

Key Elements of the U.S. Tax System

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

CAPITAL GAINS AND DIVIDENDS

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

A. It does not appear to spur economic growth significantly. But lower rates 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. Proponents of the tax preference argue that lower tax rates for capital gains and dividends offset taxes already paid at the corporate level, spur economic growth, encourage risk taking and entrepreneurship, offset the effects of inflation, prevent “lock-in” (the disincentive to sell assets), and mitigate the tax penalty on savings under the income tax. 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 are only about half of all capital gains. And even when a gain arises from the sale of corporate stock, corporate profits can often escape full taxation through business tax preferences.

ECONOMIC GROWTH

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 1954 to 2017. Of course, many factors determine growth, but the tax rate on capital gains does not appear to be a major factor.

Capital gains may arise from risky investments, and a lower capital gains tax rate might encourage such risk taking. Even without a tax preference, taxing gains while allowing full current deductions for losses on a symmetric basis would reduce risk by reducing after-tax variance of returns. However, deductibility of losses is limited, which limits the risk-reduction benefit of capital gains taxation for some taxpayers. 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 inflation causes part of almost any nominal capital gain. But inflation actually affects the returns on currently taxed assets (interest, dividends, rents, and royalties) more than it affects capital gains, which are taxed upon disposition.

BENEFICIARIES OF A LOWER TAX RATE

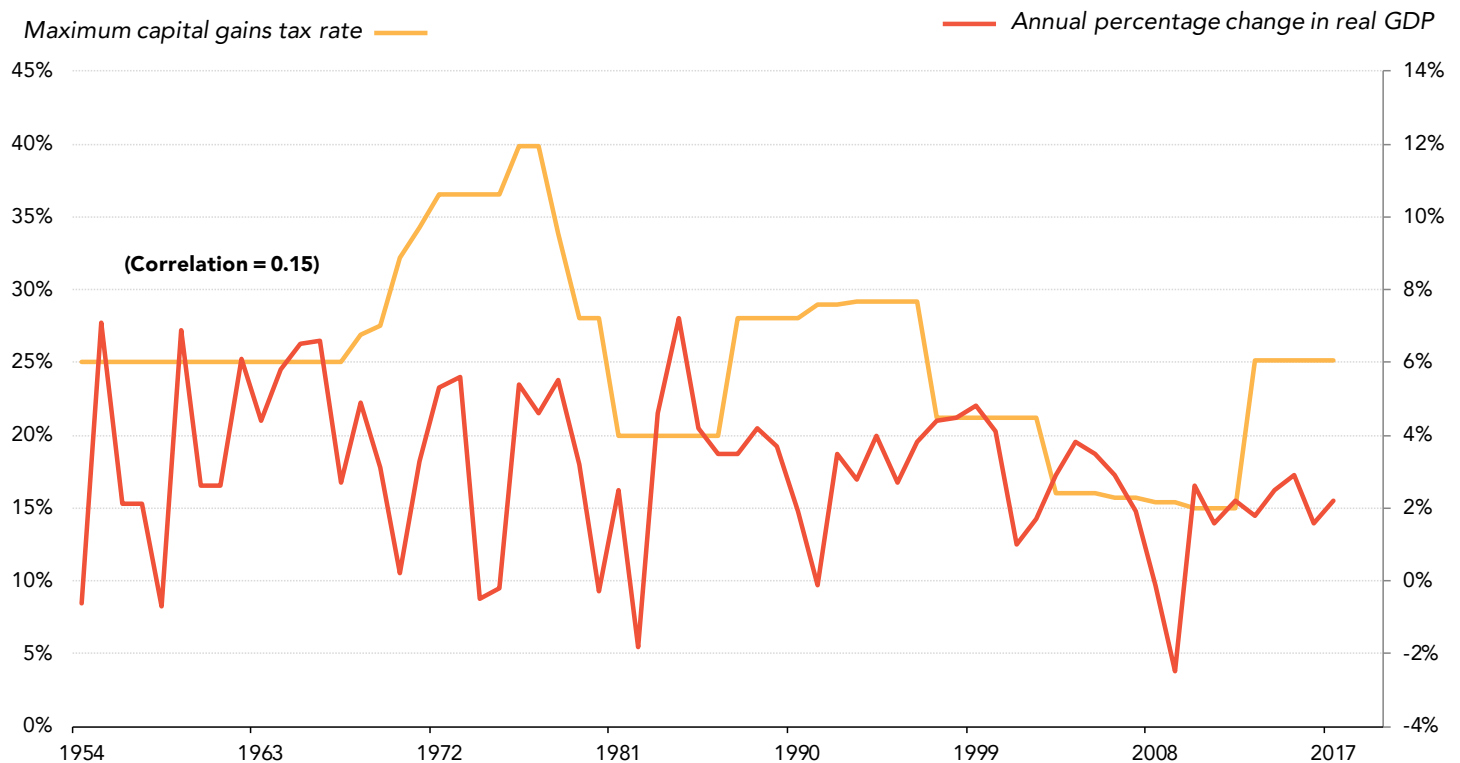
Critics are correct that low tax rates on capital gains and dividends accrue disproportionately to the wealthy. The Urban-Brookings Tax Policy Center estimates that in 2018, more than 70 percent of the tax benefit of the lower rates will go to taxpayers with incomes over \$1 million (table 1).

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FIGURE 1

Maximum Capital Gain Tax Rate and Economic Growth Tax years 1954–2017



Source: Urban-Brookings Tax Policy Center calculations; US Bureau of Economic Analysis, “National Economic Accounts”; and US Department of the Treasury, Office of Tax Analysis, “Taxes Paid on Capital Gains for Returns with Positive Net Capital Gains 1954–2014.”

Note: The maximum capital gains tax rate includes the 3.8 percent tax on net investment income (2013–) and adjusts for the phaseout of itemized deductions (1991–2009, 2013–2017).

Low tax rates on capital gains contribute to 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 up to 17 cents per dollar of income sheltered. The resources that go into designing, implementing, and managing tax shelters could otherwise be used for productive purposes.

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

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TABLE 1

Benefit of Lower Tax Rates on Long-Term Capital Gains and Qualified Dividends
Current law, 2018



Cash income level	Share of returns with tax benefit	Benefit as share of after-tax income	Share of total tax benefit	Average tax savings
Less than \$10,000	0.0%	0.0%	0.0%	\$0
\$10,000 – \$20,000	0.6%	0.0%	0.0%	*
\$20,000 – \$30,000	1.8%	0.0%	0.1%	\$10
\$30,000 – \$40,000	3.0%	0.0%	0.1%	\$10
\$40,000 – \$50,000	5.7%	0.1%	0.3%	\$30
\$50,000 – \$75,000	10.1%	0.1%	1.2%	\$70
\$75,000 – \$100,000	17.3%	0.2%	1.6%	\$140
\$100,000 – \$200,000	25.3%	0.2%	5.4%	\$260
\$200,000 – \$500,000	45.5%	0.6%	11.4%	\$1,280
\$500,000 – \$1,000,000	73.1%	1.4%	8.3%	\$7,260
More than \$1,000,000	86.5%	6.7%	71.3%	\$145,130
All	13.0%	1.1%	100.0%	\$820

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0718-1).

* Nonzero value rounded to zero.

Data Sources

Urban-Brookings Tax Policy Center. "Microsimulation Model, version 0718-1."

US Bureau of Economic Analysis. "[Current-Dollar and Real Gross Domestic Product](#)." 2018.

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Further Reading

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