CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Douglas W. Elmendorf, Director

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Honorable Brian P. Bilbray
U.S. House of Representatives
Washington, DC 20515

Dear Congressman:

I am pleased to respond to your questions about recent changes in the composition of federal revenues, the effects of scheduled increases in tax rates on capital gains, and the effects of recent changes to private-sector risk models.

Composition of Federal Revenues

As a result of the economic downturn, CBO expects revenues from individual and corporate income taxes in 2009 to account for about 50 percent of total revenue, below the average of about 57 percent over the past five years. It is not unusual for income tax revenues to account for a smaller share of total revenues in recessions because of sharp declines in major components of the income tax bases, namely corporate profits and non-wage personal income (such as capital gains realizations, business-related incomes, dividends, and interest). Social insurance (payroll) tax receipts are expected to account for a higher-than-normal share of total revenues because wages and salaries, the main components of the payroll tax base, are expected to decline much less in this recession than corporate profits and non-wage personal income. As the economy gradually recovers from the economic downturn, CBO expects corporate profits and non-wage personal income to recover, boosting the share of total revenue from individual and corporate income taxes.

Information from tax returns necessary to identify the sources of income responsible for the decline in income tax receipts in 2009 will become available over the next couple of years. That information will include changes in the distribution of personal income among taxpayers with different amounts of income and who thus face different tax rates. CBO anticipates that those data will show that although the recession has harmed the finances of taxpayers across the income distribution, higher-income taxpayers earned a smaller share of total income in 2008 and 2009 than they did just before the recession. For example, withholding for income taxes dropped sharply in December 2008 and January 2009, suggesting that year-end bonuses fell substantially. Those bonuses disproportionately accrue to higher-income taxpayers.

CBO expects that when complete information for the year is available, it will show that receipts from corporate income taxes fell substantially in 2009, to about 1.0 percent of GDP, less than half of the 2.1 percent of GDP in 2008. The decline stems from a sharp drop in taxable corporate profits. Moreover, many firms have experienced losses in 2008 and 2009, and tax law allows firms to reduce their tax liability in future profitable years by deducting those losses from taxable income. CBO expects that many firms are likely to use that feature of the corporate tax system to deduct 2008 and 2009 losses starting in 2010 and 2011 as they return to profitability, thus restraining the growth of receipts in those years.

Increases in Tax Rates on Capital Gains

In answering your questions about how the pending changes in the taxation of capital gains tax will affect revenues and behavior, it is useful to consider how the pending increase compares with previous changes. The top tax rate on most long-term gains was reduced from around 35 percent to 28 percent in 1978 and 1979, and was reduced to 20 percent in 1981. It was raised to 28 percent in 1987, reduced to 20 percent again in 1997, and reduced to 15 percent in 2003. The increase pending in 2011 is to 18 percent for some gains held over five years and to 20 percent for most other long-term gains. Thus, the pending tax change is well within the range of changes experienced in the last 30 years, and we have incorporated the impacts from those historical changes into our modeling of the effects of the upcoming law change.

Because CBO's baseline revenue projections are constructed under the assumption that no changes to tax law occur, those projections assume that tax rates on capital gains will increase in 2011 as currently scheduled. Based on the historical experience, CBO anticipates that taxpayers will take steps to moderate the impact of the pending tax increase. One step will be to accelerate the realization of some gains into 2010 that otherwise would have been realized in 2011. In later years, we anticipate that taxpayers will realize fewer capital gains by holding assets longer, in some cases until death, when they can be left to heirs without any potential income tax on accrued capital gains. The shifting of gains from 2011 into 2010 will reduce revenues modestly over that two-year period, as well as speed up their payment. In later years, the reduced realizations will keep revenues from rising in proportion to the increase in the tax rate. On net, we project that federal revenues will increase in response to the higher tax rates, but that reduced realizations will temper that increase.

The model CBO uses to estimate and project capital gains realizations on individual tax returns relies on three types of influences. For 2008, a year for which tax return data are not yet available, the model relies on stock prices, business cycle conditions, and tax rates. For the projections of realizations over the next few years, the model shifts from stock prices to corporate profits, but retains factors for the business cycle and tax rates. In the longer run, it relies on tax rates and the historical relationship between realized gains and output. As a result, changes in tax rates affect our projections of the amount of capital gains people realize, not just the tax rates they pay.

When assessing the impact of the increased tax rates on economic growth, it is important to keep in mind that taxable capital gains account for a small portion of all capital income. Much capital income is paid as dividends, interest, rent, and proprietors' profits. In addition, most capital gains are not taxable because they are held in tax-exempt accounts or are held until death. As a result, CBO does not anticipate that the pending increase in the capital gains tax rate alone will have a large enough impact on the rate of return to capital overall to change significantly the magnitude of saving and capital investment. The higher capital gains taxes could have an additional effect by discouraging innovation and risk-taking, but there is insufficient evidence on which to base a quantitative estimate.

More narrowly, CBO does not anticipate that the pending change in the capital gains tax rate, by itself, will cause much shifting of investment to tax-exempt instruments such as state and local bonds. The increase is well within the range of past changes, and substantial shifts have not been identified in response to those changes.

Changes to Risk Models

CBO has not conducted any research on the economic or budgetary impacts of recent changes to risk models or on the availability of funding to venture capital firms. In recessions, it is common for investors to lose their appetite for risk, driving up required rates of return on risky investments, which may prevent some investments (including venture capital funds and their projects) from receiving funding altogether. This appears to be an unavoidable aspect of recessions. This particular recession has also highlighted the inadequacy of the risk models used by many financial institutions. That those risk models would be re-evaluated seems a prudent response to recent events. As the economy recovers, CBO expects that investors will continue to re-evaluate those risk models, with a view to better managing the riskiness of their investments

I hope that you find this information helpful. I would be happy to answer any additional questions that you might have. The CBO staff contacts on this topic are Mark Booth, Larry Ozanne, and Damien Moore.

Sincerely,

Douglas W. Elmendorf

Douglas W. Elmendorf
Director

cc: Honorable John M. Spratt Jr.
Chairman
Committee on the Budget

Honorable Paul Ryan
Ranking Member