

## Why Capital-Gains Taxes Are Unfair by Martin Feldstein

The capital-gains tax is as unfair as it is wasteful. Its elimination should be a goal of long-run fundamental tax reform. And since lower capital-gains tax rates would actually raise revenue by inducing investors to sell assets more frequently, a substantial reduction of capital-gains tax rates should be enacted in the U.S. in 1995.

Although economists and policy officials recognize that the capital-gains tax depresses productivity and hurts economic growth, many of them are reluctant to advocate a reduction because they think that doing so would impair the fairness of the tax system. Those who defend the tax argue that capital gains are like other forms of income -- wages, dividends and interest -- and should be taxed at the same rate. Because the current U.S. taxation of capital gains is based on that false premise -- although at a 28% maximum rate, which reflects the practical reality that a higher rate would substantially reduce tax revenue by deterring asset sales -- it's important to understand why taxing capital gains is inherently unfair.

Any fair system of income taxation should be based on the principle that two similar individuals with the same income should pay the same tax. The capital-gains tax violates the basic fairness principle because the primary sources of capital gains are inflation and retained earnings.

A taxpayer who invested \$10,000 in 1973 in a diversified portfolio of stocks like those in the Standard & Poors index, held it for 20 years, and then sold it in 1993 would have seen its value grow to \$42,019 and would have been liable for tax on a nominal gain of \$32,019. In reality, the rise in the consumer-price index means that it took \$32,545 in 1993 to buy as much in consumer goods and services as \$10,000 bought in 1973. Inflation created an artificial gain of \$22,545 that doesn't correspond to any real increase in wealth. The real, inflation-adjusted gain in 1993 was therefore only \$9,474 -- the difference between the \$42,019 value of the portfolio and the initial \$10,000 investment

restated in 1993 prices. The real gain was only 30% of the taxable nominal gain of \$32,019.

Taxing the entire nominal gain violates the basic principle of fairness because the nominal gain doesn't correspond to real income. If the investor spent the entire \$32,019 nominal gain on taxes and consumption, the real value of his remaining assets would be substantially less than they had been 20 years earlier. Taxing the nominal gain is like taxing someone on the money that he takes out of his bank account. It's not real income and it shouldn't be taxed.

The second major source of capital gains is retained earnings. Each year during the past two decades the companies in the Standard & Poors index reinvested earnings equal to about 3% of the value of the stock. The direct effect of reinvesting earnings is to raise the share value by an equal amount. Since reinvested earnings have already been taxed at the company level, taxing the capital gain that results from retained earnings is double taxation. It violates the fairness principle that two taxpayers with the same income should pay the same tax. The taxpayer who realizes capital gains on stock under current law would pay substantially more tax on the underlying corporate income than someone who had the same amount of income in the form of wages, professional earnings or profits in an unincorporated business.

For someone who bought stock in 1973 and sold it in 1993, the reinvested earnings raised the value of the investment (at the 1993 level of consumer prices) from \$32,545 to \$54,145, substantially more than the portfolio's actual market value of \$42,019. Thus, after adjusting for inflation, share prices actually rose less than the amount of after-tax retained earnings that investors had plowed back into their companies. For those investors, there was no justifiable capital-gains tax liability but an actual loss of value that should have been available to reduce taxable income.

There is nothing unusual about the years 1973-93. The combination of artificial inflation gains and previously taxed retained earnings exceeds the nominal gain for other long periods as well. Looking back a decade earlier, someone who invested \$10,000 in 1963 in the Standard & Poors portfolio would have seen its value rise to \$22,958 in 1983. However, the inflation during those 20 years meant that it took \$32,549 in 1983 to buy as much as \$10,000 bought in 1963. So the share prices didn't even keep up with inflation, let alone with the extra value of retained earnings.

Of course, some individual investors are lucky enough or smart enough to outperform the overall share price index. They have gains that exceed the combination of inflation and retained earnings. It would be appropriate to tax such gains.

To be fair, however, the tax would have to treat capital losses in a symmetric way. Any investor whose share prices do not rise as much as the combined value of inflation and retained earnings should be allowed to register a loss that is deductible against ordinary income and subject to a rebate if the resulting net income is negative. Over the long run, these excess gains and losses would balance, and the U.S. Treasury would collect essentially no revenue from the capital-gains tax.

A capital-gains tax on a tax base that is adjusted for inflation and for retained earnings would be more like an insurance policy than a tax, with the government taking a fraction of the gains from those with above-average performance and giving it to those with below-average performance. Moreover, since shareholders could undo this imposed insurance policy by investing more of their assets in stocks or buying stocks on margin, it is hard to imagine any purpose that would be served by such a zero-revenue capital-gains tax.

The current capital-gains tax rules are not the only unfair feature of the income tax. But cutting the capital-gains tax rate is particularly attractive because it hurts economic performance and is a very inefficient source of revenue.

A high capital-gains tax discourages saving and

risk-taking. And because the tax is levied only when the asset is sold, it keeps investors locked into old investments even when investments in new companies offer the prospect of higher pretax returns. New businesses and rapidly growing businesses suffer while older, well-established companies continue to get capital on relatively favorable terms.

Moreover, detailed studies of past experience confirm that some reduction in the current capital-gains tax rate would actually raise tax revenue because the induced increase in the volume of realized gains would outweigh the decline in the tax rate. When an unfair and economically harmful tax can be reduced with no loss of revenue, there is no reason not to do so immediately.

There are nevertheless still some people who will oppose a capital-gains tax cut because much of its immediate effect is a benefit to high-income taxpayers. They should recall that the tax rates on capital gains in the U.S. were raised sharply in 1986 in exchange for a general tax cut that took the top tax rate on all income to 28% -- a reduction that has since been reversed with the top rate now over 43%.

Moreover, even the 1986 deal was politically necessary only because the tax scorekeepers didn't acknowledge that the \$25 billion-a-year rise in corporate taxes would fall on the same high-income taxpayers. More fundamentally, it is hard to understand how anyone can say that it is fair to oppose a cut in the capital-gains tax that has so many advantages and hurts no one -- just because it benefits high-income taxpayers more than others.

If fairness in defining taxable income were the only aspect of tax policy that mattered, the capital-gains tax should now be completely eliminated. But the immediate revenue loss that would result makes it hard to advocate abolishing the capital-gains tax at the current time. There is, however, no reason to limit the reduction in the capital-gains rate to the amount that loses no revenue at all. Good tax policy has to balance the adverse economic effects of each tax and its inherent unfairness against the need for revenue.

The Republican congressional proposal to cut capital-gains tax rates in half is a reasonable first step. Although there is a substantial margin of uncertainty about the magnitude of taxpayer responses to lower capital-gains tax rates, past experience suggests that such a rate reduction is likely to cause relatively little revenue loss and might even cause revenue to rise. But halving the capital-gains tax rate would be desirable even if it does result in some long-run revenue loss. That loss could be offset by reductions in spending or, if necessary, by other taxes that do less economic damage.

As long as capital gains are going to be taxed, the value of the taxable gain should be adjusted for the general rise in consumer prices after the asset is acquired. That would have very little budget impact over the next several years, but it would gradually introduce the needed principle of capital-gains indexation.

The reform of capital-gains taxes has been blocked by the U.S. Congress for more than a decade. The new Congress should waste no time in improving the fairness of the American tax system and the performance of the economy by starting that reform process.

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