

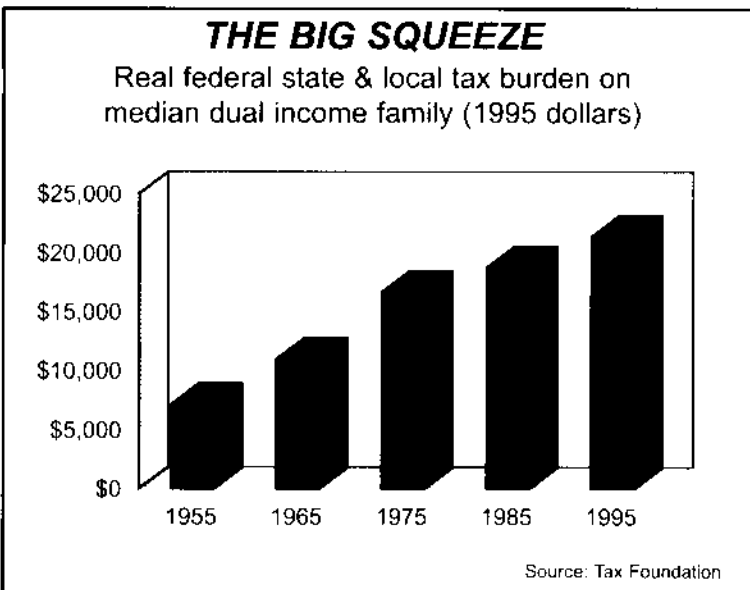
The American Miracle

ISSUE BRIEF

April 1997

Eliminating the capital gains tax to move toward our economic potential

Taxes affect not only those who pay them, but their impact on behavior has repercussions throughout the economy. The capital gains tax is no exception. The capital gains tax penalizes the elderly for saving prudently, stifles investment in new businesses and dampens economic growth. Eliminating the capital gains tax must be part of any broad tax reform effort, an effort to bring back the American Miracle for working Americans.



Why do American households feel squeezed?

The United States is deep into a recovery from the mild recession of the early 1990s, yet many, many families seem to be struggling to make ends meet. A review of economic indicators confirms that wage growth, investment and overall economic output in the 1990s has been below par. Has America lost its ability to improve the standard of living for each succeeding generation?

No, but...

In terms of material wealth, Americans today are far better off than their great-grand parents. Inflation adjusted per capita income has grown from \$3,000 in 1900 to more than \$20,000 today. In 1950 there were 30 automobiles per 100 Americans. Today there are 75.¹

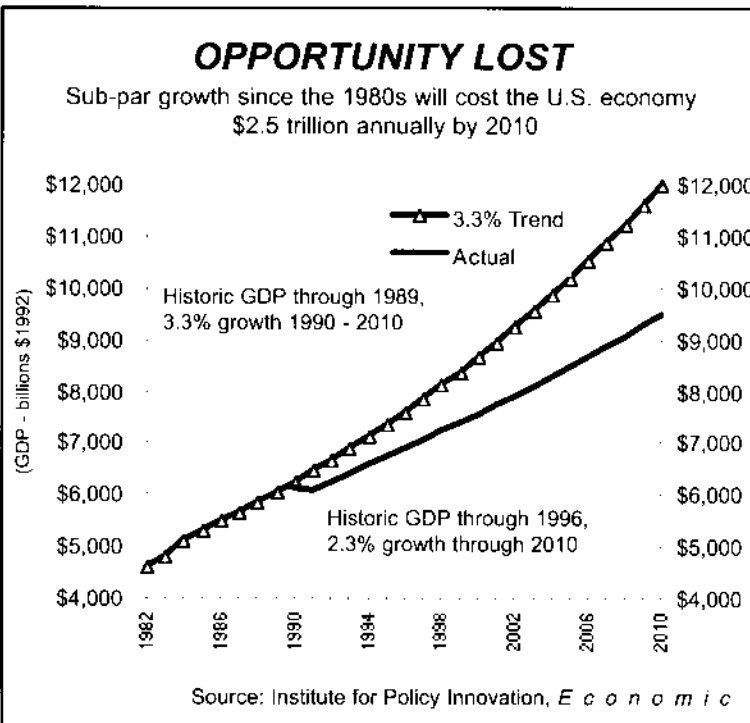
No, the American economic engine not dead, but it is performing well below its potential. Since the recession of 1990-91, Gross Domestic Product has advanced only about 2.5% a year. This compares to the average growth rate in the last five expansions of 4.4%, and average economic growth of 3.4% between 1960 and 1988. And the year 1996 was the fifth year of out the last six where the economy grew less than 3%.

While a 1% change in economic growth may seem insignificant, over long periods, small changes in a country's growth rate can have huge implications for its populace. For example, if the American economy had grown only 1% slower from 1870 to 1990, America would have a per capita GDP similar to that of Mexico.²

The sub-par performance of the 1990s, along with the slow growth of the 1970s, has had its own adverse affects on American wage earners. From 1974 to 1994 inflation-adjusted wages rose only 26%. This compares to an 84% increase from 1950 to 1970.³ No wonder American families are frustrated with their financial progress.

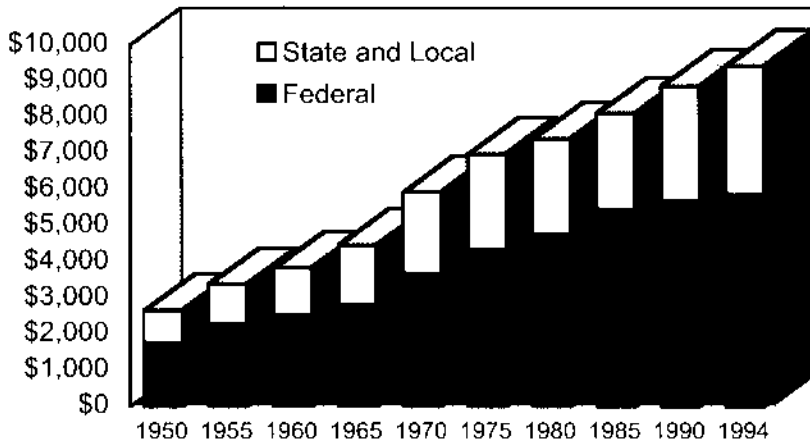
Heavier taxes, more taxpayers

When the federal income tax was implemented in 1913, only 2% of Americans had to file. Today virtually all wage earners file tax returns to the federal government. Payroll taxes paid by the employee and employer account



MORE TO BEAR

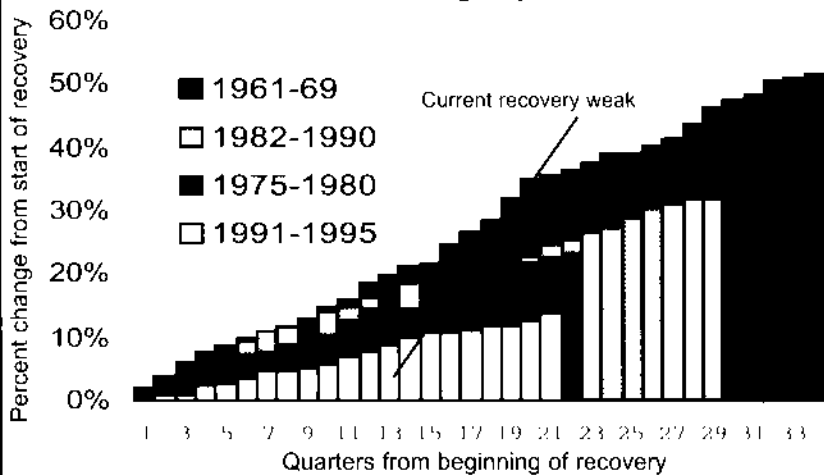
Government spending per capita (1994 dollars)



Source: Tax Foundation, *Facts & Figures on*

SMALL TIME RECOVERY

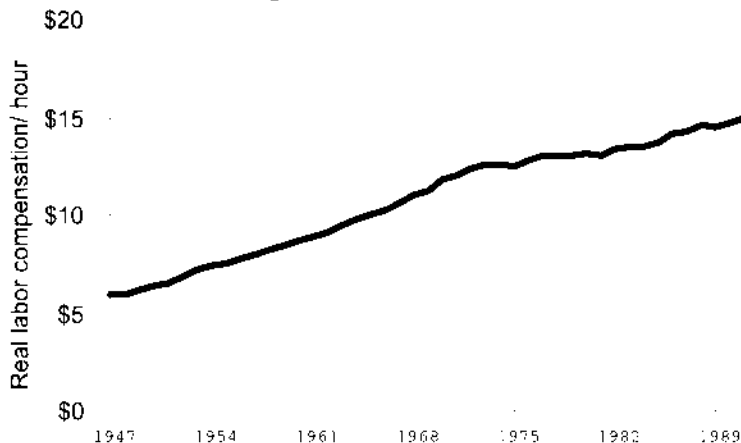
Current recovery long, but lean
Increase in real GDP for longest postwar recoveries



Source: Institute for Policy Innovation, *Economic*

FLATTENING WORKERS

Wages have stalled since 1970



Source: Institute for Policy Innovation, *Economic*

for one and one-half times the income tax bill of the typical two-income family.⁴ State, federal and local taxes are now a significant part of the family budget. The median two-income family now spends more on taxes at all levels than on food, clothing, and medical care combined.⁵ This higher tax burden means the average family paid \$18,600 in taxes in inflation adjusted dollars in 1994 vs. \$6,970 in 1950.⁶

Thanks to slow wage growth and rapidly rising taxes, the squeeze American wage earners feel is real.

Investment is key to wage growth

Between 1973 and 1991, gross nonresidential investment as a percent of GDP was lower in the United States than in Canada, Japan, France, West Germany and the United Kingdom.⁷ This under investment ultimately hurts American workers. That's because labor is paid according to what it can produce, and capital investment improves labor productivity and output. As a result, when American business increases spending on plant and equipment, inflation-adjusted wages rise as well.

In fact, a growing capital stock is *the most important* determinant of real wages. Over the past 37 years, the change in the capital-to-labor ratio has explained more than 95% of the changes in real wages. When capital available to each worker rose at a 2.4% pace between 1948 and 1970, hourly compensation rose faster than 2% a year. Since that period, the capital-to-labor ratio has grown only 1.5% a year. As a result, compensation has increased less than 1% annually.⁸

For wages to once again increase at a meaningful rate, the economy must perform closer to its potential. Disincentives to investment, including the capital gains tax, are key to returning America to its historical growth path.

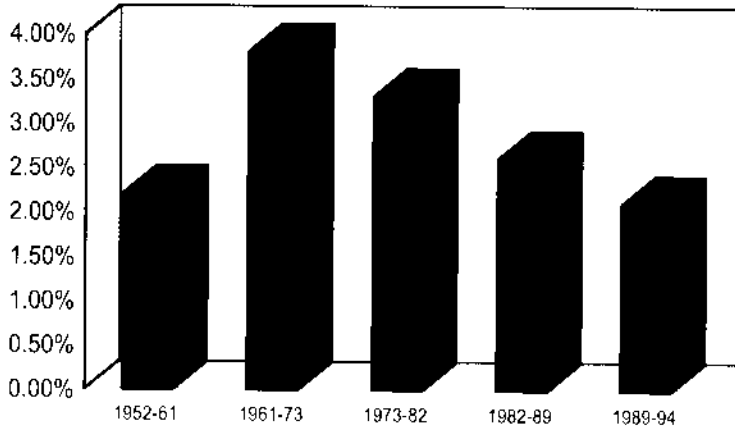
A vibrant small businesses sector is also crucial if the American economy is going to provide jobs in an environment of welfare reform. Small businesses create 8 out of 10 American jobs today. Brand new businesses have hired 12 million workers since 1985, almost 4 times the number of employees laid off by large corporations.

Tax policy should encourage investment in this important sector. However, high capital gains taxes discourage investment in new business ventures and business expansions.

For example, from 1969 to 1976, a period when the capital gains tax rose from 27.5% to 49%, commitments to venture capitalists fell from \$506 million to \$93 million. The number of companies funded by venture capital firms fell from

CAPITAL GROWTH SLOWS

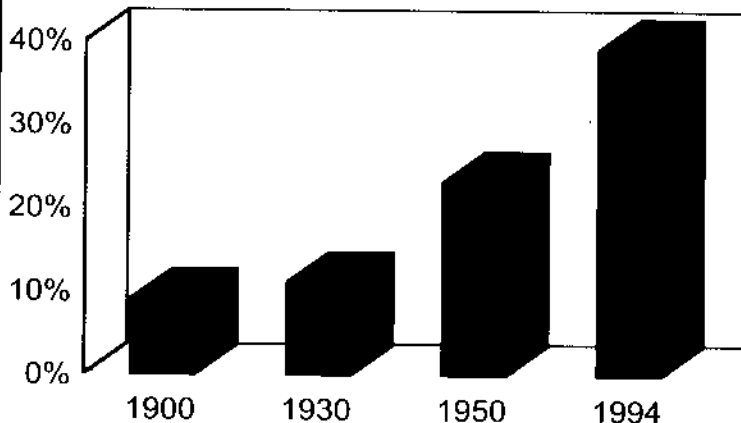
Annual growth in stock of reproducible U.S. capital



Source: Institute for Policy Innovation, *Economic*

GROWTH INDUSTRY

Federal, state, local taxes as % GDP



Source: Stephen Moore, *Government, America's #1*

INTERNATIONAL COMPARISON OF CAPITAL GAINS TAX RATES

Country	Maximum Individual Rate	
	Short Term	Long Term
United States	28.0%	31.0%*
Japan	1% of sale price or 20%	1% of sale price or 20%
Australia	48.3%	48.3% **
Belgium	0%	0%
Canada	23.8%	23.8%
France	18.1%	18.18%
Germany	53.0%	0%
Hong Kong	0%	0%
Italy	25.0%	25.0%
Netherlands	0%	0%
Sweden	25.0%	25.0%
United Kingdom	40.0%**	40.0%**

*The top statutory rate is 28%, but the actual top rate given reduced itemized deductions and phasing out of personal exemptions is 31.3% for family of four.

** Indexed for inflation.

Source: American Council for Capital Formation

1,512 in 1986 to 800 in 1991 due to the capital gains tax hike of 1986. Similarly, initial public stock offerings fell from 953 in 1986 to 371 in 1989.⁹

Providing an attractive environment for new business investment is the key to returning America to its historic growth path.

Other reasons to cut capital gains taxes

The capital gains tax is not "... a useful means of raising revenue or a means, for that matter, of doing anything else of a constructive nature."

Federal Reserve Chairman Alan Greenspan

It is unfair to tax phantom gains from inflation

Under the current tax code, a capital gain is simply the difference between the purchase and selling price of an asset. However, part of the rise in the price of an asset is due to a rise in the general price level. Yet, taxpayers pay capital gains taxes on this inflated gain along with the genuine increase in asset value.

For example, a gain of \$40,000 over 25 years on a \$10,000 investment results in an inflation-adjusted gain of less than \$20,000 when the inflation rate is 4.5% a year. Yet, the investor would pay taxes on the entire \$40,000 gain.

Worse, if an asset does not increase faster than the general price level, businessmen, investors and retirees actually pay taxes on inflation-adjusted capital losses. For example, an investment in the S&P Composite Index from 1972 to 1992 would have produced a taxable gain even though inflation wiped out the real gain over the period. Yet, the investor would have been liable for capital gains taxes on the full increase in value. As a result, the tax rate on the inflation-adjusted gain would have been 101%. That is, the investor would have lost his entire inflation-adjusted gain and more to taxes.¹⁰ Is that tax fairness?

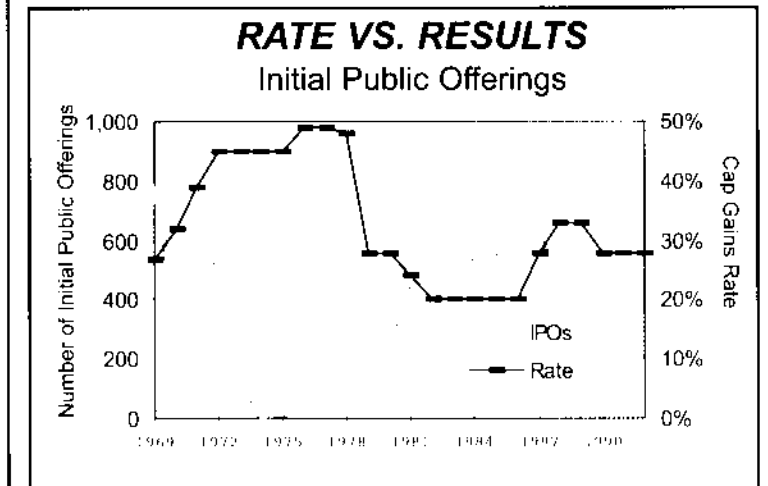
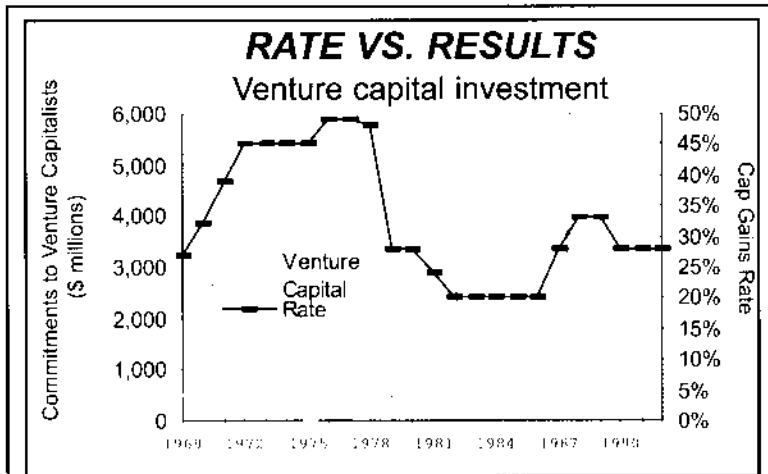
Not only the rich pay capital gains taxes

Opponents of eliminating the capital gains tax often argue that such action would benefit only the rich. Aside from the fact that benefits of tax cuts are not limited to the taxpayers affected, the fact is, the incomes of those who pay capital gains taxes are widely varied. When the capital gain itself is not included as income, half of all returns showing capital gains in 1995 were produced by households earning less than \$41,000. Furthermore, Americans making \$68,500 or less accounted for 40% of all capital gains realized.¹¹

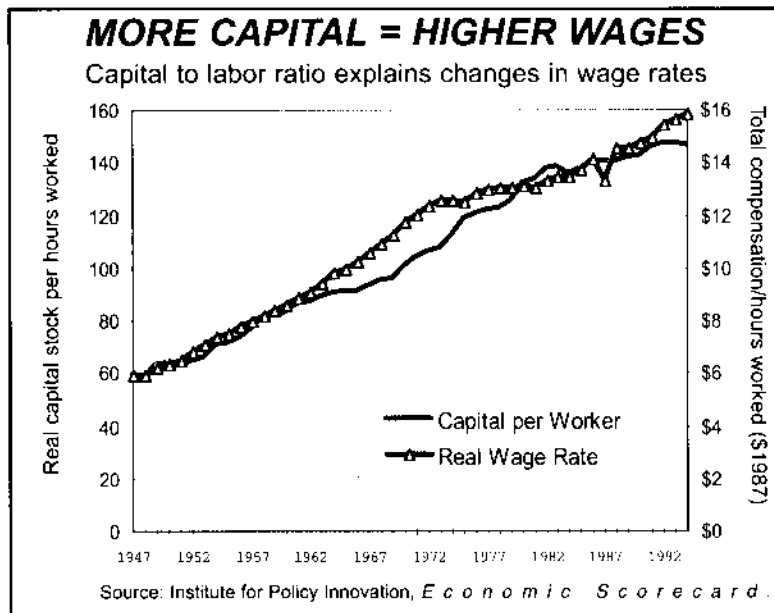
The popularity of mutual funds means middle class America is more likely than ever to report a capital gain. As of the first quarter of 1997, fully 63 million Americans owned shares in mutual funds.

Why penalize the elderly for prudence?

America's elderly are two and one-half times as likely to declare a capital gain as other taxpayers.¹² Furthermore, retiring seniors are often forced to sell business which can create an



Source: Stephen Moore and John Silvia, *The ABC's of the Capital*



Source: Institute for Policy Innovation, *Economic Scorecard*

To order the full report, **The American Miracle**, write the Today Foundation, Tax Policy Group, P.O. Box 225748, Dallas, Texas 75222-5748. The full report can also be found on the Today Foundation's web site at www.ptodayfoundation.org. For further information contact the Today Foundation at 972 298-1811 or fax: 972 298-6369.

overwhelming tax liability. Rather than punish older Americans for their successes, we should encourage saving and investing.

Capital gains rates are higher in the U.S.

The U.S. taxes capital gains more severely than the rest of the world. Residents of Germany pay no taxes on long term gains on securities. Japanese investors pay the lower of 20% on the gain or 1% of the price of asset. American competitors including Taiwan and Hong Kong impose no capital gains tax. Even France, Italy and Sweden tax capital gains at slightly lower rates.

The U.K. and Australia index capital gains for inflation, a factor more important than the actual rate over the long term.

Focus on spending, not capital gains revenue

Capital gains taxes are an unpredictable source of revenues for the Treasury. The annual take from capital gains taxes in recent years is equal to about half of the increase in federal non-defense spending from 1994 to 1995. Because the capital gains tax is a transaction tax, simply lowering the rate would unleash a flood of capital gains realizations, providing a windfall for the U.S. Treasury.

The status quo: Not acceptable

The economy today is growing at a fraction of the pace of the typical economic recovery. More disconcerting, economists expect this anemic growth to continue. According to a BankAmerica survey, the consensus forecast for 1997 is GDP growth of 2.5%. This anemic growth is due to an accumulation of economic disincentives which have made investment in America less attractive. Gross investment in plant and equipment fell to a 30-year low of 9.4% of GDP in 1992.¹³ This under investment constrains wage growth and limits opportunities for American workers.

Footnotes

- ¹Stephen Moore, *Government: America's #1 Growth Industry*, Institute for Policy Innovation, 1995, p. 23.
- ²"If Only Politicians Knew How," *Investor's Business Daily*, Feb. 13 20, 1996, p. A1. Calculation by Robert Barro, Harvard University.
- ³Data from Aldona and Gary Robbins, "The Truth About Falling Wages," *Economic Scorecard*, Third Quarter 1995, Institute for Policy Innovation.
- ⁴Tax Foundation.
- ⁵Tax Foundation.
- ⁶Moore, p. 69.
- ⁷Charles E. Walker, "The Impact of Capital Gains Taxation on U.S. Investment and Economic Growth," Congressional testimony, Feb. 15, 1995.
- ⁸Aldona and Gary Robbins, "The Truth About Falling Wages."
- ⁹Stephen Moore and John Silva, "The ABCs of the Capital Gains Tax," *Policy Analysis* no. 242, Cato Institute, Oct., 4, 1995, p. 22.
- ¹⁰Moore and Silva, p. 50.
- ¹¹According to a study by KPMG Peat Marwick. American Council for Capital Formation.
- ¹²Moore and Silva, p. 49.