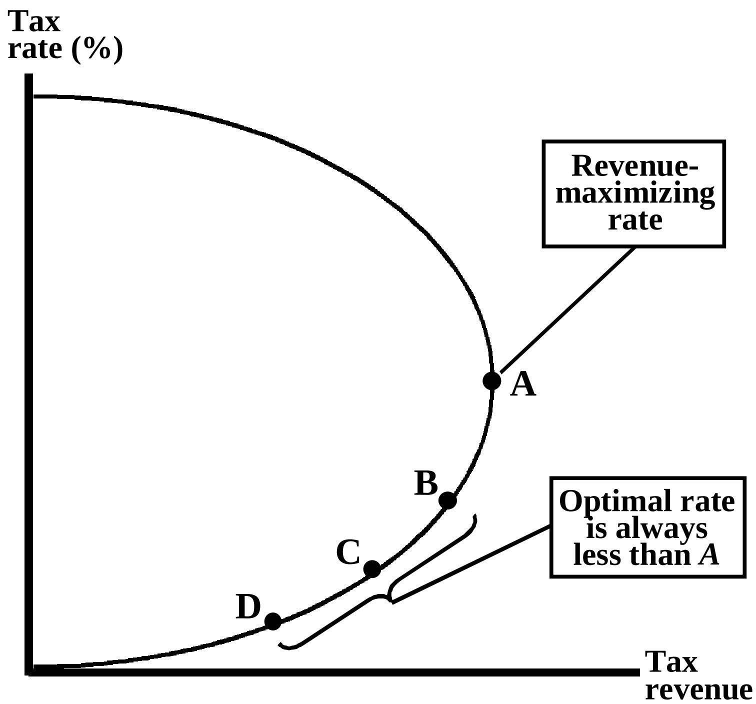
[13]The revenue-maximizing rate would be an optimal rate only if the government placed no value on the welfare of citizens. This may be the case for autocratic regimes.

[14]For an in-depth discussion of the optimal tax rate and the revenue-maximizing rate, see James D. Gwartney and Randall G. Holcombe, *Optimal Capital Gains Policy: Lessons from the 1970s, 1980s and 1990s,* Joint Economic Committee, June 1997, especially pp. 7-8.

Figure 2.1: Optimal and Revenue-Maximizing Tax Rates



This analysis highlights the destructiveness of high marginal tax rates, which are the rates applicable to the additional earnings of a taxpayer. Even as high marginal rates distort prices, reduce production, and encourage wasteful tax avoidance, they also shrink the tax base so much that they generate little additional revenue. In some cases, the government would actually collect more revenue if the high marginal rates were lowered. Studies indicate marginal income tax rates greater than 40 percent fall into this category.[15]

[15]See Dwight Lee, ed., *Taxation and the Deficit Economy* (San Francisco: Pacific Institute, 1986); Lawrence Lindsey, *The Growth Experiment: How*

Given the destructive impact of high marginal rates on output and the efficient use of resources, governments should avoid imposing tax rates in the range above or even near the revenue-maximizing rate.

During the last 15 years, recognition of the effects of high marginal tax rates has caused many countries to reduce their highest marginal rates.[16] The United States lowered personal income tax rates during the 1980s, but has gone against the grain and pushed rates upward in the 1990s. The result has been that the tax burden has risen (see Figure 2.2). With the federal budget now running a sizeable surplus, and with much larger surpluses virtually certain in the years immediately ahead, it is an opportune time to reduce tax rates and eliminate the worst features of the current tax system.

With these basic principles in mind, the following reforms would substantially improve the fairness, economic efficiency, and simplicity of the federal tax code.

II. Reform #1: Reduce the Double Taxation of Corporate Income

Corporations pay taxes on their profits. If they distribute some of the profits to shareholders in the form of dividends, the profits are subject to income tax. If corporations retain after-tax profits, the income increases their value and pushes their share prices upward. Shareholders again pay, not through the income tax but through the capital gains tax. Taxing profits at the corporate level and again at the individual level reduces the return on equity investment, constricting the pool of capital available for businesses. It also artificially biases businesses toward financing investments with debt, because interest is a deductible expense.

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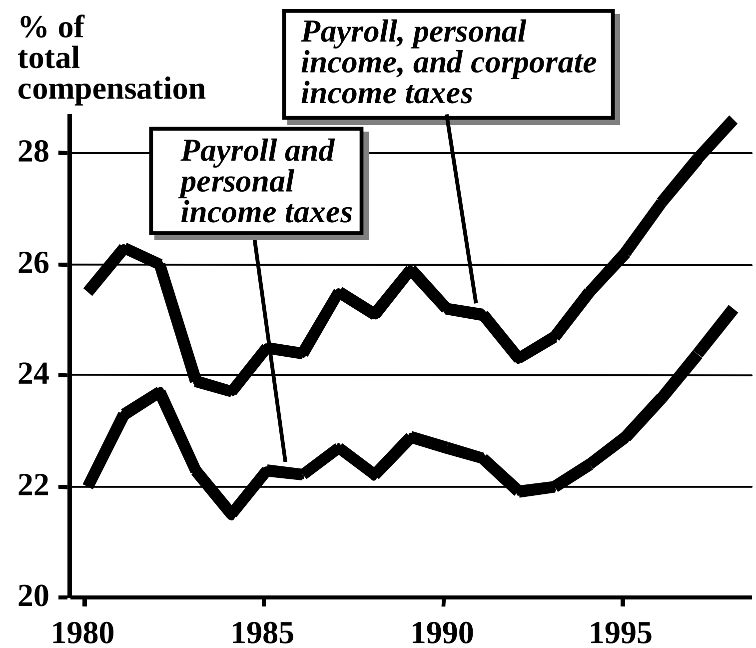
the New Tax Policy is Transforming the U.S. Economy (New York: Basic Books, 1989); and Martin Feldstein, *Tax Avoidance and the Deadweight Loss of the Income Tax* (Cambridge, Massachusetts: National Bureau of Economic Research, 1996). For certain types of taxes, the revenue-maximizing rate may be substantially less than 40 percent.

[16]Of 105 countries for which data were available, 59 cut their top marginal tax rates from 1990 to 1997, 28 raised them, and 18 left them unchanged. James Gwartney and Robert Lawson, *Economic Freedom of the World: 1998/1999 Interim Report* (Vancouver: Fraser Institute, 1998), pp. 54-8.

Figure 2.2: Tax Burden



Source: Derived from *Economic Report of the President*, 1999.

Consider the situation of Susan Shareholder, who owns a share in XYZ Corporation. If XYZ earns $1 per share, the amount Susan receives is reduced by the 35 percent federal tax on corporate income, leaving her with 65 cents. If XYZ distributes the remaining 65 cents in the form of a dividend, she may be taxed as much as 39.6 percent, leaving her with as little as 39 cents. In this case, the effective tax rate on the $1 of earnings is 61 percent. Even if Susan's personal income is taxed at a 15 percent rate, the lowest rate, the effective marginal tax rate is still 45 percent (the 35 percent corporate rate plus 15 percent of the remaining 65 cents used to finance each dollar of dividends). If XYZ retains its after-tax profit and the stock price rises to reflect that, when Susan sells her share (after holding it for more than one year), her capital gain is taxed as much as 20 percent. This leaves her with 52 cents of every $1 of net income generated by XYZ. In this case, her effective tax rate is 48 percent (the 35 percent corporate rate plus 20 percent of the remaining 65 cents). Regardless of whether it was realized as dividends or capital gains, Susan's share of XYZ's profits has been taxed twice, leading to combined rates ranging from 45 percent to 61 percent. Tax rates this high could be substantially reduced without losing appreciable revenue. Lower tax rates would lead to higher rates of capital formation and faster economic growth, and may even increase tax revenue.

Taxes on dividends and capital gains at the individual level should be lowered or eliminated. Alternatively, corporations could be allowed to deduct dividends paid to shareholders just as they currently deduct interest costs. Either reform would reduce the excessive taxation of corporate income.[17]

III. Reform #2: Reduce Marginal Rates on Social Security Recipients

Americans in their 60s and 70s are increasingly healthy and energetic. Many would prefer to continue working so that they can earn more now and save more for the future.[18] Unfortunately, current tax laws strongly discourage them from doing so.

The income and payroll taxes imposed on older Americans are particularly burdensome when combined with the "earnings test," which automatically reduces Social Security benefits for recipients who earn more than a specified amount from working. Recipients age 62 to 64 lose $1 of benefits for every $2 they earn above $9,600

[17]Some people speak as if there is an entity called business that can be taxed independently of individuals. That is a myth; all taxes are paid by people. Even if a business collects the tax and writes the check to the government, the burden of the tax still falls on people in the form of higher product prices, lower wages, or lower returns on investments.

[18]Eugene Steuerle, Christopher Spiro, and Richard W. Johnson, "Can Americans Work Longer?" *Straight Talk on Social Security and Retirement Policy*, no. 5 (August 15, 1999), Urban Institute.

a year. Recipients age 65 to 69 lose $1 of benefits for every $3 they earn above $15,500 a year.[19] Like other workers, older workers are also subject to the payroll tax of 15.3 percent (divided equally between workers and employers), and federal, state, and local income taxes of 15 percent and up.

The combined effect of lost Social Security benefits plus payroll and income taxes means that for every $100 that persons age 62 to 64 earn, they get to keep only $25.[20] The situation is not much better for those age 65 to 69: for every $100 they earn, they keep only $41.[21]

Social Security recipients in their 60s face effective marginal tax rates of 59 to 75 percent even when their earnings are low.[22] Such

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[19]According to the Social Security Administration, Social Security recipients age 65 to 69 lost $3.9 billion in benefits in 1998 as the result of the earnings test. Eliminating the earnings test would substantially increase the supply of labor from older Americans at almost no cost to the federal budget. Leora Friedberg, "The Labor Supply Effects of the Social Security Earnings Test," National Bureau of Economic Research Working Paper W7200 (June 1999).

[20]Suppose that a Social Security recipient age 62 to 64 earns an additional $107.65 above the $9,600 threshold. Payroll taxes take $15.30, income taxes $15, and reductions in Social Security benefits $50. This is a marginal tax rate of 75 percent ($80.30 ÷ $107.65). People paying more than the 15 percent marginal income tax rate or living in areas with state and local income taxes face even higher rates. These calculations assume that the 7.65 percent of the payroll tax levied on the employer is both earned and paid by the employee. This is a valid assumption because it is a component of the employee's earnings. If the productivity of an employee is not worth the cost of direct compensation as well as the taxes accompanying employment, an employer will not hire the worker.

[21]Consider the situation for Social Security recipients age 65 to 69 with earnings above the $15,500 threshold. For each extra $107.65 they earn, payroll taxes take $15.30, income taxes $15.00 and reductions in Social Security benefits $33.33. The marginal tax rate is 59 percent ($63.63 ÷ $107.65). Those with higher incomes or living in areas with state and local income taxes face even higher rates.

[22]In some instances, the interaction of the earnings test, the payroll tax, federal income tax, and state and local income taxes leads to marginal tax

high rates have no justification. The economy suffers because it is deprived of the knowledge and skills of productive workers. The elderly are harmed because the law discourages them from providing for themselves and, as a result, they become more dependent on the government. The earnings test applies only to income from work. A person can be a millionaire and still receive full Social Security benefits as long as earnings from work do not exceed the modest earnings ceilings.[23]

President Clinton persuaded the 103rd Congress to raise the tax on Social Security benefits for couples earning more than$44,000 a year and singles earning more than $34,000 a year.[24] Prior to 1993 only 50 percent of Social Security benefits were subject to income tax. This made sense because recipients had already paid income taxes on the "employee share" of the payroll tax.[25] Arguing that additional revenues were needed to balance the budget, the Clinton plan made 85 percent of Social Security benefits subject to tax. Even though the budget is now running a surplus, the tax has not been removed.

The current tax system deprives our economy of the knowledge and experience of many older workers. Two out of three Social Security recipients do not work. Of those who do work, two out of three earn less than would be the case if their earnings did not reduce

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rates of 100 percent or more. Such confiscatory rates completely remove the incentive to work.

[23]The structure of the current system reflects the "lump of labor" fallacy, the idea that the total number of jobs is fixed and therefore one person's employment deprives another of a job. This concept has no relevance in an economy that has created 33 million additional jobs during the last 16 years. Furthermore, as the baby boomers age, more older workers would help the economy continue to grow.

[24]The income thresholds are not indexed for inflation, so an increasing number of Social Security recipients pay income taxes on their benefits each year.

[25]This was consistent with the tax treatment of private pensions. Benefits from private plans are not subject to taxation if the beneficiaries have already paid income taxes on the premiums financing the plans.

their Social Security benefits.[26] As the health of older Americans continues to improve, the harmful side effects of the current system will worsen.

Several steps need to be taken to remove roadblocks limiting the economic participation of older Americans. First, the earnings test for Social Security benefits should be repealed. This might be done independently or as part of a comprehensive reform of Social Security designed to encourage personal savings, while providing recipients with greater flexibility and a more secure property right to benefits that they have earned. Second, the 1993 Clinton Social Security tax increase should be repealed. It is unfair to tax the income paid into the Social Security system and then tax the benefits funded by the payments. Third, consideration should be given to exempting workers drawing Social Security from at least the "employee share" of the payroll tax. This tax will not provide them with any additional benefits. Workers should be permitted to either keep this share of their payroll tax or use it to fund a privately controlled savings plan.

IV. Reform #3: Reduce or Eliminate the Estate and Gift Tax

If a taxpayer owns a small business valued in excess of $650,000 at death, the federal government taxes the heirs on the value over this amount, even if they continue operating the business. The estate tax imposes rates as high as 55 percent—the second-highest rate in the world. Effective tax rates range from 37 percent to nearly 80 percent in some instances.[27]

The estate and gift tax raises little if any net revenue, promotes widespread tax avoidance, and causes substantial harm to the economy. A recent study concludes that it inhibits capital accumulation and economic growth; threatens the survival of family

[26] Gary and Aldona Robbins, "Retiring the Social Security Earnings Test," Institute for Policy Innovation, May 6, 1999.
[27] Bruce R. Bartlett, "Why Death Taxes Should Be Abolished," National Center for Policy Analysis Policy Backgrounder 150 (August 18, 1999); Joint Committee on Taxation, U.S. Congress, "Present Law and Background Relating to Estate and Gift Taxes," JCX-298 (1998).

businesses and depresses entrepreneurial activity; violates the tax principles of fairness, simplicity and efficiency; and adversely impacts the conservation of environmentally sensitive land.[28] All told, the costs imposed by the estate and gift tax far outweigh any benefits.

The estate and gift tax also biases people toward consumption, undermining capital formation. People who can accumulate assets choose between consuming their wealth today or saving and investing it. Wealth that is consumed cannot generate additional goods or services in the future. In contrast, when people defer consumption, capital becomes available for those seeking to generate additional goods and services in the future.

Recently, a number of states, including New York, Louisiana, Kansas, Delaware, and Iowa have enacted legislation to eliminate or significantly reduce the burden of state-imposed estate taxes. The federal government should work in the same direction by increasing the share of wealth people can leave to their heirs and eventually eliminating this tax altogether.

V. Reform #4: Eliminate the Marriage Penalty

Because the federal income tax code does not recognize that marriage is, in part, an economic partnership in which husbands and wives share their incomes equally, most married couples pay a marriage penalty.

The main reason for the penalty is that the standard deduction and tax brackets are not twice as much for married couples as for singles. In 1999, the standard deduction is $4,300 for singles. Married couples receive a standard deduction of $7,200, while unmarried couples receive two deductions of $4,300, for a total of $8,600.

The marriage penalty reaches all the way up the income ladder. After the standard deduction and personal exemption, a single person faces the lowest 15 percent tax rate on the next $25,750 earned.

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[28]Joint Economic Committee, “The Economics of the Estate Tax,” 12/1998, at <http://www.house.gov/jec/fiscal/tx-grwth/estattax/estattax.pdf>.

Income above that is taxed at 28 percent or more. This means two single workers get the low 15 percent rate applied to up to $51,500 in taxable income (two times $25,750). In contrast, married couples are permitted to earn only $43,050 in the 15 percent bracket.

Once it is recognized that marriage is an equal partnership, it is clear that every married couple that uses the standard deduction or itemizes deductions and has income in the 28 percent tax bracket or above incurs the marriage penalty. The only married taxpayers who avoid it are those who both itemize and are in the 15 percent bracket.

The marriage penalty is bad public policy. The family has been the central supportive institution of society for several thousand years. Governments, despite their good intentions, are ill-equipped to deal with many problems that can be ameliorated by strong families. It is vitally important that public policy not weaken the family.

The best way to eliminate the marriage penalty is to make the standard deduction and the tax brackets for married couples twice the amounts for singles.[29] Senator Kay Bailey Hutchison (R-Texas) has introduced a bill to do just that. As an alternative, she has also introduced a bill that would allow "income splitting," so that married couples could choose to be taxed as two single filers, each earning half of the couple's combined income.

VI. Reform #5: Make Health Insurance Fully Tax Deductible for Individuals

Fringe benefits such as health care insurance are a component of employee compensation, not a "gift" from employers. Employers who offer extensive fringe benefits can attract workers with lower money wages, while those who offer few fringe benefits have to pay

[29]This implies that the width of each tax bracket must double as taxpayers move to higher brackets.

It has been proposed that married couples have the choice of filing as singles. This would reduce the marriage penalty, but if one spouse earned all or most of the income, the tax liability of the couple would be higher than that of another couple with the *same joint income*, but a more equal division of earnings between husband and wife. Families where one spouse stays at home or works much less than the other would be penalized.

higher wages. In essence, employees pay for health insurance and other fringe benefits in the form of lower money wages. There are two major reasons why employers and employees find it mutually advantageous to include health care insurance and other fringe benefits in the compensation package: the ability to obtain the benefit cheaper as the result of economies of group purchase, and tax advantages. Both are important in the case of health insurance benefits.[30]

When employees in the United States receive health insurance benefits as part of their compensation package, the benefits are not taxed.[31] In contrast, families and individuals purchasing health insurance directly must do so with after-tax earnings.[32] This difference in tax treatment makes the direct purchase of health insurance more costly and reduces the competitiveness of the industry.

Consider two individuals, Smith and Brown. Both receive compensation of $1,200 per month and take the standard deduction. Smith receives $900 of taxable earnings and $300 of health insurance. If Smith is taxed at a 20 percent rate, his tax bill is $180 (20 percent of the $900 of taxable earnings). This leaves Smith with after-tax compensation of $1,020 ($720 in after-tax earnings and $300 in the form of health insurance benefits). Brown's employer does not offer health insurance. Therefore, her total compensation of $1,200 is taxable. Brown's tax bill is $240 (20 percent of $1,200), $60 more than Smith. If Brown purchases the same $300 health insurance package as Smith, she is left with $60 less than Smith

[30]Approximately two-thirds of non-elderly adults purchase health insurance through group plans offered by their employers.

[31]Employer-provided health insurance originated during World War II as a means to escape wage controls. Because health insurance was not counted as a wage increase, it enabled employers to raise total compensation and attract additional workers.

[32]Taxpayers who itemize can deduct health insurance expenses only to the extent that their total medical expenses exceed 7.5 percent of adjusted gross income. Self-employed individuals can currently deduct only 60 percent of their family's health insurance expenses; this amount will be 70 percent in 2002 and 100 percent in 2003.

merely because she purchased insurance directly rather than through an employer.

This discriminatory treatment is unfair and it should be eliminated. It is not a proper function of government to channel most workers into "one size fits all" insurance plans provided through employers. Discriminatory treatment could be eliminated either by taxing employer-provided health care as income or by making the purchase of health insurance tax deductible for individuals and families. The latter is far more politically feasible. The recent tax bill passed by Congress would have made health insurance premiums tax deductible. President Clinton vetoed the bill.[33]

VII. Concluding Thought

The taxes discussed here fall into two categories. They either impose such high marginal rates that they undermine productive activity and the wise use of resources, or they unfairly tax a socially beneficial action. The excessive taxation of nominal capital gains, particularly those phantom gains that merely reflect inflation, is also indefensible. However, because of the complexity of this issue and the unique characteristics of capital gains, the subject requires a separate section, which follows.

[33]The current structure also discriminates against small employers. Group health plans covering a large number of employees are generally more economical than those covering only a small number. As a result, large firms are more likely to offer health insurance than smaller ones. This, along with differential tax treatment, provides large firms with a competitive advantage.

3. CAPITAL GAINS, GROWTH, AND INFLATION[34]

The present tax treatment of capital gains and losses is both inequitable and a barrier to economic growth. The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential growth of the economy.

President John F. Kennedy
Special Message to the Congress on
Tax Reduction and Reform
January 24, 1963

Capital gains reflect increases in the value of resources. As such, they are central to economic growth and prosperity. Capital gains are the result of investments that have already been taxed and often occur across long intervals, making inflation an important consideration. Taxpayers also have the power to choose when (and, sometimes, whether) to sell an asset and realize gains that will trigger a capital gains tax liability. These attributes need to be kept in mind when considering the proper tax treatment of capital gains.

I. Capital Gains and Economic Growth

High capital gains taxes reduce the incentive for individuals to invest in the new equipment that fuels economic growth. While other factors obviously play a role in determining economic growth, lower capital gains tax rates encourage faster growth. This relationship suggests that some of the recent unexpected strength in the U.S. economy stems from the 1997 reduction in capital gains tax rates.

Capital gains reward risk-takers who develop and invest in new businesses that are critical to creating jobs, increasing wages, and

[34]This section is based on a staff report from the Joint Economic Committee, "Cutting Capital Gains Tax Rates: The Right Policy for the 21st Century," 8/1999, available at <http://www.senate.gov/~jec/capgains.htm>.

stimulating economic growth. Entrepreneurs frequently rely on venture capital to help finance new firms, sell their companies, or make initial public offerings (IPOs). Lowering capital gains taxes raises the after-tax return, prompting more entrepreneurs to start new companies or expand current operations. Cutting the rates on capital gains taxes unleashes more venture capital to fund new firms.

Lowering capital gains tax rates and indexing gains for inflation would reduce the cost of capital. In turn, lower capital costs would encourage entrepreneurship, new businesses, and investment. Abundant capital spurs technological innovations that allow workers to produce more with less effort by providing additional capital per work hour. That situation leads to greater economic growth, lower unemployment, and higher real wages.

A recent, comprehensive ten-country study by researchers at the London Business School and Babson College demonstrates the strong connection between the pace of new business formation and the speed of economic expansion. In comparing the economic development of various nations, the study concluded that the "variation in rates of entrepreneurship may account for as much as one-third of the variation in economic growth."[35]

II. The Nature and Uniqueness of Capital Gains

Because investors often do not realize (receive money from) capital gains until years after they invest, the nominal value of the gains is influenced by inflation. If any inflation occurs during the investment period, the real gain differs from the nominal gain. If

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[35]See "New Entrepreneurs Appear Vital to Healthy Economic Growth," *Wall Street Journal*, June 24, 1999, p. A1. Another recent study of the impact of capital gains taxes on venture capital concludes that "[C]apital gains tax rates have an important effect at both the industry, state, and firm-specific levels. Decreases in the capital gains tax rates are associated with greater venture capital commitments. Increases in capital gains tax rates have a consistently negative effect on contributions to the venture industry." Paul A. Gompers and Josh Lerner, "What Drives Venture Capital Fundraising?" National Bureau of Economics Working Paper 6902 (January 1999), p. 2.

someone invests $100 in a stock and sells the stock a year later for $102, the nominal gain is 2 percent. If inflation is also 2 percent, though, the real gain is zero. If inflation is 10 percent, the investor suffers a real loss of approximately $8.

Many taxpayers have the wherewithal to delay the realization of capital gains until their tax situation is most advantageous. Taxpayers are extremely sensitive to changes in capital gains tax rates. This phenomenon explains why it is so important to measure capital gains correctly, treat them properly, and not tax them punitively.

III. The Optimal Capital Gains Tax Rate

Recall that the optimal tax rate is less than the revenue-maximizing rate. Establishing the revenue-maximizing rate sets an upper bound for the optimal rate. A study by Lawrence Lindsey, then of Harvard University and later a member of the Federal Reserve Board of Governors, estimated that the revenue-maximizing capital gains tax rate was roughly 15 percent.[36] Furthermore, evidence indicates that the 1997 cut in the capital gains rate from 28 percent to 20 percent increased tax revenue. This evidence is consistent with Lindsey's findings.

If the capital gains tax rate that maximizes revenue is approximately 15 percent, the optimal rate is lower still. Therefore, cutting the current top rate of 20 percent further would be a move toward the optimal rate. It would improve economic efficiency, increase wages, and cause greater economic expansion.[37]

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[36]Lawrence Lindsey, "Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates Under Various Assumptions," *National Tax Journal*, v. 40 (September 1987), pp. 489-504.

[37]Many economists maintain that abolishing the capital gains tax would be optimal for economic growth. Federal Reserve Chairman Alan Greenspan has supported this position. In testimony before the Senate Banking Committee on February 25, 1997, he stated, "The point I made at the Budget Committee was that if the capital gains tax were eliminated, that we would presumably, over time, see increased economic growth which would raise revenues for the personal and corporate taxes as well as the other taxes

IV. The Double Taxation of Investment Returns

Some people mistakenly contend that the tax system gives special preference to capital gains over labor income because the 10 percent and 20 percent tax rates on long-term capital gains are lower than the tax rates on ordinary income. This analysis neglects the fact that investors receive returns from corporate stock based on *after-tax* corporate profits. Double taxation of returns to capital invested in corporations causes effective (compound) tax rates to substantially exceed both statutory capital gains tax rates and ordinary income tax rates applied to labor income, as the previous section explained.

V. Inflation and the Taxation of Capital Gains

One of the most inequitable characteristics of the way the U.S. tax system treats capital gains is that it forces people to pay taxes on inflation. The nominal gain of an investment has two components: real appreciation and price increases that merely reflect inflation. If Susan Shareholder invests $20,000 in XYZ Corporation and over one year earns a nominal gain of 5 percent ($1,000), assuming inflation is 3 percent, then $600 of the gain reflects the increase in the general level of prices, and only $400 is the real appreciation. The real capital gain in this case is slightly less than 2 percent.[38]

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we have. The crucial issue about the capital gains tax is not its revenue-raising capacity. I think it's a very poor tax for that purpose. Indeed, its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero."

[38]The nominal return equals the product of the real return and inflation. In this example there is a 5 percent nominal rate of return and a 3 percent inflation rate. The formula to solve for the real return is

$$\text{real return} = (\text{nominal return} \div \text{inflation}) - 1$$

where figures are expressed as 1 plus a decimal (so a 5 percent return becomes 1.05). In the example, the nominal return of the investment equals 1.05. The inflation component is 1.03. Dividing the former by the latter

The U.S. tax system penalizes capital gains by taxing nominal gains that merely reflect inflation. People in effect pay taxes on inflation, a situation that not only compounds the bias against investment but also is unfair. Taxes owed to the government should not increase because of inflation that the government itself creates. Paying taxes on inflation also depresses investment and increases inefficiency by heightening the "lock-in effect." Investors continue to hold assets when it is economically inefficient because selling them would generate high taxes on the capital gains. The lower the nominal rate of return, the greater the inflation component of the return. Investors with low rates of return suffer a greater percentage erosion through taxes of real returns than do investors with high rates of return. Indexing gains for inflation would eliminate this inequity and improve economic efficiency.

Because the calculations of capital gains are not adjusted for inflation, investors frequently pay astonishingly high effective capital gains tax rates, sometimes more than 100 percent. Even worse, often investors have to pay taxes on real capital *losses,* implying an infinite tax rate! Analyzing tax data from 1993, the Congressional Budget Office (CBO) recently found that without the current tax law restricting losses to $3,000 annually, in aggregate there were *no real capital gains, only net real capital losses.* Even with the $3,000 loss limit, inflationary gains accounted for slightly more than half of the nominal gains. The CBO concluded,

> Taking account of that loss limit, capital assets other than bonds generated net capital gains of $81.4 billion, on average, before adjustment for inflation but only $39.5 billion once that adjustment was made. Thus, since inflation-adjusted capital gains amounted to about one-half of nominal gains in 1993, the effective tax rate on inflation-adjusted

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(1.05 ÷ 1.03) and subtracting 1 (for the original investment) to solve for the real return yields 0.0194, or 1.94 percent.

> gains was about twice the rate currently applied to nominal gains.[39]

Since the top capital gains tax rate in 1993 was 28 percent, most investors on average paid an effective capital gains tax rate of double that—56 percent.

VI. Indexation

Indexing gains for inflation would reduce the lock-in effect by eliminating taxes on gains that merely reflect inflation. Even with the present low inflation, real after-tax rates of return fall far below pre-tax nominal rates of return. A one-year investment made in 1997, with a nominal return of 6 percent, yielded a real, after-tax return of less than 4 percent. The combination of inflation and capital gains taxes took more than one-third of the original nominal return. Federal Reserve Board Chairman Alan Greenspan, who has advocated completely abolishing the capital gains tax, has also supported indexing capital gains. Asked to choose between lowering the tax rate and indexing gains for inflation, he responded as follows:

> Actually I'd go to indexing. And the reason I would is that it's really wrong to tax a part of a gain in assets which are attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So for the government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate. I would therefore say, that at a minimum, indexing capital gains at least eliminates that problem.[40]

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[39]Congressional Budget Office (CBO), "Perspectives on The Ownership of Capital Assets and the Realization of Capital Gains," May 1997, p. 28.
[40]Alan Greenspan, testimony before the Senate Banking Committee, February 25, 1997.

Some critics maintain that indexing capital gains for inflation would pose administrative problems. However, Great Britain and Australia have already successfully indexed gains. Their experience illustrates that the administrative difficulties can be overcome. Indexation would eliminate the indefensible practice of taxing illusory gains, and increase fairness by lowering the astronomically high effective capital gains tax rates imposed on many investors. Additionally, the "unlocking effect" accompanying indexing would lead to more efficient use of billions of dollars of capital assets.

VII. Beneficiaries of Lower Capital Gains Rates and Indexing

The debate surrounding capital gains taxes frequently focuses on the issue of who would benefit from rate cuts. Critics of lower rates and indexing argue that these policies would almost exclusively help the "wealthy." While it is certainly true that high-income taxpayers would be better off with these changes, the argument is simplistic and incomplete. A more thorough analysis shows that for a variety of reasons, cutting rates and indexing gains for inflation would improve the welfare of citizens at all income levels.

1. Capital gains taxes and the elderly. Capital gains taxes impose heavy costs on the elderly. The elderly often incur high capital gains on their houses or other assets they have held for many years and sell to finance retirement. According to the CBO,

> Older people account for a disproportionately larger share of realized capital gains and the taxes paid on capital gains. People 65 years old and older made up 12 percent of all taxpayers in 1993, but they realized 30 percent of total net capital gains and paid 30 percent of the tax on capital gains. Taxes on capital gains accounted for 7 percent of the income taxes paid overall, but 18 percent of the taxes paid by those 65 years old and older and 5 percent of the taxes of those under 65.[41]

[41] CBO, "Perspectives," p. 3.

People 65 and older who have held assets for a long time, including during the high inflation of the 1970s, face extraordinarily high real capital gains tax rates. Inflation has a bigger impact on capital gains for the elderly than for others. As the CBO observes, "[T]he elderly are more likely to realize losses after adjustment for inflation."[42] Indexing gains for inflation would address this unfairness and provide substantial relief for the elderly. It would also provide the elderly with additional resources to address their health and retirement needs. Indexing gains for inflation would unlock billions of dollars in assets held by the elderly. In the absence of indexing gains or lowering rates, many of the elderly will hold assets until death, at which time they may be able to pass them along to their heirs tax-free.

2. Low- and middle-income taxpayers. High effective tax rates on capital gains hurt low-income people, because investing in stocks or in businesses is one of the few ways they can accumulate wealth. High capital gains taxes punish the poor, the young, and those at the start of their careers, because these people are furthest from the sources of capital. The tax most severely hurts those trying to create wealth, not those who already have it. Therefore, cutting capital gains tax rates and indexing gains for inflation would benefit those who are not yet wealthy, but who are trying to become so.

Many people think the wealthy realize almost all of the capital gains. This is not so.[43] Statistics of income must be used cautiously here. For many taxpayers, large capital gains are rare and not part of their usual annual income flow. For example, consider a business owner with typical annual earnings of $25,000. Suppose that after owning a business (or farm) for 20 years, the asset is sold for a capital gain of $100,000. It would be extremely misleading to incorporate the capital gain along with regular income and place this individual in the $125,000 income category. Nonetheless, this is

[42]CBO, "Perspectives," p. 31.

[43]According to the CBO, "Nearly two-thirds of tax returns reporting capital gains are filed by people whose incomes are under $50,000 a year." CBO, "Perspectives," p. 2.

what is generally done. The distribution of capital gains is typically presented across income groupings that include the capital gains realized during the year. This procedure makes it appear that capital gains created over a lengthy time period—in some cases, a lifetime—are a regular occurrence. It also places everyone with a substantial capital gain in upper income brackets. Given this bias, it should not be surprising that most taxpayers with capital gains appear to have incomes of $100,000 and up.

A different picture emerges when the capital gains are separated from regular income—that is, income other than the gains realized during the year. Figure 3.1 presents the data in this manner. Based on a detailed analysis of the 1993 income figures, this table shows that households with modest incomes realize a substantial portion of both the number and dollar amount of capital gains. For example, 61.6 percent of the capital gains were registered by households with incomes of less than $50,000. These households accounted for almost 40 percent of the total dollar value of capital gains. Households with regular incomes of less than $75,000 accounted for 79 percent of the returns with capital gains and almost half (48.5 percent) of the dollar value. Thus, once the capital gains realized during the year are excluded, it is clear that low and middle income households account for a substantial portion of the total capital gains.[44]

Many middle-income taxpayers invest through mutual funds, which by law must make annual capital gains distributions on which investors pay taxes. In 1988 the amount that mutual funds paid in capital gains to shareholders, excluding institutional investors, was 3 percent of the total amount of capital gains, but by 1994 it had risen to 13 percent. As participation in mutual funds continues to increase, the figure now is likely to be still higher.[45] Investors in mutual funds have almost no discretion over the timing of capital gains taxes and

[44]The CBO acknowledges this point. "The disadvantage [of using yearly IRS returns] is that annual 'snapshots' can be misleading. For example, a taxpayer of modest income who sells a business may appear to have a very high income in that year." CBO, p. 10.

[45]Diana B. Henriques and Floyd Norris, "Rushing Away From Taxes?" New York *Times*, December 1, 1996.

Figure 3.1: Who Pays Capital Gains Taxes?

Income before capital gains	Filers declaring capital gains (%)	Cumulative percentage	Share of capital gains tax paid (%)	Cumulative percentage
Under $30,000	41.2	41.2	29.8	29.8
$30,001-$39,999	11.1	52.3	5.3	35.1
$40,000-$49,999	9.3	61.6	4.6	39.7
$50,000-$74,999	17.4	79.0	8.8	48.5
$75,000-$99,999	8.7	87.7	6.0	54.5
Over $100,000	12.3	100	45.5	100

Source: Heritage Foundation, based on IRS Public Use File, 1993.

have less ability than high-income taxpayers to rearrange their finances to minimize capital gains taxes.

3. High-income taxpayers. High-income taxpayers generally have the greatest flexibility and resources to minimize the capital gains taxes they pay. They can defer the realization of gains for long periods, and they are less likely than low- and middle-income taxpayers to use mutual funds. Accordingly, the share of capital gains taxes paid by high-income taxpayers tends to fall when the capital gains tax rate is high and increases when the rate is low.[46] This phenomenon is what happened following the 1987 increase in the top rate on capital gains from 20 percent to 28 percent. Measured in constant dollars, the capital gains realized by both the top 1 percent and top 5 percent of income recipients in 1994 were only 61 percent of their 1985 levels.[47] Realizations fell despite the rising incomes and stock prices of the period.

VIII. Conclusion

Economic growth is the proper focus for evaluating capital gains taxation. Rather than attempting to maximize the revenue from capital gains taxes, policy makers should seek to promote economic growth. Lower capital gains tax rates promote economic growth by reducing the cost of capital, encouraging new business start-up firms and other entrepreneurial activity, and increasing the prices of stocks and other assets. These factors are particularly important in high-technology fields.

The optimal tax rate—the rate that maximizes economic growth—is always less than the revenue-maximizing rate. Empirical evidence indicates that the revenue-maximizing rate for capital gains is approximately 15 percent. Therefore, the optimal tax rate for capital gains has to be less than 15 percent.

The current system taxes phantom gains that reflect inflation. In many cases, inflation results in tax rates that exceed 100 percent of real capital gains. These exorbitant rates are grossly unfair and exacerbate the lock-in effect. Indexing capital gains for inflation would be the single most powerful and effective policy to reduce inefficiency while increasing tax fairness.

Contrary to the conventional wisdom, the elderly, along with low- and middle-income taxpayers, would be the primary beneficiaries of lower capital gains tax rates and indexation. Because they often sell assets that they have worked their entire lives to

[46]For evidence, see Congressional Budget Office, "How Capital Gains Tax Rates Affect Revenue: The Historical Evidence," March 1988, p. xiv.
[47]Gwartney and Holcombe, p. 13.

accumulate, the elderly incur a large share of total capital gains realizations and, therefore, pay a large share of capital gains taxes. Compared to those with higher incomes, low- and middle-income taxpayers possess less financial flexibility, and, consequently, have less ability to adjust their investments to reduce capital gains tax liabilities.

4. SUMMARY OF RECOMMENDATIONS

Economic growth is the key to progress and prosperity. While the stability of the U.S. economy during the last 16½ years has been exceptional, the growth rate is still below the average of the 1960s and early 1970s. Historical and international experience indicate that it is possible to raise the long-term rate of growth with appropriate policies. Here and in the first volume of the series, we have analyzed various factors that influence economic growth. The following recommendations highlight the policy implications of our analysis. These recommendations will help the U.S. economy achieve its full potential and thereby create a more prosperous future for Americans.

Monetary policy

- Establish price stability as the primary long-term objective of the Federal Reserve.

Government spending

- Control the growth of federal spending and reduce it as a share of GDP.
- Reform Social Security and health care in a manner that will provide individuals with more freedom of choice and reduce their dependency on the federal government.

Trade

- Work to reduce trade barriers through the World Trade Organization and extend the North American Free Trade Agreement (NAFTA) to other countries.

Taxes

- Reduce or eliminate the double taxation of corporate income.
- Reduce marginal tax rates on the earnings of Social Security recipients by repealing the "earnings test" and eliminating the double taxation of benefits.
- Reduce or eliminate the estate and gift tax.
- Eliminate the marriage penalty.
- Lower the tax rate on capital gains and index gains for inflation, or eliminate capital gains taxes entirely.
- Make health insurance fully tax deductible for individuals.

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