Capital Gains Taxation and Economic Growth: A History

The capital gains tax rate impacts how investors realize their capital gains. Because investors can realize their gains at the time of their choosing, changes in the capital gains tax rate could lead to more or less capital gains realizations.

Historically, cutting the capital gains tax has led to an increase in capital gains realizations and therefore an increase in federal tax revenue. Interestingly, state governments also benefit from the change in federal tax revenue as increase in capital gains realizations is also taxable at the state level. Federal revenue estimators seek to incorporate some of these behavioral effects in their revenue estimates. However, tax revenues far exceeded revenue estimates even after incorporating these behavioral factors into the JCT forecasts.

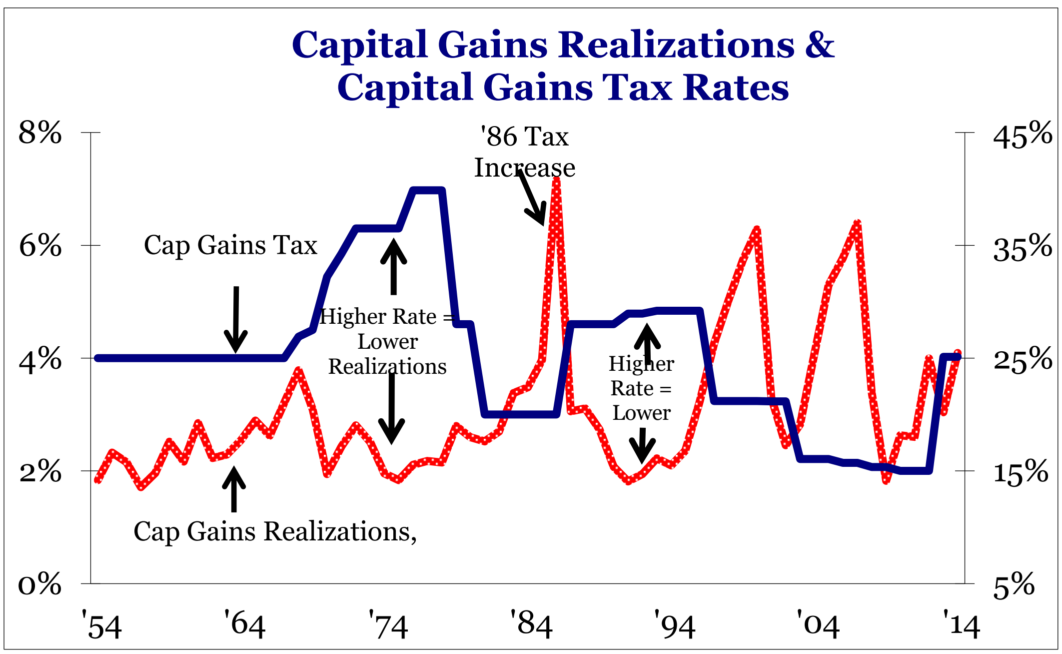
When capital gains tax rates are cut, investors undergo three distinct behaviors that lead to higher tax revenue:

1) The unlocking effect;
2) Increasing asset values; and
3) The dynamic effect.

First, high tax rates lead investors to "lock-in" their holdings. As tax rates come down, this "lock-in" effect is reduced and many assets are sold that would otherwise have remained locked-in by investors seeking to avoid the tax. The selling triggers the tax which is then paid by the investor usually at tax season time.

Second, lower capital gains tax rates increase the after-tax rate of return on assets and push asset values higher. As asset values increase, there are more gains to be taxed. In nearly every case save for the 1981 recession, lower tax rates have translated into higher stock prices. Only in one instance, 2013, did stocks increase after the capital gains tax rate was raised and this was because monetary policy stimulus dwarfed the impact of the capital gains tax increase.

And third, over the longer term, a capital gains tax cut spurs the growth of new businesses, increases the wages of workers, enhances consumer purchasing power, and grows the economy at large, resulting in more overall gains to be taxed.



Historically the level of the capital gains tax rate has impacted capital gains realizations. When tax rates are high, investors realize fewer gains. Conversely, when tax rates are lowered, investors realize their gains.

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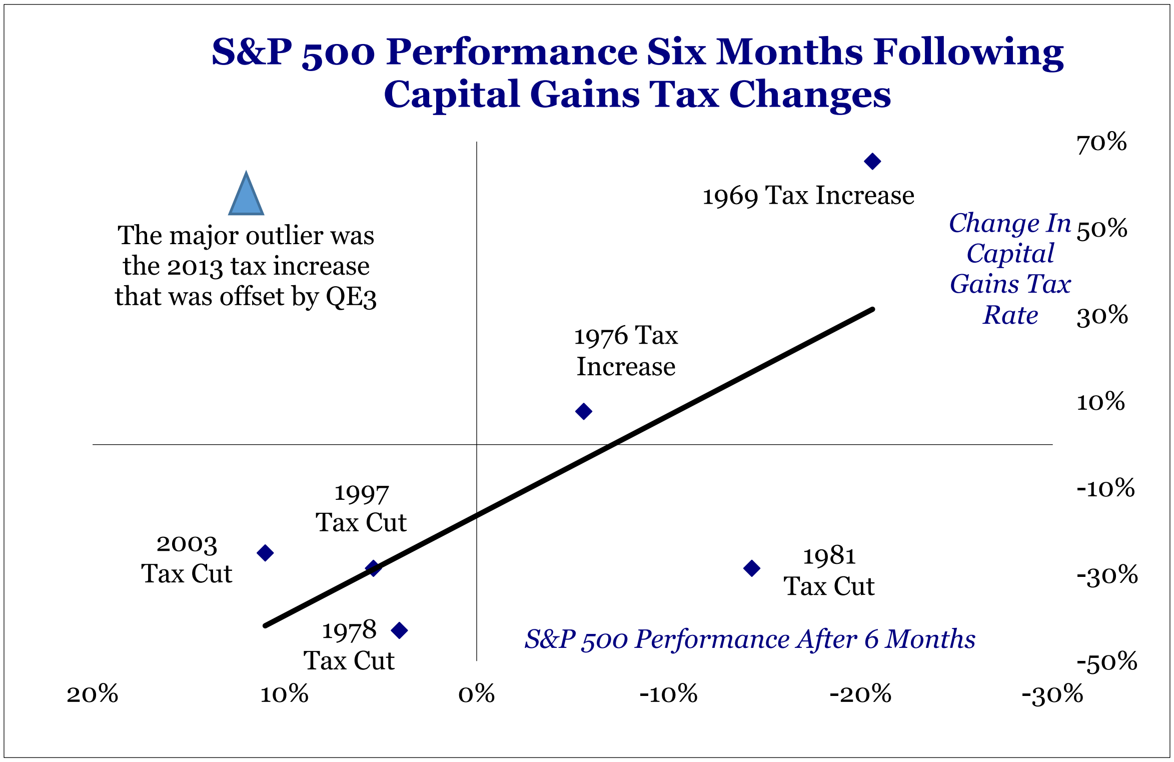
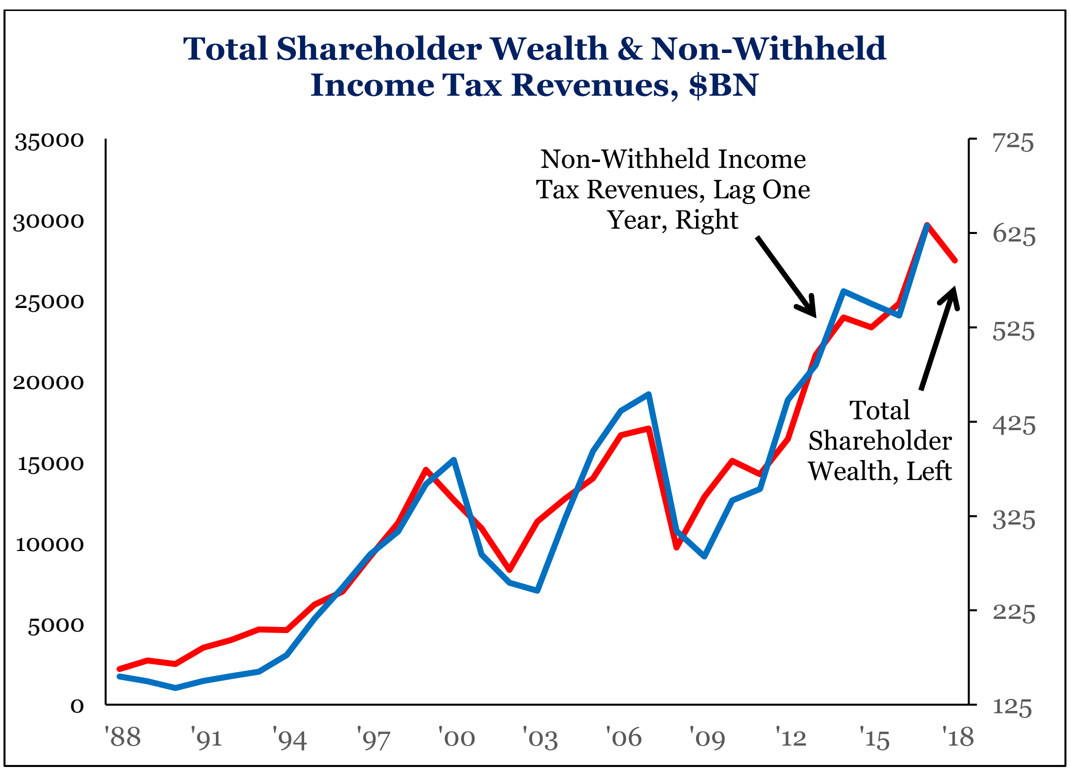
PREVIOUS CAPITAL GAINS TAX CUTS HAVE RESULTED IN HIGHER STOCKS & GREATER TAX REVENUE

A lower capital gains tax increases the after tax rate return on stocks which pushes asset values higher. When asset values increase, the US tax base also increases, thereby increasing tax revenues.

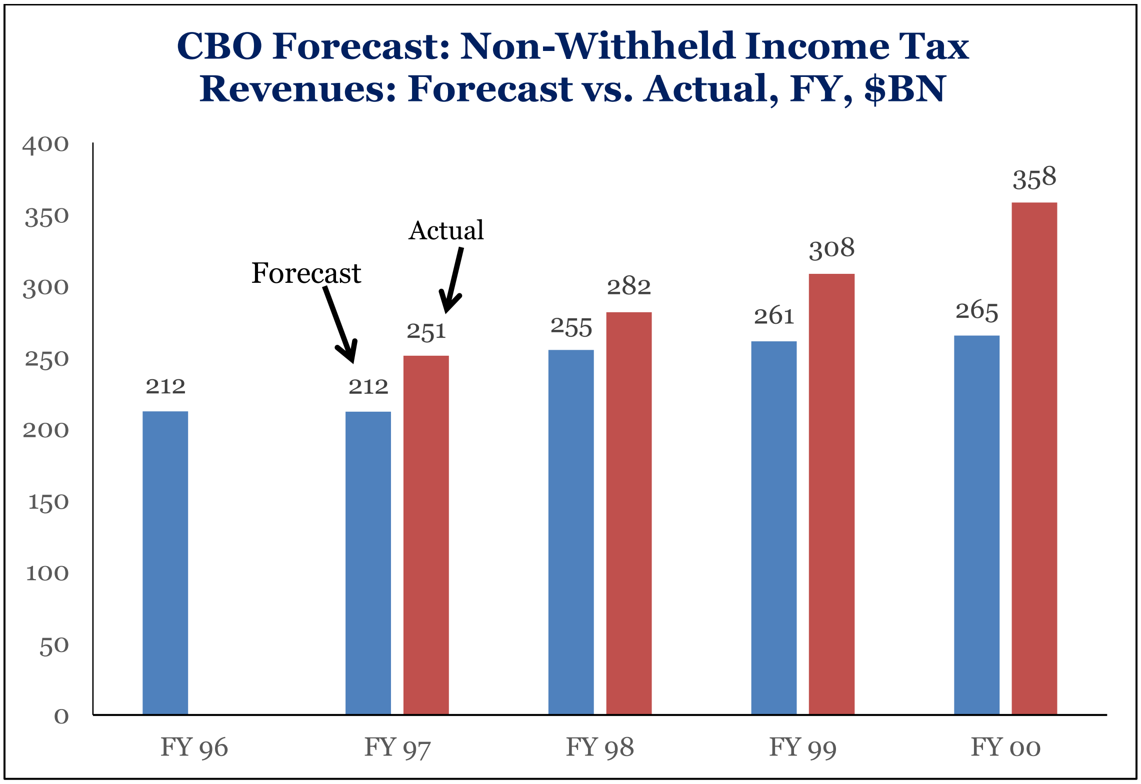


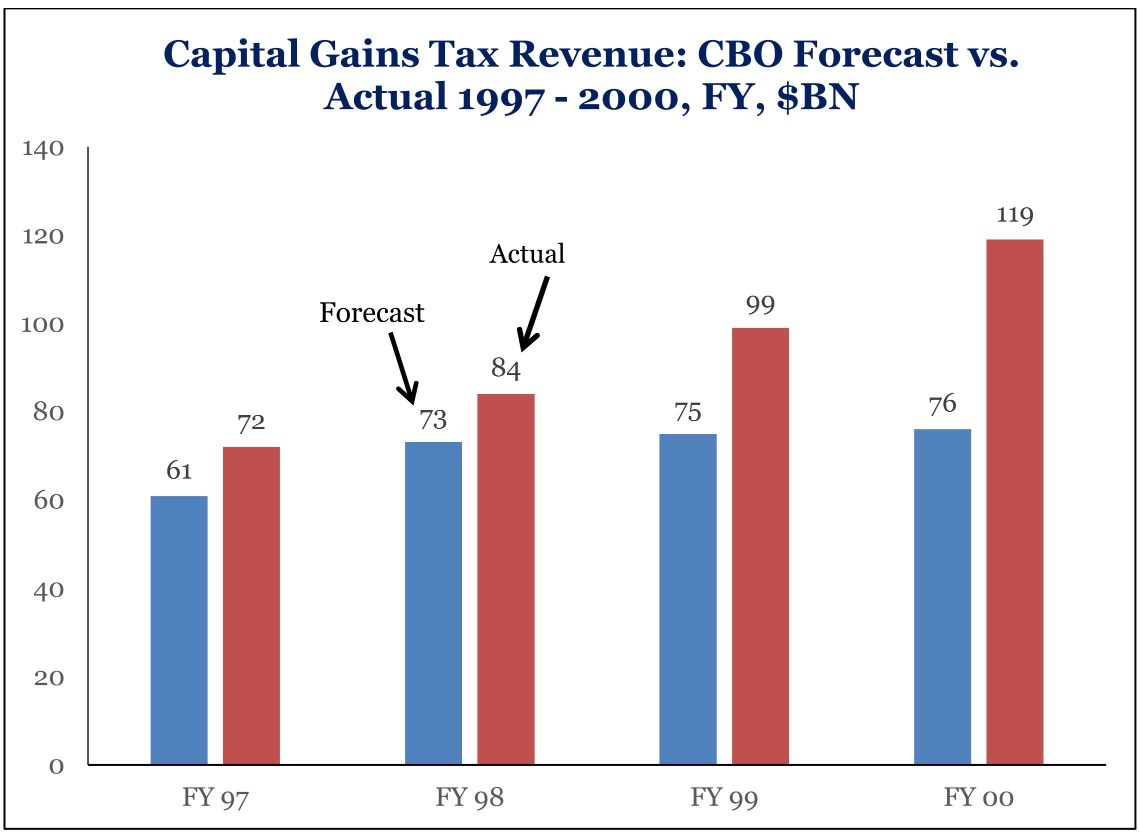


The chart on the left shows the relationship between stocks and federal tax revenues. The general level of the stock market leads "non-withheld" income tax collections by one year. In other words, as stocks increase during a calendar year, Treasury sees increased tax receipts the following April when taxpayers file their taxes.

THE 1997 CAPITAL GAINS TAX CUT EXAMPLE

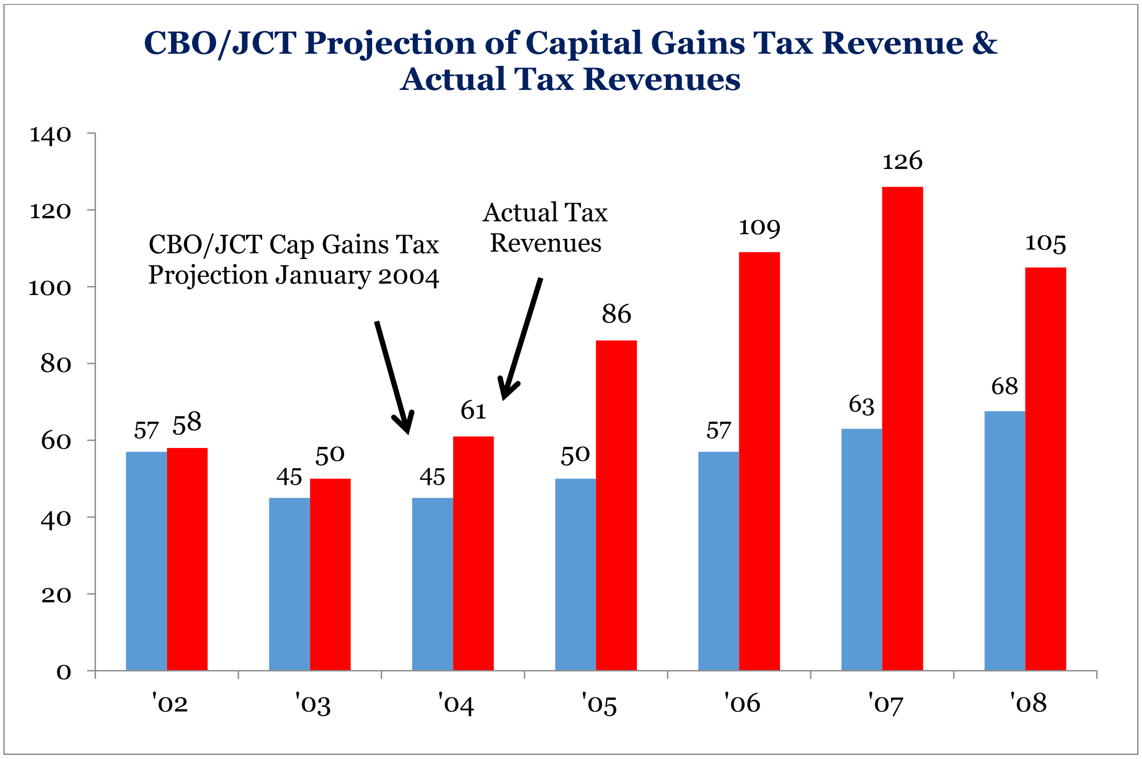
In 1997, Congress cut the capital gains tax rate from 28 to 20 percent. Revenue estimators expected to collect $285bn of capital gains tax revenue for fiscal years 1997-2000. However, tax revenues came in at $374bn, 31 percent higher than revenue estimators suggested.



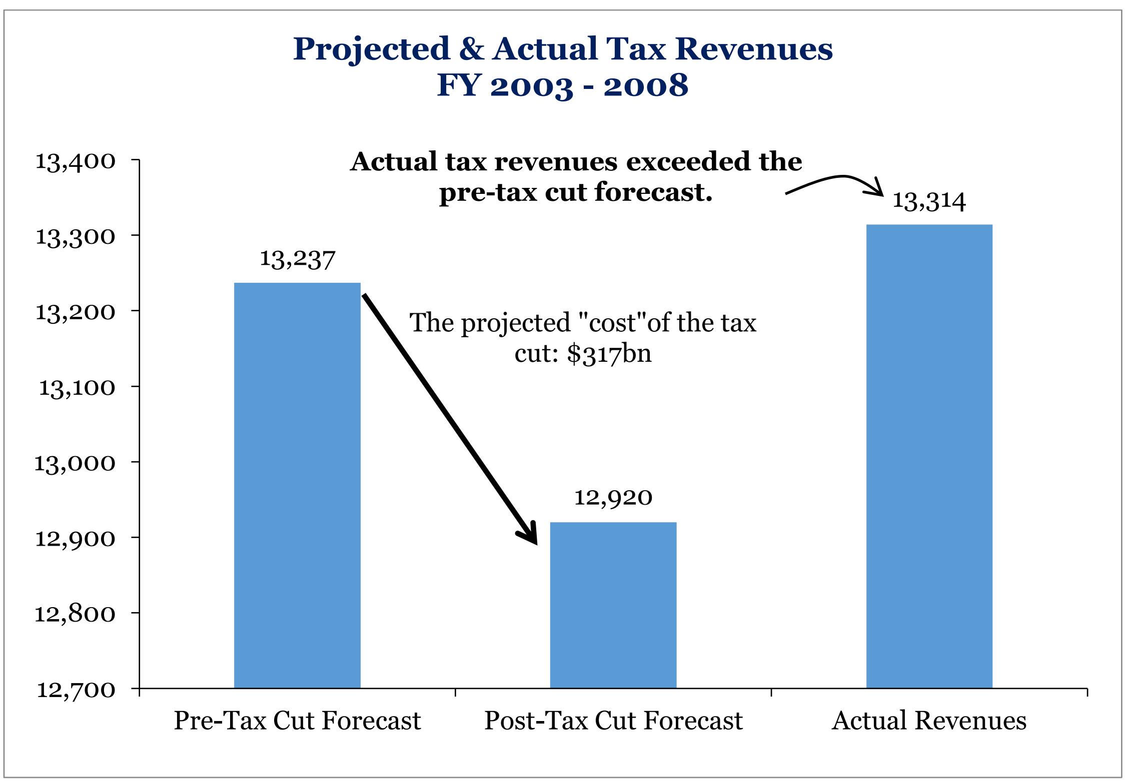


THE 2003 CAPITAL GAINS TAX CUT EXAMPLE

As part of a larger tax bill in 2003, the capital gains tax rate was reduced from 20 to 15 percent. In 2003, JCT/CBO anticipated the government would collect $327bn of cap gains tax revenue over the 5 year cap gains tax cut. However, the government collected $537bn.



The higher than expected capital gains tax revenues helped to offset other parts of the 2003 tax cut. Total tax revenues came in $395bn over CBO's forecast during the 2003-2008 time period. Not only does this mean that tax revenues were "higher than expected," but tax revenues exceeded the pre-tax cut forecast. In other words, there was no revenue loss to the Treasury while nominal GDP growth came in one percent higher than forecasted.



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