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## Advantages of Low Capital Gains Tax Rates

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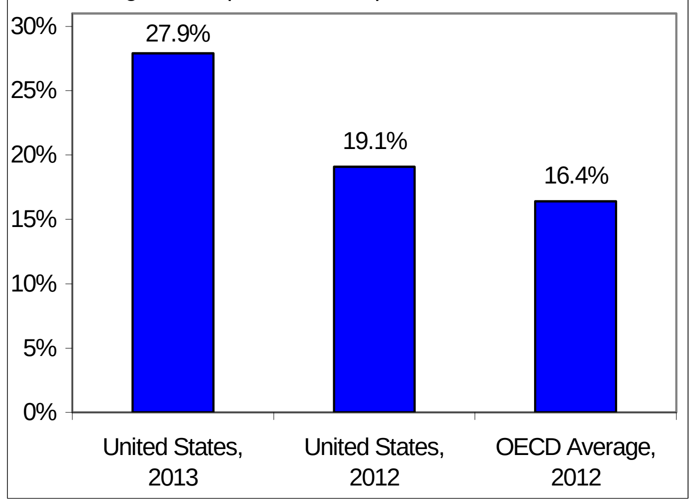
The top federal capital gains tax rate is scheduled to increase from 15 percent to 23.8 percent next year. Some policymakers think that a reduced rate for capital gains is an unjustified tax preference. However, capital gains are different than ordinary income and have been subject to special low rates since 1922.[1] Nearly every country has reduced tax rates on individual long-term capital gains, with some countries imposing no tax at all.

This bulletin describes why policymakers should keep capital gains taxes low, and it presents data on capital gains tax rates for the 34 nations in the Organization for Economic Cooperation and Development (OECD). If the U.S. capital gains tax rate rises next year as scheduled, it will be much higher than the average OECD rate.

Policymakers should reconsider capital gains tax policy. Capital gains taxes raise less than five percent of federal revenues, yet they do substantial damage. Higher rates will harm investment, entrepreneurship, and growth, and will raise little, if any, added federal revenue.

Figure 1. Top Individual Capital Gains Tax Rates




Source: Ernst & Young.

### Capital Gains Taxation in the OECD

Most nations have top capital gains tax rates that are much lower than their top rates on ordinary income. Figure 1 shows that the U.S. capital gains tax rate of 19.1 percent in 2012 is higher than the OECD average rate of 16.4 percent.[2] These figures include both federal and average state-level tax rates on long-term capital gains.

Next year, the expiration of the Bush tax cuts will push up the U.S. rate by 5 percentage points, and the new investment tax imposed under the 2010 health care law will push up the rate another 3.8 percent. As a result, the top U.S. capital gains tax rate will be 27.9 percent, which will be far higher than the OECD average. The federal alternative minimum tax and other provisions can increase the U.S. capital gains tax rate even higher.

Table 1 on the next page shows the tax rates for each OECD country. Nearly every nation has either a low statutory rate for capital gains or an exclusion that reduces the effective rate. For example, the top effective federal rate in Canada is 14.5 percent as a result of a 50-percent exclusion and a top federal tax rate of 29 percent. Some countries have exemptions for smaller investors. In Britain, for example, individuals can exempt from tax the first $17,000 of capital gains each year.[3]

Eleven OECD countries do not impose taxes on long-term capital gains, nor do some jurisdictions outside of the OECD, such as Hong Kong, Malaysia, and Thailand.[4] The nontaxation of long-term gains used to be the norm in many countries. Britain did not tax capital gains until 1965 because policymakers thought "that capital gains were not income … hence were not subject to taxation."[5] Capital gains taxation was also imposed relatively recently in Canada (1972), Ireland (1975), and Australia (1985). And only in the last few years have long-term gains been taxed in Austria, Germany, and Portugal.

Table 1. Top Individual Capital Gains Tax Rates, 2012

| | | | |
|---|---|---|---|
| Australia | 22.5% | Italy | 20.0% |
| Austria | 25.0% | Japan | 10.0% |
| Belgium | 0.0% | Luxembourg | 0.0% |
| Britain | 28.0% | Mexico | 0.0% |
| Canada | 22.5% | Netherlands | 0.0% |
| Chile | 18.5% | New Zealand | 0.0% |
| Czech Rep. | 0.0% | Norway | 28.0% |
| Denmark | 42.0% | Poland | 19.0% |
| Estonia | 21.0% | Portugal | 25.0% |
| Finland | 32.0% | Slovakia | 19.0% |
| France | 32.5% | Slovenia | 0.0% |
| Germany | 25.0% | South Korea | 0.0% |
| Greece | 0.0% | Spain | 27.0% |
| Hungary | 16.0% | Sweden | 30.0% |
| Iceland | 20.0% | Switzerland | 0.0% |
| Ireland | 30.0% | Turkey | 0.0% |
| Israel | 25.0% | United States | 19.1% |
| | | OECD Average | 16.4% |

Source: Ernst & Young.

**Measuring Income for Taxation**

The 16th amendment to the U.S. Constitution allowed "taxes on incomes, from whatever source derived," but it did not define how "income" should be measured. It turns out that there are many different ways to measure income, some of which do not include capital gains. For example, capital gains are not part of "income" in the National Income and Product Accounts. Official "national income" includes earnings from current production, but does not include changes to the value of assets.

However, the "Haig-Simons" definition of income that has been popular among liberal tax scholars includes capital gains. It is based on the early 20th century work of economists Robert Haig and Henry Simons, and it equals consumption plus the rise in the market value of all net wealth during a year. This is a very broad measure that includes labor income, capital income, and various non-cash items such as the implicit rent from owning a home. It also includes the accrued value of all capital gains during a year, whether the gains are realized or not.

While many liberal theorists favor the Haig-Simons definition of income, it is very impractical as a base for taxation. For one thing, taxpayers with little cash-flow simply could not afford to pay an annual capital gains tax on their accrued, but not realized, gains.

A Haig-Simons tax base also does not have strong support in economic theory. In fact, taxing a Haig-Simons base would create a powerful bias against saving and investment, thus harming growth. To maximize growth, we should "tax the fruit of the tree, but not the tree itself." That is, we should tax the flow of consumption produced by capital assets, not the capital that will provide for future consumption. A Haig-Simons tax base—which includes capital gains—taxes the tree itself.

Why does a Haig-Simons tax base garner support if it is impractical and anti-growth? It appears to be because the liberal idea of "fairness" includes heavy taxation of high earners. Since high earners save more than others, they would be taxed heavily under a Haig-Simons tax base. Indeed, heavy taxation of high earners was a goal of Henry Simons, and it influenced his advocacy of an anti-savings income tax base.[6]

Haig-Simons is not the only theoretical model for an income tax base. In the early 20th century, economist Irving Fisher focused on properly defining income, and he pointed out the flaws in Haig-Simons income.[7] Fisher argued that income is best measured by the flow of services consumed from the existing stock of capital. It does not include changes in the value of that stock (capital gains), nor does it include additions to the capital stock (savings). Fisher argued that Haig-Simons income erroneously mixes current income with additions to capital, which results in a complex and distorted tax code.

Today, many economists favor shifting from an income to a consumption tax base, which is essentially the tax base that Fisher had advocated. Under a consumption tax base, savings would not be double-taxed, and capital gains would not face separate taxation because the cash-flow from realized gains would be taxed when consumed.

With regard to "fairness," a Haig-Simons tax base penalizes frugal people and rewards the spendthrift. That's because earnings are taxed a second time when saved, while immediate consumption does not face a further tax. That makes no sense because it is frugal people—savers—who are the benefactors of the economy since their funds get invested in the new businesses and new capital equipment that generates growth.

As it turns out, the current federal income tax is actually a hybrid of a Fisher and a Haig-Simons base. The basic structure of the code is Haig-Simons and thus anti-savings, but the code includes features such as 401(k) accounts that reduce the tax bite on savings. With respect to capital gains, the accrual tax approach of Haig-Simons is unworkable, so the code falls back on taxing gains upon realization, which means when assets are sold.

### "Bunching" and "Lock-In" Effects

Taxing of capital gains upon realization creates numerous problems. One problem is "bunching," which means that realizations often come in a transitory spike, such as the one-time sale of a family business. The spike may push a taxpayer into a higher tax bracket than usual, which is unfair because the gain may represent years of modest accrued gains. This is one reason that some countries use a low, single rate to tax gains, rather than the normal graduated tax rate structure.

Another problem is "lock-in," which occurs when taxpayers delay selling investments that have large unrealized gains in order to avoid the immediate tax hit. Lock-in induces people to hold assets longer than optimal, and they may forgo diversification opportunities because they are stuck in current investments.

Capital gains lock-in reduces market efficiency. It interferes with the crucial economic activity of people shifting their funds from lower- to higher-yielding investments. Economic growth is synonymous with economic change, and thus growth is dependent on capital being moved from older to newer uses. Capital gains taxes create a barrier to that beneficial movement.

In a study of capital gains tax policy, the OECD found that ameliorating lock-in was a main concern of tax policy officials in its member countries.[8] Most countries have responded to the lock-in problem by implementing a reduced effective tax rate on individual capital gains.

### Inflation

If an individual buys a stock at $10 and sells it years later for $12, much of the $2 in capital gain may represent inflation, not a real return. In an economy with inflation, capital gains taxes can substantially reduce returns, and even turn them negative. And uncertainty about future inflation makes returns from capital gains more risky. Thus, inflation and capital gains taxes together suppress investment, particularly in growth companies.

This problem is widely appreciated, and one solution is to index capital gains for inflation. For investments in corporate equities, indexing would be a straightforward process of adjusting a stock's purchase price by a measure such as the consumer price index, which was the approach used by Australia between 1985 and 1999.

However, most countries do not index capital gains, but instead roughly compensate for inflation by reducing the statutory rate on gains or providing an exclusion. In 1999, for example, Australia abandoned inflation indexing in favor of a 50 percent exclusion for gains.

### Double Taxation of Corporate Equity

A key reason for reducing tax rates on both capital gains and dividends is that the underlying income is already taxed at the corporate level. Corporate profits in the United States bear a heavy burden from an average federal-state tax rate of 40 percent. When individuals receive corporate profits in the form of dividends and capital gains, the income is taxed again. By contrast, wage and interest income are only taxed at the individual level because they are deductible to corporations.

With respect to capital gains, note that corporate share values generally equal the present value of expected future earnings. If the value of expected earnings rises, shares will increase in value, which creates a capital gain to the individual. But those future earnings will be taxed at the corporate level when they occur. Thus hitting taxpayers now with a capital gains tax is double taxation.

Double taxation of capital gains and dividends disadvantages corporate equity compared to debt. The result is that firms tend to overleverage, which makes them more unstable and vulnerable during downturns. One way to fix the problem is to reduce individual taxes on corporate equity, which was the goal of the 2003 reforms that cut dividend and capital gains tax rates to 15 percent.

Even with federal capital gains and dividend tax rates at 15 percent, the U.S. tax system is biased against corporate equity. Ernst & Young calculated combined corporate and individual tax rates on capital gains for the OECD countries.[9] The U.S. rate of 50.8 percent is much higher than the OECD average of 42.0 percent. The U.S. disadvantage will get worse in 2013 when scheduled tax increases push up the combined tax rate to 56.7 percent.

### Globalization and Competitiveness

One reason to cut capital gains taxes is more practical than theoretical—international tax competition. If a government today tried to tax high earners on their capital income at the same high rates as their wage income, the tax base would shrink dramatically and little revenue would be raised. A general rule for efficient taxation is for governments to tread lightly on mobile tax bases, and capital gains are one of the most mobile.

The inverse relationship between tax rates and tax bases has been strengthened by globalization. Capital is highly mobile across borders, which has prompted nearly every country in recent decades to cut tax rates on corporations, wealth, estates, dividends, capital gains, and withholding taxes on cross-border investment flows.[10]

Many countries acknowledge that competition is a key reason to cut tax rates on capital. The parliamentary report supporting Canada's tax cuts in 2000 proposed that "international competitiveness be the criterion guiding the choice of a capital gains tax regime."[11]

**Encouraging Investment in Growth Companies**

Another practical reason to cut capital gains taxes is to spur investment in growth companies. Reduced capital gains taxes generate greater financing of young companies by angel investors and venture capitalists. Lower capital gains rates encourage people to become entrepreneurs because the payoff from a successful start-up is improved compared to a wage job. Entrepreneurs put their own money into their ventures and want to maximize the financial returns from their hard work and sacrifice.

Investors in entrepreneurial ventures take big risks in the hope that their bets on unproven technologies and unproven markets pay off years down the road. Their reward for putting up "patient capital" is a possible capital gain on some of their investments, net of their losses on investments gone sour. The U.S. tax system is biased against such beneficial risk-taking because it taxes the gains but restricts the ability to use capital losses.

The higher the tax rate on capital gains, the fewer potential projects will get the green light from investors, who are looking for a certain level of after-tax return. Put another way, higher taxes increase the "hurdle rate" that prospective projects must earn to be viable.

The chairman of the Angel Capital Association notes that angel capital comes from the "personal pocketbooks" of high-earning individuals, who could alternately put their cash into safer investments, such as tax-free municipal bonds.[12] The capital gains tax rate thus directly affects the willingness of investors to place their funds into risky start-up and growth firms.

In the United States, there are roughly 300,000 or more angel investors, who are often entrepreneurs themselves.[13] Their role in funding waves of promising young companies is crucial because some of those firms will grow to become major businesses. For example, Andy Bechtolsheim invested $100,000 in 1998 to help launch Google. He was also a co-founder of Sun Microsystems, which itself had been nurtured by venture capital in the early 1980s. Another well-know angel is Peter Thiel, who founded PayPal. His wealth from that venture has allowed him to fund many innovative young companies, including investing $500,000 in 2004 to help launch Facebook.

When angel investors such as Thiel and Bechtolsheim have successes, they will eventually want to exit their investments and realize a capital gain. Then they will often use their after-tax returns to fund more young companies in an ongoing virtuous cycle. A low capital gains tax rate is crucial to this cycle of growth and innovation. Nowhere has that cycle been move evident than California's Silicon Valley, which roared to life after reductions in the top federal capital gains tax rate from 40 percent in 1978 to 20 percent in 1981.[14] Many now-famous technology firms were nurtured on the flood of new risk capital available in recent decades, including Apple, Microsoft, Ebay, Cisco, and Amazon. If capital gains tax rates start rising again, we risk killing off the new Apples and Amazons that we need to power America's economy in the future.

**Dynamic Responses to Capital Gains Taxes**

For policymakers, capital gains tax cuts offer a way to spur economic growth while losing little, if any, revenue. When any tax rate is cut, the tax base expands over time as tax avoidance falls and economic activity increases. These dynamic responses are stronger with capital gains taxes than most other taxes.

At a microeconomic level, changes in capital gains tax rates cause taxpayers to adjust their asset holding periods, switch between growth stocks and other stocks, and switch between debt and equities. Cutting the capital gains tax rate reduces the lock-in effect and spurs increased realizations, as occurred after U.S. capital gains tax cuts in 1997 and 2003, and after Ireland cut its capital gains tax rate from 40 percent to 20 percent in 1998.[15]

A recent Congressional Budget Office working paper found that the responsiveness of capital gains realizations to the tax rate is quite large, with a "persistent" elasticity of -0.79.[16] That means that a 10 percent cut in the capital gains tax rate would increase ongoing realizations by 7.9 percent. Economist Alan Reynolds finds that the mid-point elasticity of academic estimates is a bit larger at -1.0.[17]

Elasticities of this size indicate that the government's revenue loss from a capital gains tax cut will only be about one-third or less of the loss if taxpayers didn't change their behavior. Alternately, tax rate increases will gain the government little added revenue. Note that a large elasticity also indicates that a tax rate change has a big effect on economic efficiency.

At a macroeconomic level, capital gains tax cuts would have numerous effects. Share prices would rise, thus increasing the wealth of millions of Americans. Investment in growth companies would be spurred and entrepreneurial industries would be strengthened. The expansion of innovative companies would boost productivity and increase the nation's output over time.

Stronger economic growth from a lower capital gains tax rate would raise government revenues from all tax sources. A macroeconomic analysis by Allen Sinai found that a capital gains tax rate of 15 percent would raise more revenue than a 20 percent rate because GDP, employment, and stock prices would be higher.[18] Similarly, a study by Stephen Entin found that long-run GDP and government revenues would be higher with a 15 percent capital gains tax rate than a 24 percent rate.[19]

What is the revenue-maximizing capital gains tax rate? Economist Paul Evans estimated the rate to be 10 percent.[20] An older study by economist Larry Lindsey found the rate to be 16 percent, although he testified recently that he now thinks it's about 20 percent. [21] But, as Lindsey noted, more important than the revenue-maximizing rate is the rate that maximizes economic growth, and many economists think that rate is zero.

**Conclusions**

Economists since Irving Fisher have called for ending capital gains taxation. In the 1980s, economist Bruce Bartlett looked at the positive effects of prior capital gains tax cuts and called for abolishing the tax altogether.[22] In the 1990s, Federal Reserve chairman Alan Greenspan testified that the tax's "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."[23]

Unfortunately, policymakers are going in the opposite direction with capital gains tax increases in 2013. Class warfare rhetoric has sadly overwhelmed the lessons learned here and abroad about the benefits of low capital gains taxes. Short-term expediency has replaced an interest in tax policies that promote long-run growth.

Hopefully, policymakers will reconsider capital gains tax policy in coming months. They should reverse course and cut the capital gains tax rate again in order to boost innovation, spur entrepreneurship, and help America regain its competitive edge.

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[1] The few years following the Tax Reform Act of 1986 are an exception. See Leonard Burman, *The Labyrinth of Capital Gains Tax Policy* (Washington: Brooking Institution, 1999), Table 2-4.
[2] Data in Figure 1 and Table 1 from Robert Carroll, et al., "Corporate Dividend and Capital Gains Taxation: A Comparison of Sweden to Other Member Nations of the OECD and EU, and BRIC Countries," Ernst & Young, October 2012.
[3] The exemption in 2012 is 10,600 British pounds, which is about $17,000. See www.hmrc.gov.uk/rates/cgt.htm.
[4] The zero rates apply to long-term portfolio holdings of corporate shares. Note that the Netherlands taxes capital gains indirectly with its Box 3 system of taxing an assumed yield on financial assets.
[5] Bruce Bartlett, "The Case for Ending the Capital Gains Tax," *Financial Analysts Journal* 41, no. 3 (June-July 1985): 22–30.
[6] Arthur P. Hall, "The Concept of Income Revisited: An Investigation into the Double Taxation of Saving," Tax Foundation, February 1997.
[7] See Hall for a detailed discussion of Fisher, Haig, and Simons.
[8] Organization for Economic Cooperation and Development, *Taxation of Capital Gains of Individuals* (Paris: OECD, November 2006), p. 11.
[9] Robert Carroll and Gerald Prante, "Corporate Dividend and Capital Gains Taxation: A Comparison of the United States to other Developed Nations," Ernst & Young, February 2012. This includes federal and state taxation. However, the report did not account for the effect of deferral on capital gains tax rates.
[10] Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).
[11] Herbert Grubel, "Preface," in Herbert Grubel, ed., *International Evidence on the Effects of Having No Capital Gains Taxes* (Vancouver: Fraser Institute, 2001), p xii.
[12] David Verrill, Angel Capital Association, testimony to the Senate Committee on Finance, September 20, 2012, p. 1.
[13] Scott Shane, "The Importance of Angel Investing in Financing the Growth of Entrepreneurial Ventures," Small Business Administration, September 2008.
[14] In addition to capital gains tax cuts, rule changes for U.S. pension plans in 1978 helped boost the U.S. venture capital industry by allowing higher-risk investments.
[15] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2017," January 2007, p. 86. For Ireland, see OECD, pp. 11, 58.
[16] Tim Dowd, Robert McClelland, and Athiphat Muthitacharoen, "New Evidence on the Tax Elasticity of Capital Gains," Congressional Budget Office, JCX-56-12, June 2012.
[17] Alan Reynolds. "The Misuse of Top 1 Percent Income Shares as a Measure of Inequality," Cato Institute, October 4, 2012.
[18] Allen Sinai, "Capital Gains Taxes and the Economy," American Council on Capital Formation, September 2010.
[19] Stephen Entin, "The Effect of the Capital Gains Tax Rate on Economic Activity and Total Tax Revenue," Institute for Research on the Economics of Taxation, October 9, 2009.
[20] Paul Evans, "The Relationship between Realized Capital Gains and Their Marginal Rate of Taxation, 1976-2004," Institute for Research on the Economics of Taxation, October 2009.
[21] Lawrence Lindsey, American Enterprise Institute, testimony to the Senate Committee on Finance, September 20, 2012.
[22] Bartlett.
[23] Alan Greenspan, Chairman of the Federal Reserve Board, testimony to the Senate Banking Committee, February 25, 1997.