What is the effect of a tax lower rate for capital gains?

It does not appear to spur economic growth significantly. But lower rates certainly do foster tax avoidance strategies and complexity.

Throughout the history of the income tax, capital gains have been taxed at lower rates than ordinary income. Since 2003, qualified dividends have also been taxed at the lower rates. Defenders of the tax preference argue that lower tax rates for capital gains and dividends offset the taxes that have already been paid at the corporate level. Some also claim that lower tax rates for capital gains spur growth, encourage risk-taking and entrepreneurship, offset the effects of inflation, and prevent "lock-in" (the disincentive to sell assets). Critics, for their part, complain that the lower tax rate disproportionately benefits the wealthy and encourages tax sheltering schemes.

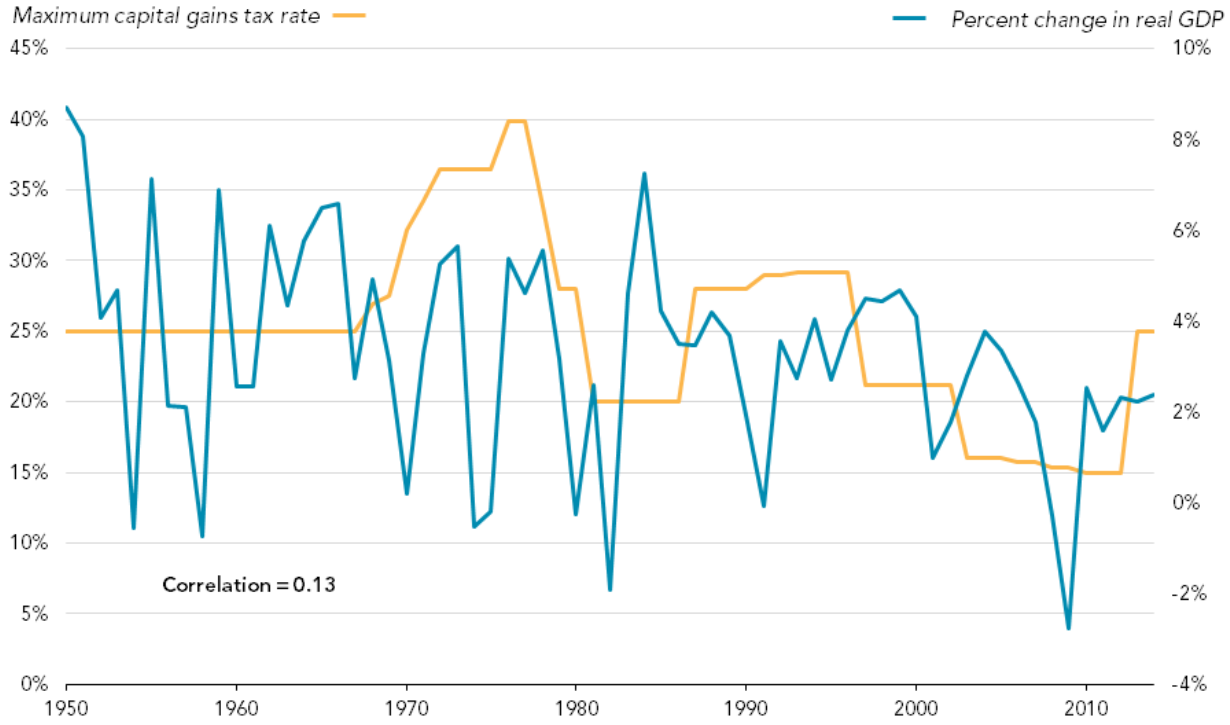
The double taxation argument goes only so far. Capital gains from the sale of stock is only about half of all capital gains. And even when a gain arises from the sale of corporate stock, profits have not always been taxed at the corporate level because corporations use various tax preferences, too.

Do lower taxes on capital gains spur economic growth? Figure 1 shows the top tax rates on long-term capital gains along with real economic growth from 1950 to 2014. Of course, many factors determine growth, but the tax rate on capital gains does not appear to be significant.

FIGURE 1

Top Capital Gains Tax Rates and Economic Growth

1950–2014



Sources: Citizens for Tax Justice; Bureau of Economic Analysis; Department of the Treasury, Office of Tax Analysis; Tax Policy Center calculations.

Capital gains may arise from risky investments, and a lower capital gains tax rate presumably encourages such risk taking. However, taxing gains while allowing deductions for losses on a symmetric basis reduces risk by reducing the after-tax variance of returns. Under current law, taxpayers can use capital losses to offset capital gains and, for noncorporate taxpayers, up to $3,000 of additional taxable income other than capital gains. Noncorporate taxpayers also can carry any remaining capital losses forward to future years indefinitely.

It is true that part of almost any nominal capital gain is due to inflation. But inflation actually affects the returns on assets that are taxed currently (interest, dividends, rents, and royalties) more than it affects capital gains, which are taxed upon disposition.

Meanwhile, the critics are correct that low tax rates on capital gains and dividends accrue disproportionately to the wealthy. For 2015, the Tax Policy Center estimates that nearly three-quarters of the tax benefit of the lower rates will be received by taxpayers with incomes over $1 million (table 1).

TABLE 1

Benefit of Lower Tax Rates on Long-term Capital Gains

Current law, 2015

Cash income level	Share of returns with benefit	Benefit as share of after-tax income	Share of total federal tax change	Average tax savings
Less than $10,000	0.0%	0.0%	0.0%	$0
$10,000–$20,000	0.6%	0.0%	0.0%	$1
$20,000–$30,000	1.7%	0.0%	0.1%	$6
$30,000–$40,000	3.4%	0.0%	0.2%	$12
$40,000–$50,000	6.1%	0.1%	0.3%	$29
$50,000–$75,000	10.8%	0.1%	1.5%	$70
$75,000–$100,000	18.2%	0.2%	2.2%	$160
$100,00–$200,000	26.6%	0.3%	7.0%	$302
$200,000–$500,000	48.0%	0.4%	7.0%	$808
$500,000–$1,000,000	74.4%	1.5%	8.1%	$7,251
More than $1,000,000	87.9%	6.5%	73.7%	$126,448
All	**12.1%**	**1.0%**	**100.0%**	**$674**

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0515-1).

Low tax rates on capital gains also play a role in many tax shelters that undermine economic efficiency and growth. These shelters employ sophisticated financial techniques to convert ordinary income (such as wages and salaries) to capital gains. For top-bracket taxpayers, tax sheltering can save 20 cents per dollar of income sheltered. The resources that go into designing, implementing, and managing tax shelters could be used for productive purposes.

Finally, the low rate on capital gains greatly complicates the tax system. A significant portion of tax law and regulations is devoted to policing the boundary between returns on capital assets and ordinary income.

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