The Washington Times
www.washingtontimes.com

Economic literacy test . . . and advice

By Richard W. Rahn
Published December 12, 2005

Before members of Congress leave for the Christmas and New Year's holidays, they are to take a test in economic literacy: their vote on extending the tax cuts President Bush proposed and Congress voted for in 2003, including the current maximum 15 percent long-term capital gains tax rate.

The tax cuts worked very well in revitalizing the economy, which has been growing almost 4 percent yearly. Millions of new jobs were created, resulting in nearly full employment. This has been particularly remarkable given the unprecedented economic battering from the hurricanes.

Now, many Democrats and some Republicans want to repeal the tax cuts -- which means increasing tax rates, like "The Grinch that stole Christmas." They argue we must increase tax rates to bring down the deficit. But tax revenues have been growing much faster than the economy (even with the tax rate cuts), and much faster than the Congressional Budget Office forecast. In fact, the deficit has been falling despite the reckless spending by Congress.

To understand the particular foolishness of increasing the capital-gains tax rate, a brief review of its history is in order. (Remember, a capital gain is the difference between the purchase and sales prices of an asset, such as a corporate stock or a home.) For several decades before 1967, the maximum capital-gains rate remained 25 percent. Beginning in the late 1960s. the maximum rate was raised several times until it reached 49 percent in 1976. Because of this very high rate, many people had an effective rate of more than 100 percent because asset purchase prices were not adjusted for inflation. These high tax rates almost killed venture capital in the U.S. and greatly diminished investment, causing fewer new jobs to be created and a fall in economic growth.

In 1978, Congress wisely reduced the maximum capital gains rate to 28 percent. As a result, capital-gains tax revenues rose (almost 40 percent) rather than declining as the CBO forecast.

In 1981, Congress again cut the capital gains tax rate to a maximum 20 percent. This time, capital-gains revenues again soared by more than 100 percent, despite contrary CBO forecasts. In 1987, Congress foolishly raised the maximum capital-gains tax rate to 28 percent and capital-gains tax receipts fell, despite CBO forecasts they would increase.

(The CBO forecast of capital-gains realizations was off by more than 100 percent for the 1987-1993 period.)

Realizing its mistake, Congress cut the capital-gains tax rate to 21 percent in 1996, and again capital-gains tax revenue soared by an average of more than 100 percent as contrasted with the period of the 28 percent rate (and surprise, surprise -- again the CBO had it all wrong).

In 2003, Congress cut the maximum capital gains rate to 15 percent at the urging of President Bush. The final capital-gains receipt numbers for 2004 and 2005 will not be in for some time, but given the surge in tax revenue (and real estate and stock prices), it is a very safe bet capital-gains tax receipts will again be up despite the lower rate. (We also know from the 2003 realization data that the CBO was wrong again.)

If it seems counterintuitive that lower rates lead to higher revenues and vice versa, remember that capital gains taxes are somewhat voluntary. If the rate is seen as too high, people will neither sell nor invest in productive assets.

People have a choice with their savings; they can put them into savings accounts or even tax-free municipal bonds -- they need not put them into assets subject to the capital-gains tax. And if tax rates are perceived as too high on all savings, people can just spend their money.

In sum, we know every time capital gains rates fell in the last 30 years revenues went up and vice versa.

Members of Congress have a choice. They can vote for a higher capital-gains tax rate based on the projections of a CBO model that has been wrong for 27 consecutive years (both in magnitude and direction), or they can vote to continue the lower rate supported by the data and recommendations of economists (including a number of Nobel Prize-winners) who have been right in their projections over the decades.

Those members of Congress who vote for a higher capital-gains tax rate will prove to their constituents that they are dim or mean-spirited or both. And you can bet many representatives will do so, thus failing the test in economic literacy.

Richard W. Rahn is director general of the Center for Global Economic Growth, a project of the FreedomWorks Foundation.

Copyright © 2005 News World Communications, Inc. All rights reserved.