The Answer Isn't Capital Gains

Commentary

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Even before the ruins of the World Trade Towers stop smoldering, Congressional leaders are quietly planning to revive their favorite scheme to boost the economy—a $20 billion plus cut in capital gains taxes, possibly as an add-on to minimum wage legislation. Proponents, led by Senate Minority Leader Trent Lott, claim that a temporary cut in the already low tax rate on profits would both raise revenues and stimulate spending and investment. That's nonsense. While a capital gains tax cut would surely boost the bank accounts of the wealthy, it would not revive our flagging economy and might further destabilize the skittering stock market.

Before the terrorists shattered any pretext of budget discipline, proponents of this plan touted it as a way to improve the budget outlook over the next couple of years. The theory is that slashing for two years the tax rate applied to sales of stock, real estate, and other property would induce a flurry of sales of such assets. Even at the lower tax rates, the surge of sales would be so great that an extra $5 billion would come into the Treasury coffers. In principle, that money could have helped Congress balance its books next year without borrowing from the Social Security trust fund.

From the federal government's perspective, this scheme is about as good an idea as asking your neighborhood loan shark to float you some money to pay your mortgage. If taxpayers hurry to sell assets to take advantage of the temporary 15-percent tax rate, it's because those sales were otherwise going to be taxed at a rate of 20 percent or higher. That is, the government is taking in 15 cents today in exchange for 20 cents (plus interest) tomorrow. It's a way to borrow—at exorbitant interest rates—without the money looking like debt on the government's books.

Actually, it's even worse, because taxpayers know that the advocates of this tax cut don't really expect it to be temporary. Most investors will wait until late in 2003 to see if Congress extends the provision, and only if they are disappointed will they sell off stock quickly. If the provision is extended, as is likely, then there is no hurry to sell in order to take advantage of the lower rates. In that case, most of the tax savings will go to investors who would have sold assets anyway and paid higher taxes. This could easily cost the Treasury $10 to $20 billion per year.

Even if it doesn't bolster tax revenues, proponents would claim that a capital gains tax cut will stimulate the economy. In fact, this tax cut could actually impede economic recovery. If people truly believe that the tax cut won't last, we can expect a massive sell-off of stocks as investors take advantage of the temporarily low rates. That is what happened at the end of 1986 as stockholders rushed to avoid the scheduled tax increase in 1987. Also, by taxing sales of assets held less than a year at the same rate as longer-held assets (currently, there is a 20 percentage point advantage to waiting a year to sell) the proposal would reward impatience. But think about it: why would we want to set off a stampede of sales and fuel investor myopia in an extraordinarily skittish stock market?

But, you say, all these tax savings will translate into more consumer spending and a stronger economy, right? Wrong. The lion's share of this windfall would go to those earning over $200,000 a year. Experience shows that the wealthy are the least prone to spend a tax windfall. Most will just bank it.

Capital gains are already taxed at much lower rates than other kinds of income, such as wages or interest earned on a savings account. There is no justification for a further rate cut now. Such an ill-conceived move would further destabilize the fragile stock market and worsen our rapidly degenerating budget situation. And, in a time when all may be called upon to sacrifice, it seems especially inappropriate to target additional tax cuts to the most well off.

It is far from clear that we need an explicit fiscal stimulus package right now. For better or worse, war will boost the economy. Indeed, the $40 billion of new military and disaster relief spending just enacted is as large a stimulus as the tax rebates mailed out this summer, and policymakers are referring to that as only a down-payment. If more is needed, maybe we should enact additional temporary tax relief for low- and middle-income taxpayers. But a capital gains tax cut is definitely not the answer.
