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Want a free lunch?

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Would you like a tax rate cut that doesn't lose revenue, but will increase jobs and economic growth? Well, there is one available in House Ways and Means Chairman Thomas' tax bill now before the Congress. It is the provision to reduce the maximum rate on long-term capital gains to 15 percent from the current 20 percent. If you are wondering why this rate cut will not lose revenue, let's look at the empirical evidence.

Capital gains taxes, unlike most taxes, are largely discretionary. Individuals or companies only have capital gains if they decide to sell an appreciated asset. If the tax rate is too high, people will often choose not to sell and the government gets zero revenue.

For example, assume you own 100 shares in XYZ company that you originally bought for $50 per share and that are now selling for $150 per share. Also assume you think the shares are not likely to appreciate much more, and hence you would like to buy another stock you think is likely to do better. If you sell your shares and the capital-gains tax is 40 percent, you will have to pay a $4,000 tax on the sale, only leaving you with a $6,000 profit to reinvest.

However, if the capital-gains tax were only 15 percent, you would only have to pay a $1,500 tax and would have an $8,500 profit to reinvest. We know from long experience that people are very sensitive to capital-gains tax rates, and a lower tax rate with higher turnover can be more profitable for government. (This same principle explains why low margin Wal-Mart is much more profitable than high margin Saks.)

It is often said in economics there is no free lunch, but that is not true when policymakers correct past policy mistakes. Every tax has a revenue maximizing rate and when that rate is exceeded, revenue declines, thus government can actually increase tax revenue by lowering the rate.

For instance, we know the revenue maximizing tax rate on labor income has to be less than 100 percent or nobody would work. Fortunately, with the capital-gains tax, we have a lot of evidence about the effects of lower rates and higher rates. Since 1978, the maximum capital-gains tax has been decreased three times (1978, 1981, 1997) and increased twice (1986 and slightly in 1990).

As you can see in the following table, each time the tax rate was decreased, the tax revenue increased substantially, and each time the tax rate was increased, the tax revenue went down.

Both the empirical evidence and the evidence from many economic models show revenues are likely to increase, or at least stay neutral, from a further rate reduction to 15 percent. The Joint Tax Committee (JTC) of the U.S. Congress will probably score the rate reduction as a small loss since they use largely static models (i.e. they largely assume no change in behavior from a tax rate change). However, the JTC has been consistently wrong on its capital-gains tax rate change revenue estimates, so sensible people (which leaves out a significant portion of the U.S. Congress) do not put a lot of faith in the JTC projections.

Most people understand that if you greatly increased the tax on beer, many people would switch from drinking beer to wine or hard liquor. However, many of the revenue analysts at the JTC would tell you that, because you don't know exactly how many people may switch from beer to wine, they will assume no one does. The JTC folks often seem more interested in being precisely incorrect than approximately correct.

It has been well documented that a reduction in capital-gains tax rates has many beneficial economic effects. It spurs investment in productive plant and equipment because it reduces the cost of capital for businesses. It leads to higher stock-market prices that benefit all who directly invest or indirectly invest through their pension plans. It encourages entrepreneurship and productive risk-taking, which is a major driving force for technological breakthroughs and improvements in productivity.

All this adds to economic growth and job creation. A capital-gains tax rate cut is a win win.

Opponents will claim a capital-gains tax rate reduction benefits the rich. Because they define rich as someone who has a certain level of income in a given year, they fail to understand under such a definition that most people in their lifetimes have one or more significant capital gains. Are you rich because in a given year you sell your house, which you have owned for 20 years, for a $150,000 gain? Are you rich because in one year you have sold a family farm or business for a $200,000 gain that you have struggled 30 years to build? Are you rich because you decide to retire and sell the stock in the company you have worked for the past quarter-century for a $300,000 gain to be used for retirement?

The folks on the left will claim that all these people are rich, despite having only middle-class incomes for most of their working lives. The truth is, a capital-gains rate cut will benefit the rich (by giving them more after-tax money), and the poor (by giving them jobs), but most of all the middle class (by giving them more ability to educate their children and have a more secure retirement).

There are many highly beneficial provisions in the president's tax cut proposal, such as elimination of the double taxation of corporate dividends. The addition of Chairman Thomas' capital-gains tax rate reduction has the benefit of giving an immediate economic stimulus without increasing the deficit, and thus ought to be included in the final package as Congress works its will.

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