

Gains Tax Relief

Congress is likely to reduce the taxation of capital gains. The Republicans favor a lower, preferential, rate on gains while President Clinton wants to exempt the tax on most home sales. Such changes would be welcome relief for particular constituencies, but, regrettably, neither would do much to make the tax code any fairer. Indexing, which would make the tax apply to economic income, rather than inflationary gains, is the reform that simple fairness demands.

Capital gains were included in taxable personal income when the modern income tax was first levied in 1914, and they have been so included ever since. Chart 1 shows the history of the maximum effective Federal income tax rate applicable to long term gains.

At present, no capital gains are excluded from taxable income except up to \$125,000 of the gain on the sale of a primary residence by a taxpayer at least 55 years old (this exclusion may only be taken once in the taxpayer's lifetime). However, the tax rate on gains from the sale of assets held one year or more is capped at 28 percent. This 28 percent rate was the maximum personal income tax rate under the 1986 tax reform. The 28 percent rate was retained on gains, when the "surtax" rate of 31 percent on ordinary income was enacted under President Bush, and again when the 36 percent and 39.6 percent brackets were added under President Clinton.

The tax code also calls for "phasing out" of exemptions, deductions, and lower rates on the initial amounts of income. As indicated by the dashed line in Chart 1a these "phase outs" can add as much as 5 percentage points to the maximum effective rates on capital gains.¹ The levels of income to which this can apply varies greatly according to the circumstances of the taxpayer. Above some level of income, the effective rate on capital gains drops back to 28 percent.

A final point concerning the history of the capital gains tax as portrayed in Chart 1a is that, prior to reforms of the 1980s, the maximum gains tax rate usually applied to

relatively few taxpayers with relatively high incomes. Nowadays, the top 28 percent rate probably applies the majority of those reporting capital gains income.

Games People Play

If the income tax truly taxed economic income, taxable income should include capital gains as they accrue each year, regardless of whether or not they were realized in a transaction. This is not done because the value of property can fluctuate, often markedly so, and it would be difficult to establish consistent procedures to estimate changes

in values as a basis for taxation. Moreover, the taxation of accruals could force sales of the assets to pay the tax and most people would find it unfair to have to come up with cash to pay a tax when they had received nothing in cash.

As a result, the capital gains tax is a voluntary tax which is due only when gains have been realized. The tax authorities have required the reporting of sales proceeds only relatively recently, and for many years capital gains tax payments were essentially on the "honor system" — taxpayers who failed to report gains were unlikely to be found out unless they were subject to a detailed audit of their finances for some other reason. Even with the reporting of sales proceeds, taxpayers retain much discretion on how much to pay because the tax is levied only on transactions in a given year, and realized capital losses may be netted out against realized gains. Chart 1b shows the amount of capital gains included in taxable income, and for the years prior to 1987 (when a portion of gains was excluded from taxable income), an estimate of the gross gains realized by taxpayers each year. The response of tax-

Capital Gains Taxes

Chart 1a

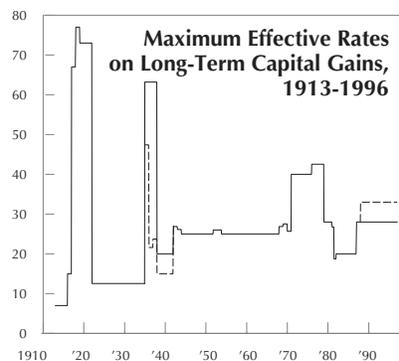
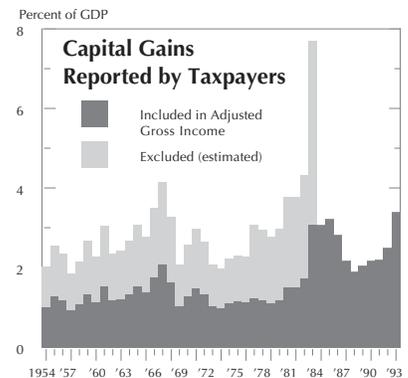


Chart 1b

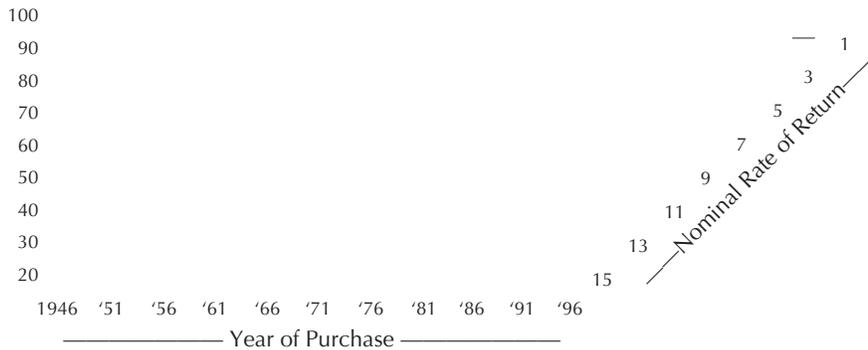


Prior to 1922, and again during the years 1987 through 1989, the rates paid on capital gains income were that same as those paid on ordinary income, *i.e.*, the amount of any capital gains realized in a given year was simply added to the taxpayer's taxable income for that year. Most of the time, however, the income tax rates levied on long-term capital gains have been less than that on other income (short-term gains have always been taxed at the same rates as other income).

This favorable treatment occurred when a portion of long-term gains could be excluded from taxable income, because the maximum rate on gains was "capped" at a level below the top rates on other income, or both. When long-term gains have been favorably taxed, the minimum holding period to qualify for long-term treatment has varied from as few as 6 months to as long as 2 years. For a relatively brief period 1935-1941, larger reductions in the gains tax rate were granted on holding periods greater than the minimum to qualify for long-term treatment, with the largest reduction on sales of assets that had been held 10 years or longer (plotted as the dashed curve for those years).

¹ Calculation of the exact "surcharge" to the capital gains rate can be very complex. We came up with the 5 percent figure by calculating various hypothetical taxpayer returns with tax-preparation software. The 5 percent level appears to a "worst case" situation, that presumably applies to very few taxpayers.

Chart 2 Effective Gains Tax Rate on Inflation-Adjusted Gains



Note: No values are plotted for combinations of holding periods and nominal appreciation for which the proceeds after a 28 percent tax on the nominal gains are less than the value of the initial investment in 1996 dollars. In such situations, the taxpayer retains less purchasing power than was originally invested and the tax becomes a wealth tax and not an income tax.

payers to the level of the tax rate is clearly evident, especially the rush to “cash in” in 1986, immediately before the gains tax increased from 20 to 28 percent.

Because of the taxpayers’ ability to manage the timing of realized gains and losses, the gains tax is not symmetrical — realized gains will be included in taxable income, but only a limited amount of realized losses can be deducted (no more than \$3,000 per year, with any excess carried forward to subsequent years). This “heads I win, tails you lose” approach by the tax collector is completely arbitrary.²

An even more significant aspect of capital gains taxation arises when there is a differential between the gains tax rate and that on other income. Lawyers and accountants can structure transactions to postpone taxable income and turn it into capital gains. The larger the difference between the tax rates, the more rewarding this alchemy becomes. But transactions that are advantageous because of tax considerations divert resources from more worthwhile endeavors that are not so favored. This is a major argument against a preferential rate on gains.

Tax Capital Gains at a Lower Rate?

Someone who holds an asset that appreciates, say, at the same rate paid on a savings account will have more than the holder

of a savings account if the tax due at the time the asset is sold is levied at the same rate as that paid on the interest in the savings account. This is because the taxes on the bank interest are on a “pay-as-you go” basis, and are not re-invested to earn more interest. This fact is often cited by opponents of a lower rate on gains: appreciating assets are already taxed more favorably simply because the tax is deferred until the asset is sold.

The advantage of the deferral increases with the rate of return, the tax rate, and the time span, but, it is smaller than many seem to believe. On the other hand, the deferral of taxes on appreciating assets also provides an argument for a favorable tax treatment of capital gains income. Realizing a capital gain may be the only reason that a taxpayer reports income subject to a high tax bracket in a given year. Socking gains that had been earned over many years with taxes in higher brackets that are designed for persons with consistently high incomes does not seem equitable, and a lower rate on gains may be seen as a form of “income averaging.” This argument was more persuasive when the brackets were more steeply progressive (rising to 70 or even 90 percent) than they are now.

Many other arguments for a lower rate on capital gains are conjectural. These include the notion that capital gains are the reward for entrepreneurship and contributions to economic growth. Capital gains are often, but not invariably, a reward for risk-taking that may or may not contribute to economic growth. But the same could be

said for high salaries, rents, or royalties, or even dividends and interest. Any reduction in tax rates would be a spur to economic activity.

A similar notion is that gains taxes “immobilize” capital — that a lower gains tax rate would free up funds for more productive purposes. However, when a capital asset is sold, someone buys it. More transactions would not create more capital. Of course, things would be more efficient if all economic decisions could be made without regard for taxes, but investment decisions are only one part of the process. The prospect of gains taxes does make people with large gains reluctant to sell. This is mainly because their heirs stand to receive a “stepped up basis” — and avoid the gains tax altogether. Lower gains taxes would decrease the incentive to hold on until death, and this prospect would seem to be the major basis for the notion that gains tax cuts “pay for themselves,” *i.e.*, that lowering the rates will not decrease revenues. This was probably so during the 1970s, when the gains could be taxed as much as 50 percent, but it is more doubtful at 28 percent. In present circumstances, a far more useful change would be to eliminate the “angel of death loophole,” by transferring the decedent’s basis to the heir, and *at the same time abolishing all estate levies*. That would really serve to reduce the role of tax planning in economic decision making.

Inflationary Gains are Taxed

The reason that gains are taxed at all is that they can be used to purchase goods and services in that same way as other forms of income (hey, they’re playing with *real dollars* down there on Wall Street!). By far the most compelling reason for taxing gains differently from other income is that many taxable gains reflect general price inflation rather than genuine economic income.

Taxing nominal gains in an inflationary world means that the effective rates on inflation-adjusted gains income can vary markedly. As Chart 2 shows, the effective rate can be much larger than 28 percent in situations where the sold asset did not appreciate much more than general price inflation (we used the CPI in our calculations). The chart does not even attempt to depict the rate for a situation in which the taxpayer winds up with less in purchasing power than he put in, *i.e.*, when the gains tax acts as a confiscatory wealth tax rather than an income tax. For example, an asset purchased in 1970 for \$1,000 could have been sold for \$3,735 in 1996 if it had appreciated at 5 percent per year. The tax on that nominal gain at 28% would be \$765, leaving the investor \$2,970 to spend. This amount was \$1,073 less than the 1996 purchasing power (\$4,043) of the 1,000 1970 dollars that the investor had “tied up” for 26 years. Stated differently, the taxpayer realized only \$923 in 1970 dollars and had to pay \$189 of that as a gains tax. What

² There are no apparent reasons why the limit is \$3,000 rather than some other amount, why that amount was not indexed along with tax brackets and exemptions in the reforms of the 1980s, or why it has not been increased since 1978.

the tax collector is saying in this instance is, essentially: “you owe me money because you converted an asset into cash” rather than “you must pay me a portion of your income.”

A lower gains tax rate would push the peaks farther back in the chart, but it would not eliminate them — taxing nominal gains will always lead to very high and confiscatory rates on real income when the taxpayer’s investment has not performed very well in relation to overall price inflation. On the other hand, it is also evident in the chart that the effective gains tax rate on the real incomes of those whose holdings have appreciated at rates well above the rate of price inflation over the years *are never much more than the 28 percent* tax on their nominal gains. This is the reverse of progressive taxation — those who have made the most pay the lowest rate.

A lower rate on capital gains would be a singularly ineffective and ham-handed way of adjusting the taxpayer’s liability to reflect genuine economic income — it would provide a substantial tax cut for those whose holdings have appreciated at rates well in excess of inflation, but it would leave those whose holdings performed relatively poorly paying high and confiscatory rates. Grant-

ing a larger rate reduction on assets held for longer time periods, which has been proposed by some, would be only a partial solution — the effective tax rate on inflation-adjusted income would still largely depend on the nominal rate of return earned by the investor in relation to the rate of price inflation.

The Republicans’ desire to tax gains at a lower rate may be seen as a “targeted tax cut” similar to those favored by the President. The GOP’s target would seem to be the founders of successful companies, who often hold stock for which they paid very little, and could “cash in” and pay taxes at rates substantially less than what is due on the salaries they pay themselves. Granting “goodies” to particular constituencies may be “business as usual” in Washington, but it is not reform.

Indexing long-term gains is the reform that the current situation calls for. Yet, as far as we are aware, indexing historical gains is not even on the table (the indexing proposals in Congress seem to be only prospective — they would apply only to investments made after the law was changed.)

We will discuss the issues, problems and objections to indexing in a future issue of *Research Reports*. □

CONSUMER PRICE CHANGES IN 1996

The CPI increased by 3.3 percent last year, but price changes for individual goods and services differed substantially from this average increase.

The rate of price inflation, as measured by the Consumer Price Index (CPI), was 3.3 percent in 1996, somewhat higher than the 2.5 percent increase the previous year. This marks the first acceleration in price inflation since 1990, and the first time in 5 years that it has risen above 3 percent. Despite this increase, the rate of price increase is roughly half of what it was in the late 1980s, and well below the double-digit rates of the late 1970s.

The rate of increase in the general price level may be even lower than the CPI indicates. According to a report issued last December by a Government-appointed panel of economists, problems in the calculation of the CPI may have led it to overstate price inflation in the past couple decades by as much as 1.1 percentage points each year. If so, price inflation last year was only 2.2 percent rather than 3.3 percent. Among other things, this suggests that the Government has been overadjusting Social Security benefits and the income tax code for price inflation, and that it could shave billions off the budget deficit by correcting for this overstatement.

The panel’s report on the CPI has revived an accusation that goes back many years, namely, that the official price figures are “rigged” by the Government. Many

people find it difficult to reconcile the reported figures of price inflation with their own experience in the marketplace, and they see the panel’s recommendations as the latest attempt to understate the problem of rising prices. However, no one has ever turned up any credible evidence of such trickery. Hundreds of Government economists, statisticians, price takers, and other number crunchers help collect and process the data used to calculate the various price series. We believe that a conspiracy to “cook” the data would be difficult to organize and impossible to conceal.

Price inflation is easier to measure in theory than in practice: it cannot be observed directly. We can only observe thousands of prices for thousands of goods and services. The Labor Department periodically surveys households to find out how much of their budgets they spend on various items. The results of this survey are used to create a “basket” of goods and services that is supposed to be representative of the “average” American’s spending habits. Changes in the price of this basket are reported as changes in the CPI.

This basket is weighted to reflect the fact that people spend more on some items than on others. Most people spend more on housing than they do on coffee, for example, so a

10 percent increase in the rent has a bigger impact on their budget than a 10 percent increase in the price of coffee. The CPI gives a greater weight to the increase in rent.

However, no one’s spending patterns are “average.” Buying habits vary with income, family size, age, location, and tastes. An increase in the price of coffee does not affect your living expenses unless you are a coffee drinker. To take another example, changes in the price of “personal and educational” expenses are given a weight of only 4 percent in the CPI. In other words, it is assumed that such expenses account for only 4 percent of a household’s expenses. Averaging across many families, this may be accurate, but it is far too low to reflect the impact of rising tuition costs on a family that faces large out-of-pocket expenses to pay for college. Conversely, it is too high for the many Americans who at any given time are not paying for schooling, and whose cost of living therefore is not directly affected by tuition hikes. Similarly, medical expenses account for 7 percent of the CPI, which is too low for the relatively small share of the population receiving extensive medical treatment and facing large out-of-pocket expenses, and too large for everyone else.

Because the CPI’s weighted basket of goods and services is an average of such widely varying spending patterns, it may not reflect the price inflation personally experienced by many people. This may be the case for a growing number of people, because the basket of goods and services that is currently used to calculate the CPI is based on spending patterns that were last measured in a 1982-84 survey of consumers. People’s spending habits change over time, and this survey is now somewhat out of date.

This suggests another difficulty in measuring price inflation. In theory, the quality of the items in the CPI basket does not change over time. After all, the goal is to compare the change over time in the price of buying the same things (or, more accurately, the same level of satisfaction that those things provide). In fact, the quality of many items does change, and the CPI is adjusted to take this into account. If the price of a car increases but the increase reflects the introduction of an improvement such as power steering, this should not affect the CPI.

Because of this quality adjustment, changes in the CPI sometimes understate the price changes that people observe in the marketplace. However, many economists believe that, on balance, the quality of goods and services has improved more than indicated by official adjustments. It often is difficult to assign a value to a quality change, and for many items in the CPI no quality adjustment is made. If quality adjustments have been inadequate, then the CPI may have overstated price inflation in recent decades, as suggested by the panel.

Critics of the CPI often cite another short-

Percent Changes in Selected Consumer Price Indexes
December 1995 – December 1996

<i>Expenditure Category</i>	<i>Percent Change</i>	<i>Expenditure Category</i>	<i>Percent Change</i>	<i>Expenditure Category</i>	<i>Percent Change</i>
All Items	3.3	Household furnishings and operation	1.0	Tires	0.0
Food and beverages (17% of expenditures)	4.2	Housefurnishings	-0.1	Automobile insurance	3.8
Food	4.3	Bedroom furniture	3.4	Automobile finance charges	-2.0
Food at home	4.9	Sofas	1.8	Automobile fees	1.0
Cereals and bakery products	3.7	Living room chairs and tables	-1.1	Public transportation	11.2
White bread	8.3	Televisions	-5.3	Airline fares	14.7
Meats	5.2	Video products other than televisions	-0.6	Public transportation within city	5.8
Beef and veal	2.4	Audio products	-0.6		
Pork	11.3	Refrigerators and home freezers	2.2	Medical care (7% of expenditures)	3.0
Poultry	7.9	Laundry equipment	3.1	Medical care commodities	2.6
Fish and seafood	1.7	Stoves, ovens, dishwashers, and air conditioners	-0.7	Prescription drugs	3.2
Eggs	12.0	Information processing equipment	-11.6	Over-the-counter drugs	1.3
Dairy products	10.1	Clocks, lamps, and decor items	-4.2	Medical care services	3.2
Fresh whole milk	10.9	Tableware, serving pieces, and nonelectric kitchenware	0.9	Physicians' services	3.0
Cheese	8.0	Lawn equip., power tools, hardware	2.4	Dental services	5.1
Ice cream and related products	7.7	Housekeeping supplies	0.7	Eye care	1.2
Fresh fruits and vegetables	4.8	Housekeeping services	1.1	Hospital and related services	4.1
Apples	3.5			Hospital rooms	3.6
Bananas	7.5	Apparel and upkeep (6% of expenditures) ..	-0.2	Other inpatient services	4.4
Potatoes	-8.6	Men's apparel	1.6	Outpatient services	4.8
Lettuce	7.2	Suits, coats, and jackets	-0.3		
Fruit juice and frozen fruit	7.4	Shirts	1.9	Entertainment (4% of expenditures)	2.9
Frozen vegetables	2.4	Dungarees, jeans, and trousers	1.7	Entertainment commodities	2.4
Sweets, including candy	4.9	Boys' apparel	0.5	Newspapers	3.0
Nonalcoholic beverages	-2.0	Women's apparel	-0.9	Magazines, periodicals, and books	2.4
Coffee	-6.7	Coats and jackets	2.1	Sport vehicles, including bicycles	0.1
Canned and packaged soup	4.8	Dresses	-5.8	Other sporting goods	-0.3
Frozen prepared food	4.6	Separates and sportswear	-0.2	Toys, hobbies, and music equipment	8.3
Snacks	5.8	Suits	-3.9	Photographic supplies and equipment	-0.4
Food away from home	3.1	Girls' apparel	-2.9	Pet supplies and expense	5.3
Lunch	3.0	Infants' and toddlers' apparel	-1.4	Entertainment services	3.4
Dinner	2.8	Watches	-6.1	Club memberships	-0.7
Alcoholic Beverages	3.6	Jewelry	-4.7	Admissions	4.0
Beer and ale	2.9	Footwear	1.5	Fees for lessons or instructions	5.9
Wine	6.2	Laundry, dry cleaning, and other apparel services	2.4		
Distilled spirits	2.1			Other goods and services (7% of expenditures)	3.6
Housing (41% of expenditures)	2.9	Transportation (17% of expenditures)	4.4	Tobacco and smoking products	2.7
Shelter	2.9	New cars	1.6	Personal care	1.1
Renters' costs	3.4	Subcompact	0.9	Cosmetics and related products	2.5
Homeowners' costs	2.8	Compact	3.2	Beauty parlor services for females	2.8
Maintenance and repairs	3.6	Intermediate	0.8	Haircut and other barber shop services for males	4.6
Fuel oil	23.3	Full-size	2.0	Personal and educational expenses	4.6
Electricity	0.7	Luxury	2.6	School books and supplies	5.5
Utility (piped) gas	11.0	New trucks	2.2	College tuition	5.3
Telephone services	2.1	New motorcycles	3.8	Elementary and high school tuition	4.6
Local charges	0.9	Used cars	-1.6	Day care and nursery school	3.7
Interstate toll calls	3.7	Motor fuel	12.7	Legal service fees	3.8
Water and sewerage maintenance	3.5	Automobile maintenance and repair	3.1	Personal financial services	3.4
Cable television	7.8			Funeral expenses	4.7
Refuse collection	1.8				

coming of it as a measure of "the cost of living." It does not include most of the impact on living expenses of one major item, taxes. Excise taxes, *i.e.* taxes on specific products such as cigarettes and gasoline, are included in the price estimates, but income, personal property, payroll, and other taxes are not. In particular, higher state and local taxes have increased the cost of obtaining many goods and services in recent years, but this is not reflected in the CPI.

The flip side of this is that the CPI's basket of goods and services does not include those provided by the government. The cost of living is affected by the burden of taxes, and the standard of living is affected by what those taxes buy in terms of defense, safe neighborhoods, road maintenance, the quality of education in public schools, etc. The CPI does not measure changes in the price or quality of these things.

The accompanying table shows price

changes for 1996, as measured by the Bureau of Labor Statistics, for many of the goods and services included in the CPI. For items that are adjusted for quality, such as cars, TVs, and information-processing equipment, the figures reflect the change in price after the adjustment. The table reveals where price pressures were greatest last year. Consumers who purchased relatively more of the items for which price increases were

relatively large suffered a larger increase in their living expenses than that implied by the 3.3 percent increase in the aggregate CPI. Those who purchased more of the items whose prices increased slightly or decreased experienced a smaller increase in their cost of living. Readers may judge for themselves how accurately the increase in the CPI mirrors their own experiences in the marketplace last year. □

PRICE OF GOLD

	1995	1996	— 1997 —	
	Mar. 2	Mar. 7	Feb. 27	Mar. 6
Final fixing in London	\$374.75	\$393.90	\$360.00	\$352.60

Research Reports (ISSN 0034-5407) (USPS 311-190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Periodical postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: \$16 per quarter or \$59 per year. POSTMASTER: Send address changes to **Research Reports**, American Institute for Economic Research, Great Barrington, Massachusetts 01230.