Joint Committee on Taxation
February 14, 1990
JCX-5-90

ESTIMATE OF ADMINISTRATION PROPOSAL FOR A REDUCTION IN TAXES ON CAPITAL GAINS OF INDIVIDUALS

This document provides estimates of the revenue and distributional effects of the Administration's capital gains proposal.

1. Description of Proposal

The proposal would allow for a 30-percent exclusion from income of the (net) gain realized on the sale of a capital asset which has been held for more than one year. The exclusion would apply to all capital assets (except collectibles) and would be available to individual taxpayers only. Beginning on January 1, 1991, the 30-percent exclusion would be available only for those assets held more than 2 years; for assets held less than 2 years (but more than 1 year) a 20-percent exclusion would be allowed. Similarly, beginning on January 1, 1992, the 30-percent exclusion would apply for assets held for 3 years or more; a 20-percent exclusion would apply for assets held between 2 and 3 years; and a 10-percent exclusion would apply for assets held less than 2 years (but more than 1 year).

Additionally, the proposal would require full recapture, at ordinary income tax rates, of prior depreciation and depletion deductions. Also, the excludable portion of capital gains would be made a preference item for purposes of the individual alternative minimum tax (AMT).

2. Effective Date

As transmitted to Congress, the Administration's proposal would be effective on the date of enactment. The staff of the Joint Committee on Taxation (staff) has been advised the Treasury Department revenue estimates of this proposal assumed the date of enactment would be March 15, 1990. S. 2071, introduced February 6, 1990, by Senator Packwood (and others), and H.R. 3792, introduced February 7, 1990, by Mr. Archer (and others), expressly provide for an effective date of March 15, 1990. Accordingly, the estimate presented below reflects that effective date.

3. Enclosed Tables

Table 1 provides a detailed breakdown of the revenue effects of the various components of the Administration proposal. It presents a decomposition of the estimate into static and behavioral components, as well as the effects of depreciation recapture, the staggered holding period requirement, and choice of the effective date. Table 2 presents the staff's estimate of the distributional effect, at 1990 income levels, of the Administration proposal.

4. Long-Run Revenue Effects

Table 1 provides revenue estimates only for fiscal years 1990 through 1995. For the reasons set forth below, the estimate does not quantify the revenue effects of the Administration's capital gains proposal for fiscal years beyond 1995.

As required by statute, the estimate is based on the baseline macroeconomic forecast for the United States economy provided by the Congressional Budget Office (CBO). The CBO baseline forecast extends only through 1995. Any extrapolation of the baseline beyond 1995 either would require a purely mechanical approach (e.g., an assumption that economic trends would continue unchanged in the future) or would involve an independent forecast of such trends. Either approach would be arbitrary and could well result in the use of economic assumptions inconsistent with those underlying the CBO five-year forecast. In addition, any baseline assumptions made by the staff would likely create a debate about out-year macroeconomic growth which the staff has traditionally avoided.

Even if these technical problems of assuring consistency were overcome, the uncertainties inherent in long-range macroeconomic forecasting have led the staff to conclude that it would be inappropriate to provide a specific revenue estimate for years beyond 1995. Two issues that arise in the process of estimating this proposal illustrate this point:

(a) There is evidence that the elderly realize proportionately more capital gains than the non-elderly. This evidence might suggest that, as the United States enters the next century and the population ages, gain realizations as a percentage of GNP would be greater than they are today. On the other hand, if the age of retirement increases in future years, this could reduce the currently-observed propensity of the elderly to realize gains.

(b) The effect of possible changes in the personal savings rate creates similar long-range estimating problems. Since capital gain realizations result from past savings by individuals, it is reasonable to expect changes in future realizations as the personal savings rate either increases or decreases. Unfortunately, existing data provide no acceptably reliable basis for predicting future changes in this critical variable.

Despite these and other uncertainties as to future macroeconomic trends, the staff believes the analysis of the period 1990-1995 provides information which may be useful in assessing the general trend and magnitude of the post-1995 revenue effects of the Administration's capital gains proposal. Two points in particular emerge from this analysis:

First, changes in the tax rate on capital gain income are likely to produce a substantial taxpayer behavioral response. The staff believes, however, that this response is larger in the short run than in the long run; and it is the staff's best judgment that the long-run behavioral response will be insufficient to produce a long-run positive revenue effect. Accordingly, the estimates project revenue losses for each fiscal year 1992 through 1995, and the staff believes these losses will continue for years beyond 1995.

Second, the historic economic data suggest that capital gain realizations grow as the overall economy grows. Consequently, if the economy continues to grow in years beyond 1995, the staff would predict the revenue losses in those years would exceed the revenue loss for 1995, and would grow in magnitude each year thereafter.

PRELIMINARY

- Table 1 -

ESTIMATED REVENUE EFFECTS OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

Fiscal Years 1990-1995

[Billions of Dollars]

	Item[1]	1990	1991	1992	1993	1994	1995	1990-95
I.	Static effect of the 30% exclusion[2].................	-2.6	-17.7	-18.7	-19.9	-20.4	-20.9	-100.2
II.	Effect of induced realizations[3].....................	3.0	18.9	14.4	14.9	13.4	13.8	78.4
III.	Effect of full depreciation recapture................	0.3	1.8	1.9	2.1	2.1	2.2	10.3
IV.	Effect of phase-in of the 3-year holding period......	--	-0.3	-2.0	-0.9	0.4	1.6	-1.2
V.	Effect of treating excluded portion of gain as a preference item for AMT purposes..................	--	0.1	0.1	0.2	0.2	0.2	0.8
VI.	Effective date of the proposal[4].....................	0.1	0.6	--	--	--	--	0.7
	TOTAL, Revenue Effect of the Proposal................	0.7	3.2	-4.3	-3.6	-4.3	-3.1	-11.4

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NOTE: Details may not add to totals due to rounding.

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[1] All estimates in this table are done incrementally; that is, assuming provisions described on preceeding lines of the table have been enacted.

[2] This line reflects an estimate of the proposed exclusion assuming no change in taxpayer behavior.

[3] This line reflects an estimate of the increase in budget receipts attributable to taxpayer decisions to realize more capital gains as a result of the lower tax rate.

[4] Lines I-V, above, reflect a January 1, 1990, effective date; line VI represents an adjustment to these lines to reflect an assumed effective date of March 15, 1990.

PRELIMINARY

- Table 2 -

DISTRIBUTIONAL EFFECT OF THE ADMINISTRATION'S CAPITAL GAINS PROPOSAL

[1990 Income Levels]

Income Class[1]	Number of Returns With Tax Change [Thousands]	Aggregate Tax Change [Millions of Dollars]	Average Tax Reduction[2] [Dollars]	Percent Distribution of Aggregate Tax Change
Less than $10,000.......	59	$ -4	$ 68	(3)
10,000 - 20,000.......	638	-56	88	0.4%
20,000 - 30,000.......	1,360	-136	100	0.9
30,000 - 40,000.......	1,811	-297	164	1.9
40,000 - 50,000.......	1,502	-415	276	2.6
50,000 - 75,000.......	2,423	-1,004	414	6.3
75,000 - 100,000.......	984	-785	798	4.9
100,000 - 200,000.......	1,299	-2,709	2,085	17.0
200,000 and Above......	681	-10,522	15,454	66.1
TOTALS..................	**10,756**	**$-15,928**	**$ 1,481**	**100.0%**

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<u>NOTE</u>: Details may not add to totals due to rounding.

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[1] The income concept used to place tax returns into income classes equals adjusted gross income plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) inside buildup on life insurance, (4) worker's compensation, (5) nontaxable social security benefits, (6) deductible contributions to individual retirement accounts, (7) the minimum tax preferences, and (8) net losses in excess of minimum tax preferences from passive business activities.

[2] The tax reduction reported here assumes no change in taxpayer behavior. Thus, this measure understates the tax benefit received by certain taxpayers.

[3] Negligible.