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RSC Policy Brief:
The Effect of Capital Gains Tax Cuts on Revenue

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Background: Over the past three decades, there have been five notable changes to the capital gains tax rate. In 1978, 1981, 1997, and 2003 legislation was enacted lowering the capital gains tax rate. Over this same period, the capital gains tax has been increased just once in 1986.

The most recent change, the 2003 Jobs and Growth Tax Relief Reconciliation Act, reduced the top capital gains tax rate from 20% to 15%. This provision is scheduled to expire at the end of 2010, at which time the top rate will revert back to 20%.

Many Democrats have called for a higher capital gains tax rate. For example, Representative Rahm Emanuel introduced H.R. 5176 in the 109th Congress which, among other things, would increase the top capital gains tax rate to 35% (the highest rate since 1977). The FY 2008 and FY 2009 budget resolution conference reports both call for the capital gains tax rate to return to 20% after 2010.

Most conservatives argue that such capital gains rate increases will not only prove harmful to the economy but will have the opposite effect on revenues. Instead of resulting in additional revenues, history proves the contrary. Even Senator Obama, during the April 16, 2008 Democrats Presidential Debate in Philadelphia, did not defend the view that capital gains tax rate hikes increase federal revenues:

> **Charlie Gibson:** *And in each instance, when the rate dropped, revenues from the tax increased. The government took in more money. And in the 1980s, when the tax was increased to 28 percent, the revenues went down. So why raise it at all, especially given the fact that 100 million people in this country own stock and would be affected?*
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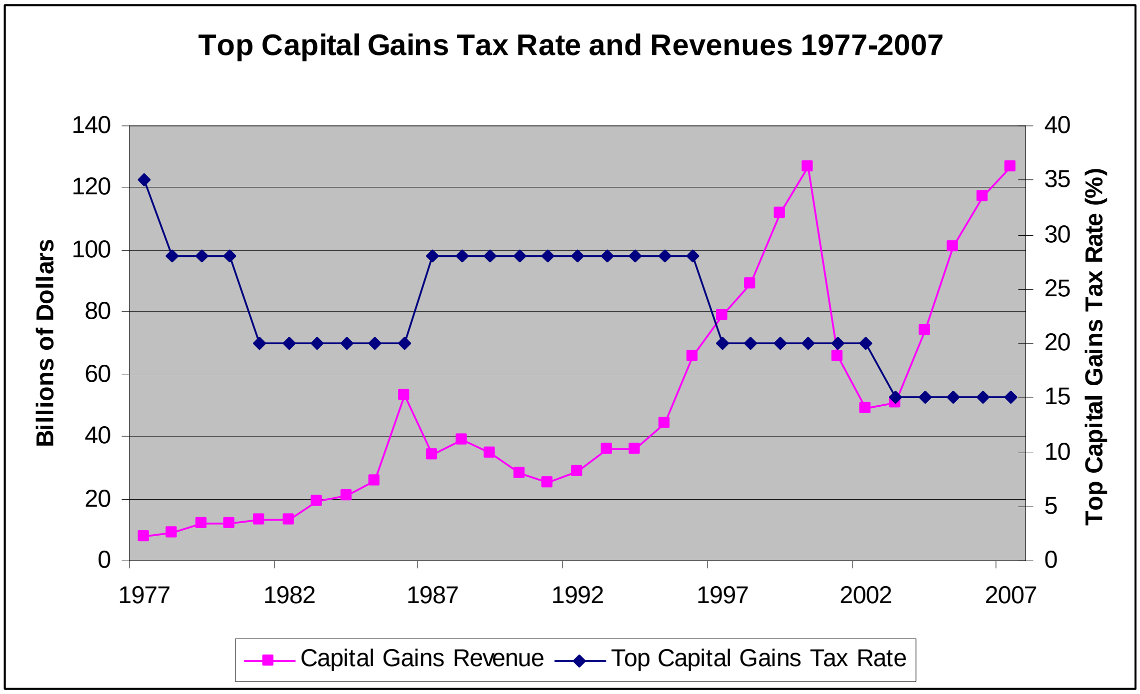
> **Senator Obama:** *Well, Charlie, what I've said is that I would look at raising the capital gains tax for purposes of fairness.*

Overview of Capital Gains Tax Rates and Revenue from 1977-2007: In 1977, the top capital gains tax rate was 35%. After five changes between 1978 and 2003, four that lowered the capital gains rate, the top capital gains tax rate is currently 15%. This 57 percent reduction in the top capital gains tax rate over the last thirty years has coincided with a fifteen-fold increase in capital gains revenue. From 1977 to 2007, capital gains revenue increased from $8 billion to $127 billion (see chart below).

Figure 1: Top Capital Gains Rate, Capital Gains Revenue 1977-2007



To put this increase in perspective, from 1977 to 2007, capital gains tax revenue increased by a factor of 15 while overall federal revenue increased by a factor of 7 (increasing from $355 billion to $2.6 trillion). Consequently, with the downward trend in the top capital gains tax rate, capital gains revenue has increased sharply as a percentage of federal tax revenue—increasing from 2.3% of all federal revenue in 1977 to 4.9% of all federal revenue in 2007.

1978, 1981, 1986, 1997, and 2003 Capital Gains Tax Changes and Revenue: A more detailed look at what happened to capital gains revenue after each of the recent changes to the top capital gains tax rate:

The 1978 Capital Gains Tax Cut. In 1978, the top capital gains tax rate was reduced from 35% to 28%. Under the lower rate, capital gains revenue increased by 51% in 3 years, increasing from $8 billion to $12 billion.

The 1981 Capital Gains Tax Cut. In 1981, the top capital gains tax rate was reduced from 28% to 20%. Under the lower rate, capital gains revenue rose by 325% in 6 years, increasing from $12 billion in 1981 to $53 billion in 1986.

The 1986 Capital Gains Tax Increase. In 1986, as part of the Tax Reform Act of 1986, the top capital gains tax rate increased from 20% to 28%. Over the next five years, capital gains tax revenue plummeted—decreasing from $53 billion in 1986 to $24 billion in 1991, a reduction of 54%. By 1996 (the last year of the higher rate), capital gains revenue recovered and grew to $66 billion. Still, over this ten-year period of a higher top capital gains tax rate, capital gains tax collections only grew by 25%.

The 1997 Capital Gains Tax Cut. In 1997, the top capital gains tax rate was reduced from 28% to 20%. Under the lower tax rate, capital gains revenue surged by 92% over four years, increasing from $66 billion to $127 billion. However, in 2001 and 2002 capital gains revenue plummeted because of the drop in stock market prices, declining by 62% from 2000 to 2002.

The 2003 Capital Gains Tax Cut. In 2003, the top capital gains tax rate was reduced from 20% to 15%. Under the lower tax rate, capital gains revenue grew by 159% in five years—increasing from $49 billion in 2002 to $127 billion in 2007.

Common Arguments that Capital Gains Reductions Lose Revenue: The Center on Budget and Policy Priorities, a liberal think tank, argues that capital gains tax cuts lose revenue in a paper entitled: *Experts Agree that Capital Gains Tax Cuts Lose Revenue*. The paper is a good example of some of the arguments made by proponents of raising the capital gains tax rate. Below is a sample of the claims made by the paper:

Claim 1: "While a capital gains tax cut can lead investors to rush to 'cash in' their capital gains when the lower rate first takes effect, it does not raise revenue over the long run."

The argument here is that capital gains tax reductions might increase revenue in the short term, but still lose revenue in the long term. The problem with this argument is that it is contradicted by the actual data. There has been a strong jump in revenues after each of the four capital gains tax cuts in the short run. But, the growth of capital gains revenue is also self-evident over the *long run*. Specifically, from 1977 to 2007—a period covering the last year the capital gains rate was 35% to last year—the top capital gains rate declined by 57% and capital gains tax collections increased by *1,488.0%*.

Claim 2: "Cutting capital gains rates reduces revenues over the long run. That's the conclusion of the federal government's official revenue-estimating agencies..."

But how have these past projections compared to actual revenue collected? In January 2001, CBO famously released budget projections showing a $5.6 trillion surplus over the period from 2002-2011. Since the federal budget has actually run a deficit in every year thus far covered by this period—including the three single largest budget deficits in U.S. history—the January 2001 CBO outlook is often noted for being too optimistic in its projections (though it is also the case that Congress spent $487 more in FY 2007 than CBO projected). However, in one respect, CBO's projections were pessimistic. In January 2001, CBO projected capital gains receipts under the then 20% top capital gains tax rate would come to $106 billion in 2007. Under the lower 15% top tax rate enacted in 2003, capital gains revenue actually came to $127 billion in 2007, or 20% above the projection that assumed the higher rate would be in effect.

In January 2003, the last year CBO's budget outlook based estimates of capital gains revenue on the assumption that the top rate would be 20%, CBO projected capital gains revenue would be $76 billion in 2007, *40% below* the actual figure of $127 billion with the *lower* 15% capital gains tax rate in effect.

Conclusion: Two general conclusions can be reached about the impact on revenue of the four recent capital gains tax reductions and the one capital gains tax increase. First, though capital gains revenue fluctuates from year to year, the upward trend in capital gains revenue, during this period of lower capital gains tax rates, is unmistakable. Second, after each of the four most recent capital gains tax reductions, there has been a large initial *increase* in capital gains tax collections, and after the only recent capital gains tax increase there was a large initial *reduction* in capital gains tax collections.

Additional Reading: For further information on this issue see:

- CRS Report: *Capital Gains Tax Rates and Revenues*
- CBO: The Budget and Economic Outlook: Fiscal Years 2008 to 2018
- U.S. Treasury Department—Office of Tax Analysis

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