

Should We Lower the Capital Gains Tax?

On July 16, 1998, the Cato Institute held a Policy Forum, "Should We Lower the Capital Gains Tax?" Among the speakers were Newt Gingrich, Speaker of the House; Kenneth Kies, a partner in the Washington office of Price Waterhouse who was formally with the Joint Committee on Taxation; and Lawrence Kudlow, chief economist with American Skandia. Excerpts from their remarks follow.

Newt Gingrich: Central to the debate, not just for the United States, but for the future of the world, is the question, Does statism work or does free enterprise work? Everywhere on the planet the issue is the same. Human freedom is tied to private property rights, the rule of law, free enterprise, technological advance, and the idea that free people pursuing new ideas to create wealth is the most powerful way to raise the standard of living.

I was recently in a conversation with German and British parliamentarians. They got to talking about computers and how to make sure that poor people get them. I said that the real answer is economic growth. They stared at me like I'd lost my mind because that is such a non-European idea. I said that 99 percent of American homes have televisions and 97 percent have telephones—because our society is so much wealthier than it was 100 years ago. The answer to Dickens's *Bleak House* was economic growth and the encouragement of entrepreneurial innovation. This is a sophisticated model that no major political figure, with the singular exceptions of Jack Kemp and Ronald Reagan, has been able to explain. It's the center of what this debate is about. Frankly, if some of our friends on the left want to argue against economic growth, against technological change, against general prosperity, we should allow them to do so. But I believe that the average American actually gets the idea.

When we were sworn in in January 1995 the budgets for the next 11 years—1995 through 2005—were going to have a combined deficit of \$3,140,000,000,000. The projection that came out of the Congressional Budget Office yesterday is that over the next 11 years, 1998 through 2008, the budget *surplus* will be \$1,600,000,000,000. That is, over a 10-year period, a swing of \$4 trillion.

That's real change. The elite media don't

want to cover it. This is a different society. We're moving in a different direction. We've reestablished the work ethic instead of victimization. We've reestablished the right to entrepreneurship, which is Ronald Reagan's big domestic contribution. And we are moving toward a system that takes advantage of the information age and the world market.

It is in that context that I introduced my bill, which would create more economic growth. The Economic Growth Act of 1998 is effective as of the date introduced, June 24. It would cut the capital gains tax rate to 15 percent. Now I agree with Steve Moore and Alan Greenspan that the correct rate is zero if you want maximum economic growth. If you really wanted the most wealth created over the next 20 years, you would have a zero rate for the capital gains tax, which is a tax on job creation. But even 15 percent would be down from the current rate of 20 percent, which we reduced last year from 28 percent. The rate for those who are in the lower income tax bracket would go down from 10 percent to 7.5 percent. And of course this would be a simplified rate; we would eliminate the exception categories of real estate, depreciation recapture, collectibles, and gains from small business stocks. So we think this is a very powerful step in the right direction.

Our core message is very simple: Cutting the capital gains tax rate helps anyone who is preparing for retirement, starting a business, saving for college tuition, or planning to buy a house. The lower the capital gains tax rate, the better off society is.

We believe there's \$11 trillion of locked-in capital. What we want to do is increase the velocity with which people move from investments that are less productive to investments that are more productive. We want to lower the risk of investing in the next 30 new ideas that are Microsoft or Merck or Pfizer or Intel, because that's the way you accelerate growth.

So, our challenge here is to liberate that money so it can move to better investments. Humans change their behavior, and there's no area in which it's easier to change your behavior than capital gains, because if the tax goes up you just don't sell. You see this very dramatically if you look at 1985–86 when there was a preemptive sale of assets

to get ahead of the increase in capital gains taxes. People made sure they sold their capital prior to the tax going into effect in order to escape the higher tax rate, which then led to a dramatic drop in the total number of capital sales the year after the tax went into effect.

In 1978–79 we lowered the tax on capital gains, and a lot more people sold their capital and moved it to a better, more productive place. In 1981–82, even in the middle of a recession, people sold more of their capital because the rate went down. And in 1986–87 when the rate went up, we saw probably the largest recorded drop in capital sales ever. And all we're saying here is that when you lower the tax on selling capital, more people sell capital. And when you raise the tax, fewer people sell. And if you liberate capital and it moves to more productive investments, it has to increase economic growth.

When people sell capital, the sale represents unlocking money to go from a less productive investment to a more productive investment so that the general economy grows faster. Why do you have Microsoft producing Windows? Because somebody somewhere took a gamble that Bill Gates wasn't nuts when he dropped out of college. You know, lots of Europeans and Asians come to us and say, gee, how can we get our government to do that? The answer is you can't. We need to be much clearer about this. Bureaucracies don't make those kinds of gambles. And they certainly don't make them work.

In January 1997 the baseline estimate was that there would be \$205 billion of net capital sales last year. The Congressional Budget Office then adjusted it for our tax bill to \$256 billion, and then in January 1998 to \$382 billion. The difference between \$205 billion and \$382 billion is fairly significant. I would argue that there were two big things going on: The first is that we were changing the nature of the American political economy. Reforming welfare, balancing the budget, saving Medicare without a FICA tax increase, having less regulation, having the initial securities litigation bill pass and the veto overridden, all those were sending pro-free-market pro-growth signals that were positive. Second, in 1995 we had begun pushing the capital gains tax cut. People were

“I agree with Steve Moore and Alan Greenspan that the correct capital gains tax rate is zero if you want maximum economic growth.” —Newt Gingrich

beginning to realize their capital much more. But the key is that their behavior, which has changed fairly dramatically, has some very real revenue effects.

So, we want to reduce the maximum rate to 15 percent on our way to zero. We want to unlock \$11 trillion of unrealized capital gains. We believe that unlocking relates directly to the tax rate. And we want to suggest that if you look at both the direct revenues and the indirect revenues, you have a healthier economy with a greater rate of innovation, with more entrepreneurs founding new companies, with a greater chance to lead the world market at the high end of the product value scale.

Lawrence Kudlow: One of the key influences on American politics in the next few years will be the emergence as a political force of investors with a desire to keep Washington on a tight free-market leash. One of the most interesting political questions in recent years was why the Democratic Congress was boot-ed out of office in 1994, a year when the economy was growing at close to 4 percent in real terms. The rule of thumb for politics is that 3 percent or better economic growth tends to favor the incumbent.

I would argue that one of the reasons 1994 was so anomalous was that the financial markets behaved very poorly. Interest rates went from 5.75 to 8.25 percent, and 70 percent of the companies listed on the New York Stock Exchange lost at least 20 percent of their value, a kind of silent bear market. The tax rate increases of the prior year, the attempts to nationalize health care, and other Clinton cabinet trial balloons suggesting the emergence of a European-type industrial policy mobilized for the first time the full strength and power of what I call the new investor class. Those are people who have given up on the Social Security Administration's ability to generate retirement wealth and decided in the 1980s and 1990s to take matters into their own hands, to exercise personal responsibility, and generate their own investment portfolios. Polling data from Robert Teeter and Peter Hart suggest that 43 percent of all Americans own shares. A second poll done for the *Wall Street Journal* suggests that 51 percent of the population own at least \$5,000



Lawrence Kudlow: “The investor class will keep the government on a short, free-market leash.”

worth of shares. In rough terms, that's 120 million people, just a little bit less than the entire working population of 130 million.

That number doubled once in the 1980s and again in the 1990s. Forty-nine percent of the newest investors, those who bought shares in the 1990s, are women. Thirty-eight percent are nonprofessional, salaried workers. The typical new investor earns less than \$75,000 a year. Some 65 million people have invested more than \$5 trillion in mutual funds. Roughly 25 million people have invested slightly more than \$1 trillion in 401(k)s. And another 32 million people have invested some \$700 billion in tax-deferred variable annuities. Yes, there's overlap, but those are very impressive numbers. What's more, those people are long-term investors. They have survived the 1987 crash and the bear markets of 1990 and 1994, the nasty 10 percent corrections in July 1996 and October 1997, and they're hanging on through the Asian crisis. Eighty percent told Teeter-Hart that they would keep their investments if the market declined 20 percent or more.

Most important, those investors are people who have learned from their own success and their own perseverance that free markets, not governments, create wealth. They are more than willing to exercise their own judgement, their own responsibility, and what I think is a profound act of self-government. They'll accept the risk of short-term losses. But as long-term investors, they recognize that the basic trends of the American economy and the American stock market have really been upward since the country was founded and certainly over the last 100 years.

If you took the protracted period from 1970 to 1997, which includes a bear market from 1970 to 1982 and a bull market from 1982 to 1997, somebody who invested \$5,000 a year every year in the top 25 percent of mutual funds would have been sitting on \$1.4 million in 1997. That number, \$5,000 a year, is a very interesting number because it is just slightly more than the average Social Security contribution, which is now about \$3,600 a year.

This group of people, which I might characterize as “retail” rather than professional investors, is extremely well informed. They use stockbrokers and financial planners. They have accountants and lawyers. They watch CNBC, Bloomberg, and other news shows. They're operating on the Internet. They don't need or want the federal nanny state to assist them. And it really is a profound sense of self-government that we are watching in this revolutionary way of investing.

Again, using 1994 as the first example, this group of people does not want the heavy hand of government regulating, or taxing, or inflating, or directing our resources. They believe now, on the evidence of their own monthly accounting statements showing the rise in wealth, that private markets and private companies do it best. In 1994 there was a sense that the Republicans were offering an alternative policy of taxing and regulating, and the new investors voted for it. In 1996, I believe, the investor class was responsible for the shift in President Clinton's policies. In 1995 and 1996 he essentially ran for reelection as a moderate Republican. And I believe that this class of investors, which is even bigger than the American Association of Retired Persons and the teachers' unions, is going to be a profound force in American politics for years to come. The political party that tells the voters in unequivocal terms that it will use the growing budgetary surplus to reform and simplify the tax code; reduce the tax burden; and reform Social Security, health care, and education by allowing and permitting individuals to make the principal choices is going to prosper in the next decade or so. The investor class will keep the government on a short, free-market leash.

New numbers from the Congressional Budget Office suggest cumulative surpluses

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“Taxpayers with incomes below \$200,000 were paying capital gains tax on illusory gains.”

—Kenneth Kies

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of \$580 billion through the year 2003. That's up from \$150 billion in a CBO report dated March 1998. But the long-term estimates of that office are still too cautious. It's still predicting a 2.1 percent real economic growth rate, and I expect it to be 3 percent or better.

The CBO basically says that the sources of unexpected income and the unexpected strong revenue flows are a mystery. The analysts say they just don't understand it and therefore don't know whether it will continue. Which makes sense in their case because they didn't expect it and would never have believed it in the first place. So if you don't buy it, you don't expect it to continue because it doesn't exist. I would offer a modest suggestion about the source of this income and revenue: it's called prosperity and wealth creation. In the past 15 years this nation has improved its economic policies. We've had lower tax rates, lower inflation rates, lower interest rates. Many industries have been deregulated. Our currency is strong. We're essentially the freest trading nation in the world. And of course, one of the wonderful stories in the last 15–16 years is the rise of American entrepreneurs, men and women who have reinvented the economy through the greatest surge in technological innovation since the last quarter of the 19th century.

The productivity-enhancing benefits of technological innovation and investment have been increasing growth, profits, output, jobs, and, yes, the tax revenues of the federal government. Revenues are rising, and tax bracket creep is rising. That's what a progressive system produces during periods of prosperity. Why the CBO refuses to acknowledge that is beyond me.

The bottom line is this: I would stick with my estimate of significantly higher budgetary surpluses in the next five years. If I'm right, we have a great opportunity to undertake the reforms necessary to make our healthy economy even healthier, to make our competitive economy even more competitive. The tax system ought to be streamlined. The rates should be brought down. We could live with one or two or three brackets, but we sure don't need five or six. And though I believe that lower tax rates will produce more tax revenues through improved economic growth

rates, if in the short run revenue falls, we have plenty of resources to cover that. In a pinch, we could even cut spending.

Second, we need to reform Social Security. In particular, I think we need to improve savings rates among the middle and lower middle income classes by reducing payroll tax rates and then moving those investments into market vehicles. That is what the investor class wants to do. And I tell you, if this Republican Congress doesn't make that possible, the investor class stands ready to act, not only as investors, not only as taxpayers, but as voters. They are the invisible hand driving politics today, which is a good reason to be optimistic.

Kenneth Kies: The capital gains tax issue is as much about theology as it is about economics. People who feel strongly about what they think about capital gains, feel very strongly about it. And there are people on all sides of this debate. There are those who adamantly believe the rate should be zero. There are probably more who think the rate ought to be the same as the rate for all other income. Robert McIntyre of the Center on Budget and Policy Priorities designed a so-called flat income tax that actually had five marginal rates and was introduced by Rep. Richard Gephardt. McIntyre was candid about what it would do. He was asked if it would raise taxes on higher incomes. And he said yes, it would. But those people have been “the beneficiaries of life's lottery.” Apparently, anybody who makes money just hit the lottery, in his view.

One thing I learned at the Joint Committee on Taxation is that how you cut capital gains matters. For instance, from time to time, people have put forward proposals that would cut capital gains tax rates only for regular tax purposes and not for alternative minimum tax purposes. That is kind of a bad joke because most people would be pushed into the AMT. That problem is going to become even more pronounced over the next 10 years. We are going to witness a migration of taxpayers from the regular tax into the AMT because the AMT exemption amount of \$45,000 is not indexed for inflation. That is a huge problem independent of what is done to capital gains because much of this growth is going to occur at rel-

atively modest income levels, in the \$50,000 to \$75,000 and \$75,000 to \$100,000 expanded income classes.

I'll just give you one example to show you how important this problem is. By the year 2005, a family of four that has \$58,300 of gross income in 1996 dollars, does not itemize their deductions, and has no preferences will be subject to the AMT. Those people will not get the joke.

Politically, I think the whole debate on capital gains is behind the times by about 15 years. Two big things have happened since 1980. The number of taxpayers who have a capital gain has dramatically risen. There are now, I believe, 20 million taxpayers who have a capital gain. Five million of them are in the 15 percent tax bracket. Five million of them are over age 65. That profile will only increase over time. The capital gain issue really has become a middle-class issue, but much of the rhetoric has not caught up with that fact.

Also a Congressional Budget Office report last May analyzed the benefits of indexing. It broke out capital gains in 1994 by expanded income class. And then it looked at each income class separately, at people who earned \$0–\$10,000, \$10,000–\$20,000, \$20,000–\$30,000, and so on. It recalculated in the aggregate what the gain or loss would have been had the basis been indexed for inflation, to eliminate inflationary gain. In every income class below \$200,000, the net result was a capital loss. Taxpayers with incomes below \$200,000 were paying, in the aggregate, capital gains tax on illusory gains.

Only in the over-\$200,000 income class was there real gain. The report suggested that higher income people are more likely to own growth stocks, are more likely to be risk takers. People in lower income classes are more likely to hold dividend-paying stocks because they use them for current income. That's particularly true of people over age 65. So those people are the ones most likely to find, when they actually sell a capital asset and pay a tax, that they are paying tax on gains that are only inflationary, not real economic gain.

I think that part of this debate is going to get more and more attention because it highlights how the current capital gains tax unfairly taxes people—especially retired and middle-class people—on apparent gains that often aren't real economic gains. ■