April, 2008

Capital Gains Tax Cuts Decrease Revenue over the Long Run and Hurt the Economy

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In the April 16th, 2008 Democratic debate in Pennsylvania, moderator Charles Gibson implied that capital gains tax cuts are essentially costless, or even make money for the government, "...in each instance, when the rate dropped, revenues from the tax increased; the government took in more money. And in the 1980s, when the tax was increased to 28 percent, the revenues went down. So why raise it at all, especially given the fact that 100 million people in this country own stock and would be affected?"

This is deeply misleading. In the long run, and overall, capital gains tax cuts, do in fact cost the government a great deal of revenue, even though in the short run total revenue from capital gains taxes may go up. The first reason for this is that, unlike the income and payroll taxes working Americans pay, investors get to decide when they pay capital gains taxes. If Paris Hilton owns $100 million in Hilton stock, and it goes up to $120 million, she has a $20 million capital gain, but she will not pay taxes on this gain until she sells the stock, which may be many years later.

When there is a cut in the capital gains tax rate, there is an incentive to sell the stock then, and get the lower tax rate before a new administration raises it again. Thus, when the capital gains tax is cut, there is a rush of investors selling stocks to pay their capital gains taxes now, when the rate is law, rather than later when the rate may be raised back up. Capital gains tax revenue to the government, thus, may go up now, but it will go down later, and it will go down overall.

In addition, when capital gains taxes are cut, there is an incentive to pay CEOs and top managers more in stock and options and less in regular dollar income, so as to capitalize on the lower tax rate. This would raise capital gains tax revenue to the government, but lower income tax revenue by a greater amount.

Finally, capital gains tax cuts tend to occur during periods of Republican control. These periods, unfortunately, have been shown to result in drastic increases in income inequality – today there is more income inequality than at any time since the Gilded Age. With so much income shifted towards the wealthiest Americans, capital gains can increase, as they own the vast majority of stock, but at the same time these policies have resulted in stagnant or declining real wages for the rest of Americans, lowering income tax revenue, and contributing to the record budget deficits we have seen in conservative administrations.

Was it unfair to use Paris Hilton in the example above when Charlie Gibson says 100 million Americans own stock? No. Again Gibson is being misleading. 100 million Americans may own stock, but for most this entails a small part of their income. In 2004, the top one-half of one percent of households owned more stock than the bottom 90% combined. But even if you only have $100 in capital gains, isn't it better to not have the taxes on that increased? Not if the increase in capital gains taxes will mean you pay $5 a year more in taxes, but in return get $1,000 a year more in value from the resulting increased government spending on things like student financial aid, more police officers, universal health insurance that you can never lose and more spending on Cancer research. And, in any case, capital gains taxes can be increased only for the wealthiest households, for example only those with annual capital gains above $200,000.

But isn't it *always* better to cut taxes, and let everyone spend their money how they want to, and have the free market provide everything more efficiently? If that were true then the optimal tax rate would be zero. There would be no taxes at all, which means there would be no government at all. This would obviously lead to disaster (maybe not so obviously to some conservatives), because in spite of the mythology, Economics has shown the unfettered free market is not the most efficient for everything (scientific, academic economics, as opposed to sound-bite ideologue "economics").

There are many worthwhile and high return things the unfettered free market will not provide, will under provide, or will provide much less efficiently than will the government, or the market *with* some government role. This is due to market imperfections like externalities, asymmetric information, natural monopoly, and much more which are well established in economics and can be found in any university microeconomics text.

What about the argument that cutting the capital gains taxes provides an incentive to save? As Berkeley Economists Brad DeLong and David Levine put it, "The capital gains tax rate has wandered all over the place in the past generation. Private savings have not shifted significantly in response. Moreover, any increase in private savings must be balanced against the increased government borrowing due to the tax cut. Unfortunately, research shows that each dollar of tax cuts increase private savings by less than a dollar; the net effect is to lower national savings. Continued belief that lowering tax rates will boost American savings is the triumph of faith over experience."[1]

So let's listen to scientific economics and not sound-bite "economics", and be willing to raise taxes on the wealthiest Americans – who have had nothing but huge cuts under conservatives – for a balanced budget, government services which are valuable to the middle class, and the kind of high return public investments that the market will not provide, or under provide, due to textbook market imperfections.

[1] At: http://www.j-bradford-delong.net/oped/acapitalgainstaxcutoped.html .

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