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Non-Dynamic Duo

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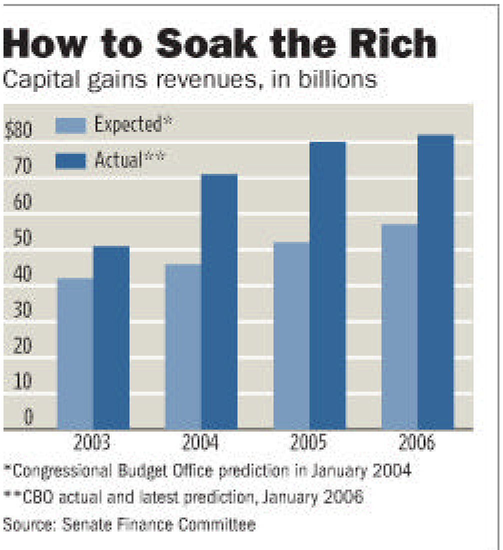
Review and Outlook

A House-Senate conference committee is still mulling whether to extend the 15% capital gains and dividend rates through 2010, and it seems the only roadblock is the Congressional budget estimate that this two-year extension would "cost" the Treasury $20 billion. But here comes Senate Finance Chairman Chuck Grassley to the rescue.



The Iowa Republican has sent a crisp letter to the Congressional Budget Office questioning that revenue estimate given its dreadful forecasting record. With the 15% tax rate, Mr. Grassley writes, "capital gains taxes are now projected to exceed the amount originally projected under the higher capital gains tax rate [of 20%] that prevailed before 2003." As the nearby chart shows, tax receipts are now expected to be $87 billion more than CBO originally predicted for the years 2003-2006.

CBO's letter of explanation for its blunder is a doozy. The agency threw up its hands and acknowledged that its computer model fell "well short of explaining the surge in [capital gains] realizations that occurred in 2004" and that nearly half the increase in capital gains realizations between 2003 and 2004 "remains unexplained" by the model. Perhaps it's time for a new model. Then CBO resorted to economic mumbo jumbo and claimed that "we cannot conclude that the unexplained increase is attributable to the change in capital gains tax rates." Maybe it's the tides.

Now, we concede that estimating stock sales and then capital gains tax revenues is an imprecise science affected by many factors other than the tax rate. And errors should be expected in such revenue projections. But for nearly 30 years CBO's errors have been anything but random. Starting with the famous Steiger capital gains tax cut of 1978, and again with the cuts in 1997 and 2003, actual capital gains revenues and realizations have exceeded what the computer models predicted.

CBO and the Congressional Joint Tax Committee also advised Congress that raising the capital gains tax rate to 28% from 20% as part of the 1986 tax reform would bring in more revenue to the Treasury. Instead, capital gains revenue fell. After the 1997 rate cut, this non-dynamic duo were also off by a country mile, or $84 billion from 1997-1999.

The rationale behind the 2003 tax cut was not to raise tax revenues, of course, but to spur investment and growth and to reverse the fall in the stock market after the dot-com crash in 2000. That is precisely what happened. This has been an investment-led economic expansion, with some $5.1 trillion in stock wealth restored, and the Bush tax cuts are one of the reasons. That gift to the 100 million-plus members of the U.S. investor class will be put in harm's way if the dividend and capital gains rates are allowed to rise back to 35% and 20% after 2008.

So we're glad to see Mr. Grassley on the case. He should tell his fellow conferees that the surest way to cost the Treasury money would be to let those tax rates increase. And while he's at it, how about prodding the static revenuers at CBO and Joint Tax to fix their models, or better, throw them out and get new ones.