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Capital Gains Myths

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This article is a summary of parts of Lee’s forthcoming article “Critique of Current Congressional Capital Gains Contentions,” 15 Va. Tax L. Rev. — (1995). Professor Lee believes that the reasons given by the House Ways and Means Committee Report and capital gains cuts proponents in the recent hearings and the House floor debate in support of the CWATRA 50-percent individual generic capital gains cut are untrue in whole or in part. These stated reasons, reports Lee, are that a capital gains cut will (1) increase the personal savings rate, (2) encourage risk taking by entrepreneurs seeking new technologies and primarily benefit small-business people, (3) unblock many sales (true) permitting more money to flow to new, more highly valued uses such as new technologies and small business, (4) increase tax revenues short term (true) and long term, (5) primarily benefit middle-income taxpayers many of whom are temporarily pushed into higher income status by once-in-a-lifetime sales of a business, farm, or residence; (6) perhaps benefit lower-income taxpayers as they become higher-income taxpayers due to substantial income mobility; and (7) lead to increased investment and thus greater productivity and higher wages for all Americans. The facts, writes Lee, are that (1) after the last capital gains tax cut personal savings fell; (2) less than 10 percent of capital gains realizations go to small business (around 1 percent to venture capital startups) and most investment in small business is by the entrepreneur, family, and friends who probably would invest anyway; (3) while realizations will go up, most of the proceeds that are not consumed will go back on the public market into non-new-issues stocks; (4) increased realizations alone after an initial surge will lose revenue and any macroeconomic effects will take effect after the five-year budget window or be small (increased entrepreneurial activity); (5) taxpayers who infrequently realize capital gains account for less than 10 percent of realized gain while the top 10 percent by income of families who realize capital gains year after year account for 70 percent of the realizations; (6) income mobility studies mostly reflect the life cycle of young lower-income taxpayers growing older with higher wages and two-earner households and higher-income older taxpayers growing still older and retiring; and (7) notwithstanding the last capital gains tax cuts, average wages adjusted for inflation at the middle and bottom stagnated or fell. The trickle down, quips Lee, was from the top 1 percent to the top 5 percent.

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COMMENTARY / SPECIAL REPORT

H.R. 1215, Contract with America Tax Relief Act of 1995 ("CWATRA"), passed along partisan lines by the House of Representatives on April 5, 1995,1 provides both (a) a 50-percent exclusion for realizations by noncorporate taxpayers of gains from capital assets (other than from collectibles) held for at least one year and (b) indexing for inflation of the basis of capital assets acquired by noncorporate taxpayers on or after January 1, 1995, and held for three or more years. H.R. Rep. 104-84, the accompanying House Ways and Means Committee Report, provides unusually detailed "Reasons for Change"2 in support of these provisions. Additionally, various congressional committees held extensive hearings on the CWATRA capital gains proposals during the winter of 1995. This article examines those reasons in the order set forth in the report, as amplified by the contentions of capital gains cuts proponents and opponents in the recent hearings and the House floor debate, concluding that most are either wrong or better answered through other techniques not on the table. A principal underlying thesis of this article is that the proposed 50-percent exclusion of capital gain would produce inequitable results because the 50 percent or more of annual capital gains realizations enjoyed by the top 1 percent of families are on the average themselves more than 50 percent real or economic gains.3 Thus, a 50-percent exclusion is too generous. Such exclusion would lower the effective rate of federal taxation on realized income of families in that top 1 percent with capital gains considerably below that of other high-income families without capital gains down to the effective rates of moderate income families,4 thus violating principles of both horizontal and vertical equity, i.e., taxpayers with like amounts of income should be taxed equally and the rate of taxation should increase with ability to pay. Conversely, the capital gains reported by the bottom 90 percent of families (below $100,000) on the average are all inflationary gains,5 so that a 50-percent exclusion is not generous enough for them. The proposed inflation adjustment, while avoiding these inequities, would tend to block realizations by high-income families6 more than current law, thus reducing

4This was the pattern in the 1960s and 1970s when the effective rate for the top 1 percent was around 35 percent despite a top rate of 91 percent gradually reduced to 70 percent, with high-income taxpayers with capital gains being 10 percentage points or so below this average effective rate and high-income taxpayers without capital gains being 20 percentage points or so above it. House Ways and Means Majority Staff, Tax Progressivity and Income Distribution, 101st Cong., 1st Sess. 2 (House Ways and Means Comm. Prnt 1990); United States Treasury Department, Tax Reform Studies and Proposals (Parts 1 and 2), 91st Cong., 1st Sess. 81-86 and 142-45, respectively (Comm. Prnt 1969); 110 Cong. Rec. (Part 2) 1438 (Senate January 30, 1964) (Remarks of Floor Manager Senator Long, D-La.); Hearings on the Subject of Tax Reform (Tax Reform, 1969) before the House Ways & Means Comm. (Part 4), 91st Cong., 1st Sess. 1592, 1598-99 (1969) (Statement of Ass't Sec'ty Stanley Surrey). The reduction of the top ordinary income and capital gains rates to 50 percent and 20 percent in 1981, coupled with the accelerated capital recovery rules, and thus tax shelters, resulted in an effective rate at the top of 24.9 percent. Tax Progressivity and Income Distribution, supra at 29; Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990 47 (1987). By 1990 the Tax Reform Act of 1986 repeal of the capital gains preference and limitations on passive losses (tax shelters), together with the various revenue raising provisions of the budget acts, had brought the top effective rate back up to 27 percent. Progressivity and Income Distribution, supra at 2-4, 12-13; Joint Committee on Taxation Staff, Tax Policy and the Macroeconomy: Stabilization, Growth and Distribution, 102d Cong., 1st Sess. 5, 29-30, 55 (House Ways & Means Comm. Prnt 1991) Thus, the federal income tax system remained somewhat progressive, but less than in prior decades. Tax Policy and the Macroeconomy, supra at 67-68. The new top ordinary income "rates" of 36 and 39.6 percent brought the effective rate of the top 1 percent up to 33 percent (or about 90 percent of the historic top effective rate). Ways and Means Democrats, Highlights Republican Tax Package (March 9, 1995), 95 TNT 50-52 (March 14, 1995). The agenda of some of the supporters of CWATRA is to eliminate two-thirds of the 1993 increase in taxes at the top. 141 Cong. Rec. H 4219 (House April 5, 1995) (Remarks of Rep. Jim McCrery, R-La.) ("If two years ago you were against the tax increase, why would you not be now for giving back to the people about two-thirds of that tax increase?").

5H.R. Rep. No. 104, 104th Cong., 1st Sess. 35-6, 38 (1995). This article discusses only the generic 50-percent exclusion of gain and indexing for inflation of the basis of capital assets disposed of by noncorporate taxpayers provisions of CWATRA; the other capital gains proposals were scarcely discussed in the hearings or House floor debate, which is probably a strong indicator of their ultimate legislative viability.

6The top 1 percent of returns (by adjusted gross income) reported more than 50 percent of the realized capital gains in the early 1980s as in earlier decades (except for the mid-1970s). Congressional Budget Office, How Capital Gains Tax Rates Affect Revenues: The Historical Evidence 30-1 (March 1988); see 141 Cong. Rec. H 4208 (House April 5, 1995 Daily Ed.) (Remarks of former chair Sam Gibbons, D-Fla.). Between 50 percent and two-thirds of the capital gains reported by taxpayers with over $200,000 in adjusted gross income were real or economic in the 1970s and early 1980s with the percentage of real gains climbing with income. Treas. Dep't, Report to Congress on the Capital Gains Tax Reductions of 1978 10, 11, 47 (September 1985) (Tax Reductions of 1978); Congressional Budget Office, Indexing Capital Gains 25 (August 1990).

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revenues. Combining indexing and a 50-percent exclusion as CWATRA does would be inequitable because lower- and moderate-income capital gains realizers would still have uncompensated real losses on the average and obtain no benefit from the 50-percent exclusion, while higher-income realizers on the average would have real gains that would benefit from the 50-percent exclusion. The real danger in indexing is that it has little or no constituency among the traditional interest groups supporting capital gains preferences (because they either have little or no basis or do much better than inflation). Therefore, if enacted alone, indexing would probably prove to be a Trojan Horse, with political pressure building for its replacement with a 50-percent generic capital gains exclusion, which after a few years could be done with no revenue loss. There are many solutions that avoid most or all of the above problems but none have sufficient political support for enactment in the current climate. Consequently, the current 28-percent ceiling on individual capital gains should be maintained and no further preference given at the current time.

Myth No: 1. A Capital Gains Tax Cut Will Increase the Saving Rate of American Households

H.R. Rep. No. 84 points out that net personal savings in the United States averaged 4.8 percent of gross domestic product (GDP) in the 1980s, below the rate of our major trading partners, and further dropped to 3.5 percent of GDP in 1992. House Ways and Means Chair Bill Archer, R-Texas, believes that 95 percent or more of the net proceeds of capital gains sales are reinvested in capital assets. Under this view, reducing capital gains taxes that are vacuumed up by Treasury and redistributed in consumption must increase the savings rate. According to the report, many economists testified that a reduction in capital gains taxation by increasing the rate of return on savings would increase savings. The actual theoretical and empirical economic literature conflicts as to whether an increase in rate of return increases savings. As Dr. Barry Bosworth, Senior Fellow at the Brookings Institute, put it at the January 11, 1995, Ways and Means Hearing on the Contract: “We [economists] don’t agree on a damn thing about how to stimulate private savings and what will work and what won’t work.” Indeed, Chair Archer’s premise of 95-percent reinvestment was wrong in the real world of the leveraged buyouts in the 1980s, when over half of the proceeds were spent on consumption items. Most significantly, this “cut the capital gains rate-increase private savings” experiment has been tried before and failed. The 1978 and 1981 capital gains cuts did not increase the individual savings rate despite claims at the time that they would. Indeed, household savings fell in the period following such cuts. From this, one could con-
clude that the savings incentives in the Contract will not lift the private savings rate. Rather, given that the decline in savings occurred as to Americans now 55 or older, other causes appear to have been at work. For example, the decline may be attributable to an increase in the availability of insurance and Social Security and Medicare benefits, reducing the necessity for private savings. The most direct way to increase private savings is likely to be to reduce the federal budget deficit.

Myth No. 2: A Capital Gains Tax Cut Will Encourage Risk Taking by Individuals Pursuing New Businesses Exploiting New Technologies

H.R. Rep. No. 84 reasons that risk taking is stifled if taxation of any resulting gain is high and the ability to claim losses is limited. Proponents of the capital gains cuts in the Contract steadfastly maintained in the 1995 hearings that a generic capital gains cut (some added indexing) is necessary either to unlock frozen capital assets for investment in starting up or expanding young businesses or to reward the entrepreneur and investors for the greater risk in new ventures. The opposing view is that entrepreneurs (who together with family and friends are the primary source of capital for new ventures) are motivated by the rewards of running their own business and not the capital gains tax rate on selling out. As Rep. Fortney Pete Stark, D-Calif., asserted at the January 25, 1995, Ways and Means Hearing on the Contract, “entrepreneurs are born, not made.” Thus, “stifling” appears a myth, at least with a top capital gains rate of 28 percent, a top ordinary rate of 39.6 percent, and an existing preference of 50 percent for stock in certain small businesses under section 1202, which CWATRA would repeal. For most entrepreneurs, a capital gains preference appears to be a subsidy rewarding them for what they would have done anyway rather than an incentive to do what they otherwise would not have done.

The real myth is that the capital gains preference “essentially” benefits the small-business folks, farmers, and home owners, in whose interest congressional capital gains cuts proponents usually claim the need for the additional capital gains preferences. Rep. Ron

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18Lee, supra note 9, at 1415; Ways and Means Hearing January 24, 1995 (Statement of Mark Bloomfield); id. (Statement of Rep. Phil English, R-Pa.); Tax Reductions of 1978, supra note 3, at viii, 144-46; Hearings on Economic Growth and the President’s Budget Proposals before the Senate Finance Committee (Part 1), 102d Cong., 2d Sess. 56, 60 (1992) (Statement of Robert Gilbertson, representing American Electronics Association); accord, id. at 61 (Statement of John J. Motley, representing National Federation of Independent Business); 1990 House Hearings on Fairness, supra note 8, at 118 (Statement of Professor Alan Auerbach); id. at 130 (Statement of Dr. Henry Aaron, director of Economic Studies at the Brookings Institute); Joint Committee on Taxation, Proposals and Issues Relating to Taxation of Capital Gains and Losses, 33 (JCS-10-90 March 23, 1990); Capital Gains and Losses 1995, supra note 21, at 19.

21The 1989 floor debate on the capital gains cut sponsored by Rep. Ed Jenkins, D-Ga., and Rep. Bill Archer, R-Texas, most clearly identified the capital gains special interests of timber, small business and high tech ventures, farmers, (farmland and recurring sales of livestock), and occasionally residences. 135 Cong. Rec. at H 6281 (House September 28, 1989 Daily Ed.) (Remarks of Rep. Beryl Anthony, D-Ark.) (beneficiaries of capital gains cut are homeowners, farmers, small businessman, small investor nest egg); id. at H 6284-85 (Remarks of Rep. Tom Campbell, R-Cal.) (“Northern California and the Silicon Valley is composed of entrepreneurs, risk-takers who are willing to put their effort and their money on the line”, capital gains is only the start to reward competitiveness); id. at H 6289 (Remarks of Rep. Steve Gunderson, R-Wis.) (small business and farm; individuals source of own capital in small businesses, they build up equity 20-30 years for retirement; also farmers sell under section 1231) 20 head of breeding stock a year); id. at H 6290 (Remarks of Rep. Bill Frenzel,
Wyden D-Ore., in the January 25, 1995, Ways and Means Hearings on the Contract, epitomized the myth: "There is this perception in America that the capital gains issue will help, you know, somebody who is clipping coupons and working out of a high-rise building in Manhattan and will not, you know, essentially be of benefit to the kind of people that you’re talking about [i.e.,] Americans who are middle income, they’re retired, they’re small businesses, they’re entrepreneurs trying to start a biotech company who would benefit from this."25 Some congressional supporters of the current capital gains proposals, such as Rep. Wyden, might actually believe that the primary beneficiaries of the cuts are these interests. They are deluded. Small-business people and farmers together probably account for 5 to 10 percent of annual capital gains realizations at best;26 venture capital, around 1 percent;27 and the overwhelming number of sales of personal residences are not taxed due to rollovers, the $125,000 age 55 exclusion, and the step-up in basis at death.28 In good stock market years 50 percent of the realizations are equity, overwhelmingly public stock, and the bulk of the rest of the realizations are improved real estate.29

in small businesses also appeared more recently to be less than 15 percent by value of the equities in all corporations. In 1988, the 10,400 largest and mostly public corporations (out of less than four million corporations in all including 5 corporations) held 84 percent of the corporate assets by adjusted basis (so that self-created goodwill would not be counted). Also public stock trades much more frequently than stock in a close corporation. Lee, supra note 9, at 1416. The Small Business Administration estimates that only 10 percent of business finance resources currently go to small business. Letter dated April 3, 1995, from Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Business Administration to Rep. Zoe Lofgren, D-Cal., reprinted in 141 Cong. Rec. H 4318 (House April 5, 1995 Daily Ed.). Thus annual realizations of close corporation stock probably do not exceed 10 percent of the present corporate equities by amount. Tax realizations of close corporation stock probably do not exceed 10 percent of all annual capital gains realizations, note 29 infra, so realizations of stock in close corporations probably do not exceed 5 percent of all capital gains realizations on the average.

25In 1983 venture capital investments amounted to only 0.1 percent of total net worth and less than 1 percent of the market value of equity of all nonfinancial corporations. Tax Reductions of 1978, supra note 3 at 139; see Poterba, supra note 21, at 382 (initial public offerings by venture backed firms averaged 1.1 percent of total capital gains realizations).


27Prepared Statement of Jane G. Gravelle, Senior Specialist in Economic Policy Congressional Research Service Before the Senate Finance Committee February 15, 1995, 95 TNT 32-38 (February 16, 1995) (gains from equities range from about 20 to 50 percent of annual realizations depending on the relative performance of the stock market; much of remainder is gain on real estate); Tax Reductions of 1978, supra note 3, at ii, iii, viii, 15, 16; Capital Gains and Losses 1995, supra note 21; Hearings on H.R. 8363 (the Revenue Act of 1963) before the Senate Finance Committee (Part I), 86th Cong., 1st Sess. 197 (1963) (41 percent of capital gains realizations in 1959 from corporate stock); 1963 Senate Hearings; Congressional Budget Office, Effects of Lower Capital Gains Taxes on Economic Growth, 30 (August 1990) ("In 1984, 46 percent of net capital gains was on corporate stock . . . ."). During the 1985-89 period, sales of stock, securities, and partnership interests (Footnote 29 continued on next page.)
Timber and livestock, other frequently touted capital gains special interests, make up only a fraction of annual realizations of capital assets.\textsuperscript{30} Other capital gains proponents probably realize that the interests that they champion garner only a small percentage of the benefits (as a reward), but such small business and farm or timber interests, depending on the region, are both the vocal constituents and the members of Congress and local opinion leaders who do want the benefits of a capital gain preference. So they follow the late Speaker of the House Tip O'Neill's adage that "[a]ll politics is local"\textsuperscript{31} and support the preference for their constituents' small piece of the benefits. Still others really want the preference for the wealthy realizing the bulk of capital gains year after year, mostly from public stock and real estate investments, who are their constituents\textsuperscript{32} and are cloaking that interest in the mantle of the small business, farm, and residence. The classic example of this cloaking came in a 1976 Senate Finance Committee Hearing when Senator Abraham Ribicoff, D-Conn., challenged the claim of the Merrill Lynch & Co. representative that capital gains taxes impacted most severely on small investors; the witness agreed but rejoined, still cloaking, that the point he was trying to make was that of the investor in his own company who sells it on retirement.\textsuperscript{33}

**Myth No. 3: Lowering Capital Gains Rates Will Unblock Many Sales Permitting More Money To Flow to New, More Highly Valued Uses**

The Ways and Means report states that a reduction in the capital gains tax should improve the efficiency of the capital markets; all economists agreed that a capital gains cut would reduce "lock-in" and increase realizations. The report concludes that such unblocking would permit money to flow to new, more highly valued uses, thus improving the efficiency of the capital market.\textsuperscript{34} For more than 50 years, capital gains cut proponents have claimed that unblocking would permit capital to flow from sales of public stock to new companies.\textsuperscript{35} That case has never been made. Despite claims of capital gains cuts proponents that the CWATRA 50-percent generic capital gains cut "would free up capital for small business and entrepreneurs, providing the economy with seed corn..."\textsuperscript{36} realizations from public stock do not flow to new venture capital or to closely held businesses (unless they are of public stock held by the entrepreneur herself).\textsuperscript{37} As Sen. Dale Bumpers, D-Ark., father of the section 1202 targeted small-business stock preference slated for repeal by CWATRA, stated in the aftermath of the House's passage of CWATRA: "I have never understood what economic benefit this country derives when somebody sells General Electric and uses the money and buys DuPont stock."\textsuperscript{38} The Small Business Administration also regards a generic capital gains cut as "rewarding nonproductive speculation in real estate or the stock market..."\textsuperscript{39} The facts behind this rhetoric are that most mature corporations raise outside capital these days through debt and not common stock offerings.\textsuperscript{40}
Not surprisingly, therefore, less than 3 percent of the action on Wall Street consists of public offerings of new common stock. Initial public offerings make up one-third to one-half of new common stock offerings, most of which probably could qualify under section 1202 as to noncorporate purchasers and thus obtain a preference under current law. To the extent this is not so, the remedy is amendment of section 1202, not its repeal and replacement with a wasteful generic capital gains preference.

**Myth No. 4: Unblocking Sales Will Have the Short-term and Long-term Effect of Increasing Revenues**

The Ways and Means Committee report also claims that this unblocking of sales will have the short- and long-term effect of increasing revenues. Whether the proposed preferences would raise revenue is harder to predict since this is another economic question upon which economists cannot agree in theory or empirical studies. The issues are microeconomic (increased realizations through unblocking effects) and macroeconomic (growth in the economy) effects. The Joint Committee Staff estimates that increased realizations induced by the CWATRA capital gains cuts would lower the "static" loss in the five-year budget window by 60 percent. The catch is that the Joint Committee believes that after an initial surge in realizations (50 percent of the baseline during the initial five-year budget window) most taxpayers will settle into a permanent level of lower realizations yet higher than would be expected in the absence of a rate reduction. But this permanent level of realizations would still lose revenue over the five-year budget window and beyond. The Joint Committee found that the capital gains relief in the originally proposed Contract would have cost $53.9 billion over five years and $170 billion over 10 years. It scored the capital gains proposals as modified on March 9, 1995, as losing only $31.7 billion over the first five years, with most of the change attributable to a scaled back corporate capital gains provision. Treasury put the capital gains costs of original proposals at $60.9 billion and $183.1 billion, respectively. Treasury scored CWATRA’s capital gains provisions considerably lower, however, losing only $11 billion over the five-year budget window and $91 billion over the 10-year window. Here too there was an experiment, the 1978 and 1981 capital gains tax cuts. Treasury and the Joint Committee both found that, over the long haul, these capital gains cuts lost revenue under a “timed series” analysis.

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**Footnote 53 continued on next page.**

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The big debate is over the macroeconomic or "feedback" effects. Neither Treasury nor the Joint Committee on Taxation takes such effects into account in estimating future revenue gains and losses, in part because there is wide disagreement among economists as to such effects. The Treasury study of the 1978 and 1981 capital gains cuts did not take such macroeconomic effects into account. It is very difficult to separate the effects of such tax cuts from other forces at work in the economy at that time. For instance, the increased capital gains realizations during 1978-1985 coincided with stock and real estate booms. Moreover, the Joint Committee on Taxation believes that if the CWATRA capital gains cut produces a growth in productivity, "it would occur slowly at first, with most of the effects outside the five-year budget window." While any changes in entrepreneurship would more likely occur within such budget window, "[such activity had been a very small factor in previous market responses to changes in the taxation of income from capital."

Both capital gains proponents and opponents of the CWATRA capital gains cuts come to this issue with a history. The opponents remember that the Reagan administration sold the 1981 tax cuts (including cutting the maximum individual capital gains rate from 28 to 20 percent, very close to the CWATRA rate cut) on macroeconomic assumptions as to increased savings and productivity that, together with not-tied-down spending cuts, would lead to balancing the budget. The current deficit is the result of those tax cuts, increases in defense spending, and the failure to make deep cuts in other spending. The proponents, on the other hand, remember that the problem of scoring a capital gains cut as a revenue loser played a major role in stymieing President George Bush’s proposed capital gains cut in 1990, and some members of Congress see a reprise currently. Then Treasury's estimates showed a revenue gain while the Joint Committee's showed a revenue loss of almost the same amount. Some ap-

59Ways and Means Hearing January 24, 1995 (Statement of Rep. Robert Matsui, D-Calif.); Transcript of the Ways and Means Hearing on the Republican Contract, January 5, 1995 (Statement of Rep. Sam Gibbons, D-Fla.) ("I will not go down the road again, having made the mistake once, of voting for tax reductions and just taking an empty promise that we're going to get the spending cuts."); Barbara Kirchheimer, "Finance Majority Prefers Deficit Reduction to Tax Cuts," 95 TNT 55-1 (March 21, 1995) (same simile by Senator Bob Packwood, R-Ore.); 141 Cong. Rec. H 4214 (House April 5, 1995) (Remarks of Rep. Sam Gibbons, D-Fla.) ("It is deja vu all over again. The same rhetoric, the same people."); id. (Remarks of Rep. Sander Levin, D-Mich.). President Ronald Reagan's first budget message to Congress contained "overoptimistic" macroeconomic offsets to proposed tax cuts projecting a $342 billion increase in federal receipts over 1981-86. Joint Committee on Taxation Staff, Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains, 7 n.10 (JCS-12-90 March 27, 1990) (Methodology 1990). Instead, total receipts rose just $170 billion and only after substantial revenue increases in 1982 and 1984. Id. See also Hearings on Tax Aspects of the President's Economic Program before the House Committee on Ways & Means (Part 1), 97th Cong., 1st Sess., 14, 17, 42 (1981) (Statement of Sec'y Don Regan); id. 56-7, 61, 70 (Statement of Office of Management and Budget Director David Stockman) (spending control plan is essential and indispensable anchor; "combination of incentive-minded tax rate reductions and firm budget control is expected to lead to a balanced budget by 1984"); id. at 115, 118 (Statement of chairman of President's Council of Economic Advisers Murray Weidenbaum); 127 Cong. Rec. (Part 12) 15768 (Senate July 15, 1981) (Remarks of Chair Bob Dole, R-Kan.); id. (Part 14) at 18051 (House July 29, 1981) (Remarks of Rep. Kent Hance, D-Texas); id. at 18079 (House July 29, 1981) (Remarks of Rep. Clarence Brown, R-Ohio); id. (Part 13) at 17834 (Senate July 28, 1981) (Remarks of Senator William Roth, R-Del.); id. at 17975 (Senate July 29, 1981) (Remarks of Senator Steve Symms, R-Idaho) ("The tax reductions will be more than paid for by spending reductions, additional revenues from faster economic growth, and higher levels of private saving and investment.").


61Treasury scored a 30-percent exclusion against a 28-percent rate (or 19.6-percent maximum individual rate) as gaining $12.5 billion over five-year window; Joint Committee, losing $11.4 billion). Methodology 1990, supra note 59, at 2. The administration believed that reducing the tax rate on capital

Footnote 61 continued on next page.
parently misremember Treasury as using macro-economic assumptions and the Joint Committee as using static assumptions. Neither used macro-economic assumptions; both used microeconomic assumptions of induced realizations.

Clearly, more realizations and hence more revenue would result from taxation at death of unrealized appreciation (many more realizations would occur prior to death) or annual accrual of unrealized appreciation in public stock. Those who support additional capital gains preferences would give them up rather than face the חי with income taxation at death — that was President John F. Kennedy’s proposed package in 1963, which was rejected by capital gains cut proponents. Their opposition to annual accrual would be even more intense unless perhaps coupled with pass-through corporate shareholder integration, which would be the ideal answer to a host of current law policy problems.

Myth No. 5: Many Americans Realizing Capital Gains Are Middle-Income Taxpayers Pushed Into Top Brackets by a Once-in-a-Lifetime Sale

Treasury scored 76.3 percent of the benefits of the individual CWATRA capital gains exclusion and indexing as going to taxpayers with “family economic income” of $100,000 and above. Treasury’s distribution tables showed the top 1 percent of families (700,000 families, beginning at $349,438) as receiving 45.9 percent of such tax benefits; the top 5 percent (2,300,000 families beginning at $145,412), 66.5 percent of such benefits; and the top 10 percent (3,500,000 families beginning at $108,704), 73.9 percent. The Republican majority on the Ways and Means Committee rejects, however, “the narrow view that reductions in the taxation of capital gains will benefit primarily higher-income Americans. Traditional attempts to measure the benefit of a tax reduction for capital gains are deficient.” Proponents of a capital gains cut claimed that most capital gains are realized by middle-income taxpayers, some of whom are pushed into high-income status by the once-in-a-lifetime realization in just one tax year of gain that has accrued over a number of years, as in the case of a retirement sale of a small company that was formed many years ago. The Joint Committee estimated that the top 5 percent of such tax benefits would offset much but not all of the rate reduction.

Chair Bill Archer, R-Texas, is reported to have thought that the Joint Committee on Taxation used a static methodology while Treasury used a dynamic methodology. Barbara Kirchheimer, “Archer Wants Mini-reconciliation for Contract’s Taxes, Spending,” 95 TNT 3-2 (January 5, 1995).

“Ways and Means Hearing January 10, 1995 (Statement of Ass’t Sec’y Leslie Samuels); Methodology in Revenue Estimating 1995, supra note 54.

“Senate Hearing on Capital Gains February 15, 1995 (Statements of Dr. Henry Aaron and Dr. Jane Gravelle).

“The benefit of the Democratic quid (increased capital gains preference) was outweighed by the burden of the Republican quo (taxation of unrealized capital appreciation at death which would have more than paid for the capital gains cuts through increased realizations, President’s 1963 Tax Message 26, reprinted in Hearings before the House Committee on Ways & Means (Part 3), 88th Cong. 1st Sess. (1963)). 1963 Senate Hearings, supra note 29, at 285 (Colloquy between Senator Paul Douglas, D-III., and Secretary of the Treasury Douglas Dillon); 1963 House Hearings (Part 3), supra at id. at 1327 (Statement of Henry Bison, National Association of Retail Grocers); 1343 (Statement of Donald Alexander, Association of Institutional Distributors) (heaviest burden would fall on small- and medium-sized businesses); id. at 1364 (Statement of Samuel Foosaner, New Jersey Manufacturers’ Association) (burden on small business particularly from “goodwill” based upon capitalized earnings); id. at 1419 (Statement of Keith Funston, representing the New York Stock Exchange); id. at 1538, 1540-42 (Statement of Albert Mitchell and Stephen Hart, Esq., National Livestock Tax Committee); id. (Part 5), at 2529-91 (Statement of Rep. Joseph Montoya, D-N.M.); see also 1963 Senate Hearings, supra at 496 (Statement of Joel Barlow, representing the Chamber of Commerce of the United States).
business, farm or residence. This is the “king-for-a-day” myth.

In 1990 then Rep. (now Sen.) Byron Dorgan, D-N.D., asked the Joint Committee on Taxation Staff to make a time-series study of a sample of capital gains realizations, which demonstrated that the 43.7 percent of the individual taxpayers in the sample who realized capital gains only once in the five-year period surveyed (1979-83) had an average capital gain of $2,000 and realized only 9.8 percent of all capital gains realized by individuals in the period. On the other hand, the 15.7 percent of the individuals who realized capital gains in all five years realized an average capital gain of $100,000 and 58.9 percent of total capital gains realized over the period. Those who realized such gains in at least four years out of the five-year period recognized 70.9 percent of the total dollar value of reported capital gains. The Staff of the Joint Committee on Taxation concluded in 1995 that “[h]igher-income taxpayers generally hold a larger proportion of corporate stock and other capital assets than do other taxpayers. Thus, while many taxpayers may benefit from an exclusion or indexing for capital gains, a larger proportion of the dollar value of any tax reduction will go to those higher-income taxpayers who realize the bulk of the dollar value of gains.”

Some members of Congress may even believe the claims that 70 percent of capital assets are held by taxpayers with no more than $50,000 of AGI and that such taxpayers pay most of the capital gains taxes.

They are deluded both as to the facts and as to patterns of wealth in this country. The opposite is more true: 70 percent of the benefits of a capital gains preference are realized year after year by the same top 10 percent of families and 50 percent of the capital gains realizations are enjoyed by the top 1 percent of families with the bulk of their gains being real and not inflationary. It could be no other way taking into account the sources of capital gains realizations (mostly public stock and investment real estate) and concentration of ownership of such assets at the top.

Myth No. 6: There Is Substantial Economic Mobility in the United States so That a Lower-Income Taxpayer May Be Higher-Income a Decade Later (and Presumably Realize Her Share of Capital Gains)

H.R. Rep. No. 84 claimed as a further deficiency in traditional studies of benefits of a capital gains cut that they classify taxpayers only by their current economic condition; studies show that there is substantial economic mobility in the United States so that an individual classified as lower income may be higher income in a decade. “Substantial” income mobility is another misleading myth. Treasury under the Bush administration, to answer the Democratic charges of the failure of trickle down economics embodied in the 1978 and 1981 tax cuts, performed mobility studies concluding that as many as one-third of the taxpayers at the bottom of the income scale in 1979 moved up the scale during the 1980s and similarly as many as one-third in the top 20 percent moved down the income scale.
during this period. Much of the apparent upward mobility in income reflects, however, the young growing older and becoming part of a two-working spouse household or reaching peak earning years; downward mobility, growing older and retiring. "Although the poor can 'make it' in America, and the wealthy can 'fall from grace', these events are neither very common nor more likely to occur today than in the 1970s."  

Myth No. 7: Reduction in Capital Gains Leads To Increased Investment and Thus Greater Productivity and Higher Wages  
The Ways and Means Committee report stressed as the most important aspect of the benefits of a capital gains cut that it would lead to economic growth benefitting all Americans. Again, this experiment has been tried before and failed. The decline in wages at the middle and bottom over the past two decades indicates that the benefits of the capital gains cuts of 1978 and 1981 did not trickle down. The 23-percent decrease in the effective rate at the top due to the Economic Recovery Tax Act of 1981's 28.5-percent cut in the top investment income (70 to 50 percent) and top capital gains rates (28 to 20 percent) in addition to its proportionate 25-percent reduction in the breakpoints for all income tax brackets (phased in over three years) and the 6-percent increase in the effective rate at the bottom due to the 1983 increase in the regressive payroll taxes only exacerbated the fact that pretax income from 1978 to 1990 increased only at the top (where it almost doubled primarily due to speculative bubbles in the stock and real estate markets) while income remained stagnant at the middle and bottom as average wages fell and average hours worked by families increased, both in large part due to a greater percentage of work-

77U.S. Department of the Treasury Office of Tax Analysis, Household Income Mobility During the 1980s: A Statistical Assessment Based on Tax Return Data (June 1, 1992) ("Treasury, Income Mobility"); see 138 Cong. Rec. S 9125 (Senate June 29, 1992 Daily Ed.) (Remarks of Senator Pete Domenici, R-N.M.); see generally Peter Gosselin, "Back to the Future: Conservatirs Try to Redeem the Eighties as a Decade of Success, and a Roadmap to the Nineties," Boston Globe p. 77 (Sunday May 3, 1992). Treasury asserted that tracking individual members in the income quintiles from 1979 to 1988 in every quintile no more than two-thirds of those in the quintile at the beginning of the decade were in the same quintiles at the end; the same pattern occurred in the top 1 percent — only 47.3 percent of those in the top 1 percent in 1979 were still in the top 1 percent in 1988, but 75 percent were still in the top 5 percent.  

78An Urban Institute study on income class mobility released at about the same time concludes that there has been some income mobility decade by decade, but the degree of such mobility did not increase during the 1980s, and such mobility reflected to a large degree the life cycle of workers. Isabel Sawhill and Mark Condon, Is U.S. Income Equality Really Growing? Sorting Out the Fairness Question (Urban Institute Report 1992). The work life cycle is that "for rich and poor alike, earnings rise from the time individuals enter the work force through middle age — roughly doubling, in the average — and fall after retirement." Many of the people in Treasury's bottom quintile in 1979 were in fact middle- or high-income taxpayers such as business people or farmers with a bad year, and especially recent college graduates. Indeed, the average age of those in the bottom [first] quintile in 1979 who had risen to the top or fifth quintile 10 years later was 22; to the middle class, age 23. Steven Mufson, "Treasury's Look at Income Mobility; Study Fuels Argument Over Who Benefited from the Reagan Era," Washington Post A-17, col. 1, at col. 3 (Wednesday, June 3, 1992) (relying on Lee Price, a staff economist with the Joint Economic Committee). Conversely considering, for example, that the median age of the top 1 percent was 53 in 1981, Fisher, supra note 75, at 44, looking 10 years after 1979 at those who had been in the top 1 percent of taxpayers then, the median age would be at least 63 and one would expect that a large percentage had retired and in 1990 therefore had lower incomes.  

ing spouses. Contrary to the extreme rhetoric, the trickle down economics cuts did not cause the pretax income disparities, but they did make the after-tax disparities even wider.


83138 Cong. Rec. S 3385-86 (Senate March 12, 1992 Daily Ed.) (Remarks of Senator Al Gore, D-Tenn.) ("Middle-income families have seen their real income go down, a very slight increase in the top 20 percent, but look at the top 1 percent. Real incomes after taxes and after inflation adjustment have gone up 136 percent. That is fine if it does not come at the expense of the rest of the country, but what we have done is we have increased, more than doubled the income of the top wealthiest 1 percent by taking money away from middle-income Americans."); see also id. at H 620-21 (House February 26, 1992 Daily Ed.) (Remarks of Rep. Jim Moody, D-Wis.) ("the tax bill of 1981 and a number of subsequent measures produced what has generally been acknowledged to have been the most massive redistribution of wealth in this nation.").

84The pretax changes in income appear due to increased pay for skills (particularly those attained through education), which in turn may reflect to some degree the globalization of the economy with the economic principle of "factor price equalization" coming into play according to MIT Professor L. Thurrow, Head to Head 52-3 (William Morrow & Co. 1992); Economic Report of the President, 102d Cong., 2d Sess. 101-92, 112-13 (House Doc. 102-177 1992).