CHANGING THE LOCKS ON CAPITAL GAINS

A Critique of the New Tax Provision

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Abstract

The tax provisions covering capital gains are known to cause a "lock-in" in the sense of a delay in selling an appreciated asset. The 1993 deficit-reduction act adds a new incentive to hold by providing a 50% cut in the tax when an investment in certain businesses is held five years or longer. The reduction is from a top rate of 28% to 14%. The reduced rate tends to weaken the lock-in but the long holding period required to win this rate tends to strengthen it, with detrimental effects, it is here argued, on the liquidity of capital and the optimum allocation of resources. The locks have simply been changed.

It would be far better to go immediately to a 14% rate after one year than to delay it for five years. This would reduce the prevailing lock-in without introducing a new one. The increased liquidity would be an attraction to prospective risk-takers. It would increase the inducement to make the financial investment in the first place without impairing the viability of the real investment in plant, equipment and employment. It would encourage growth and long-run revenue and might even produce higher short-run revenue because of the increased inducement to invest.

The 1993 act also failed to deal with two aspects of the taxation of capital gains that are crying for attention: (1) the taxation of inflation-bloated gains; and (2) the calculation of taxable gain only when realization occurs. Both lacks contribute to the lock-in.

This paper considers all three topics.

Changing the Locks on Capital Gains

It has long been maintained that the capital gains tax encourages holding onto appreciated assets thereby raising the price and reducing the volume of transactions. This has become known as the "lock-in" of capital gains. The 1993 deficit-reduction act adds a new incentive to hold by providing a 50% cut in the tax when an investment in certain businesses is held five years or longer. The reduced rate tends to weaken the lock-in five years after purchase but the long holding period required to win this rate tends to strengthen the lock-in in the interim. Detrimental effects, it is here argued, result from this new incentive, especially with regard to the liquidity of capital and the optimum allocation of resources. The locks have simply been changed.

The 1993 act also failed to deal with two aspects of the taxation of capital gains that are crying for attention: (1) taxation of inflation-bloated gains; and (2) taxation on realization only. Both aspects contribute to the lock-in.

Controversy over the capital gains tax is one of the fixtures of recent American fiscal history. It was rekindled by former President Bush's budget proposals early in 1992, the various plans that surfaced during the presidential campaign of that year, and President Clinton's bill, as passed in May 1993, followed President Clinton's proposals in keeping the top capital-gains rate at 28% and cutting the tax rate in half on profits from stock purchased directly from eligible small corporations and held for five years; with the effective date set at January 1, 1993. The conference report that was ultimately passed by both houses, despite initial changes in the Senate, followed the the same lines.

The pressure for a revision of the capital-gains tax occupied much of the discussion before the vote. Rep. Armey (R., Texas) wrote in April 1993: "As the budget works its way through Congress, President Clinton continues to call for 'an investment recovery' to create jobs. Cutting the capital-gains tax and indexing gains for inflation are the fastest route to that goal. The President has actually asked Congress for a limited capital-gains tax reduction - his plan focuses on long-term investment and only for smaller start-up businesses. But new evidence reinforces what many Americans already know: Only an across-the-board capital-gains cut would provide the dramatic employment and economic growth Mr. Clinton craves."[1]

An across-the-board cut did not prevail but small-business succeeded in preserving its place in the tax bill. Under a heading, "How a small-business group found a niche in tax bill", the *Wall Street Journal* reported just before the House vote in May, 1993:

"The tax-bill language gives investors in such specialized small-business venture-capital firms the same 50% capital-gains tax cut proposed for other small businesses by President Clinton. Also, individual investors could defer from their taxes as much as $50,000 a year in capital gains from stock or property sales if the gains were reinvested in minority venture-capital firms. Corporations could defer as much as $250,000 a year. The House Ways and Means Committee estimates that the measure would cost taxpayers $320 million over five years."[2]

This points up the main issues leading to the 1993 changes: Should there be a cut in the capital-gains tax; if so, should it be by rate reduction or indexing or other means; should the rate be affected by the holding-period; and should it be a targeted or an across-the-board cut?

Pre-election Consensus on A Capital-Gains Tax Cut

During the pre-election period of 1992 President Bush maintained his position in favor of lowering the capital gains tax. His opponent, Governor Clinton, also had an element of the same plan but it was narrowly focused on the "enterprise zone" idea: a capital gains tax preference would be given investments in the zone. Although Governor Clinton's announced tax plan would mainly impact family income over $200,000, the enterprise zone plan would tend to place the program as a whole in the moderate category--perhaps only a stone's throw away from the Bush plan.

President Bush's plan was to reduce the top rate to 15.4% from 28%. The main claim that had been made for a similar rate reduction plan a few years earlier was that it would raise revenue and reduce the deficit. This time the emphasis was on helping to pull the country out of the recession and contribute to long-term growth of the economy and the productivity of the working force.

A newspaper report in October 1992 included the following:

"A Senate proposal phasing out capital gains taxes for investors in new, small companies also was quashed; it was a modest version of Mr. Bush's top priority capital-gains tax cut. But under the bill, investors in enterprise zones would get capital-gains breaks."[3]

A much stronger position was held by Governor William Weld of Massachusetts. He said:

"I've never understood the rationale for the capital gains tax in the first place. I think we should look toward some sort of phase-out, both federally and on the state basis." [4]

It should be noted that President Clinton's enacted tax proposals, which raised some income tax rates to 36% and beyond, do not not alter the existing 28% limit on capital gains. This has led to suggestions that the "rich" in the sense of those who enjoy high income from dividends, interest and salaries, would be worse off under the plan than those whose wealth and compensation embodies capital gains that would be subject to the 28% limit. It is cheaper to live off capital gains than dividends; and this creates incentives for firms to reinvest earnings rather than pay dividends. This is more so in the new law than in the prior law which had a nominal top rate of 31% ("nominal" because of adjustments in deductions and exemptions that raise the effective rates at high levels in both laws).

Significance of the Declining Rate Plan

As we have seen, both of the major contenders in the presidential campaign proposed a reduction in the capital gains tax rate with the length of the holding period. The economic question is whether any time-declining rate proposal is a good idea. (The contining distinction between short-term and long-term capital gains is a different matter, not considered here.)

There were two separable features of President Bush's plan: a reduction in the rates of capital gains tax; and a reduction that gets greater as the holding period is increased, up to three years. Both features could potentially have had significant effects. President Clinton's declining rate law is narrower, being "targeted" to a particular area or group.

Under a proposal of Secretary of the Treasury Bentsen in late March 1993, the limit on the small business tax break would have been raised on new investments in businesses with as much as $50 million in equity and debt. (Senator Bumpers had wanted $100 million.) After holding for 5 years the top capital gains rate would be 14%, the lowest rate since the 30's. The eligible gain could be the greater of 10 times the original price of the stock or $1 million.

At that time there was concern that Clinton's "sweetening" of the capital gains proposals would not satisfy the advocates of Senator Bumpers' more generous plan. Also, some senators were concerned that to keep the maximum capital gains rate at 28% while raising the personal tax limit to 39.6% (36% plus a 10% surcharge) would encourage the "game-playing" that the 1986 Tax Reform Act was designed to prevent.

President Bush's rate reduction was to have been achieved by excluding a portion of the gain from taxation and then applying the existing maximum rate of 28% to the rest of the gain. Specifically, with a holding period of one year, 15% of the gain would be excluded, leaving the remaining 85% subject to a rate of 28%, making for an effective rate of 23.8% against the entire gain. With a holding period of two years, 30% of the gain would be excluded, resulting in a top rate of 19.6% against the entire gain. With a holding period of three years, 45% of the gain would be excluded, making for a top tax rate of 15.4% against the entire gain.

Under the 1986 tax law, capital gains were taxed at the same rate as ordinary income. The exemption of capital gains at death remained. In 1990, a rate preference was established with a 28% ceiling on capital gains. Even apart from this, a substantial advantage remained in favor of long-term capital gains: An asset holder could defer realization of gains indefinitely or until lower tax rate years. It has been estimated that the resulting capital gains advantage remained about half as large as before the 1986 act. (*Cf*. Ferris and Reichenstein 1988). Thus two separate "clienteles", those seeking capital gains and those preferring ordinary income, for tax reasons or whatever, still existed. The Bush plan would have enlarged the capital gains differential and accentuated the separation of the two clienteles. This was reminiscent of the pre-1986 situation when there was a 60 percent long-term capital gains exclusion.

President Bush's Earlier Proposal

President Bush's earlier, very similar, proposal in 1989 provoked considerable discussion and some opposition. Herbert Stein was vehement: "The whole struggle is a great waste of time and energy for the president, the Congress and the country." He continued, "There is at best only slight evidence that cutting the tax rate will have the positive effects claimed - on saving, investment, productivity, jobs or revenue. In my opinion, the idea is logically, morally and economically offensive - but it won't kill us. The important thing now is to get it over with quickly."[5]

The "Lock-In"

The rate reduction in the Bush plan was intended partly to overcome the "lock-in". As pointed out above, this is the tendency of a tax that is imposed solely at the time of realization of a gain to discourage the sale or, at least, induce its further postponement. The rate reduction would unlock built-up gains that would have been allowed to accumulate had the higher rate remained in effect.

Not generally recognized is that the sequence of reduced rates, as the length of the holding period increases, introduces a "lock-in" of its own. This new lock-in is apart from the substantial one set in place by not taxing gains that have accrued at death.

The three-year plan thus would have provided a "lock-in" incentive for a three-year period. This postpones the acquisition of tax revenues and, more important, it discourages the movement of capital fo its highest and best use. Under the plan, there would have been an incentive to postpone the sale of appreciated assets from a top rate of 28% to 23.8%, then 19.6% and finally to a level of 15.4% for assets held three years or more. Under the law as enacted a rate of 14% applies in five years in targeted cases.

Revenue Consequences of a Declining Rate Plan

Would an extended holding period increase or reduce Treasury revenue from the capital-gains tax? It was reported as late as January 1993 by authors Bogart and Gentry that, "Despite extensive research, the debate continues as to whether cutting the tax rate on capital gains increases or decreases revenues"[6]. Using an interstate approach, the same authors concluded: "In general, our estimates cast doubt on the popular justification that cutting the tax rate on capital gains income would be self-financing"[6]. On this basis, a reduction in capital gains rates would not lead to a sufficient increase in realizations to maintain revenues, without long-run growth induced by the cut.

Referring to the Treasury and congressional staffs, Martin Feldstein has said:"Their current procedure allows for a substantial change in realizations of capital gains when they estimate the revenue effects of changes in the capital-gains tax"[7].

It is useful to note the relative unimportance of capital gains taxes in the total picture. Capital-gains taxes account for a relatively small share of U.S. tax collections. Alan Auerbach has published a working estimate that they constitute about 10 percent of the revenue from the individual income tax and 4 percent of total federal revenue [8].

The Bush-proposed reduction in rates, to 23.8%, 19.6% and 15.4%, was expected to unlock gains held back by rates as high as 28%. Even if there were a single drop to one of the lower rates, and a consequent unlocking of gains, there is no assurance that total capital gains revenue would rise. It all depends on whether the increased volume of sales of appreciated assets would be sufficient to overcome the lower tax rate. In short, it would depend on the elasticity of revenue in relation to the rate. Substantial discussion of that matter occurred in connection with President Bush's earlier proposals and the result was, at best, inconclusive, as Bogart and Gentry, quoted above, have suggested.

The important point is that the plan would create its own lock-in, an inducement to hold on for three years. The immediate revenue effect could well be negative. When the plan has been in operation for at least three years we could have --but cannot be sure of--a sort of steady state in which the locking and unlocking effects would counteract each other, with such net unlocking effect as an overall reduction from the 28% rate might have. Forecasting each year's revenue would have to be a formidable task. The five-year targeted holding period that was enacted in 1993 aggravates the complexities because of the length of time involved.

Efficiency Consequences of a Declining Rate Plan

In trying to determine the efficiency effects of a declining capital gains tax cut, it must be emphasized that any resulting increases in other investment income must be considered as well. It has been found by authors Haliassos and Lyon (1993) that "reforms that reduce the capital gains tax rate, offset by increases in the tax rate on other investment income, *reduce* efficiency" [emphasis in the original] [9]. Apart from immediate revenue, what is important is that illiquidity is introduced into the capital market by a declining rate plan, whether three-year or five-year, with consequences for economic efficiency.

Growth Consequences of a Declining Rate Plan

Herbert Stein pointed out in 1992 that President Bush's proposal to cut the capital gains tax was a long-run growth remedy, not a cyclical solution:

"Mr. Bush has never said...that his capital gains tax should wait until we are in a recession and employment is low or that it should be withdrawn if the economy recovers rapidly and we regain full employment.

"The capital gains proposal is a proposal to raise the rate of growth of output per hour of work by increasing the rate of saving or improving its allocation. It is not designed as a job-creating measure, even if the claims for it are valid. It might, if fortuitously adopted at an appropriate stage of the business cycle, have a temporary job-creating effect, although even this is doubtful, since the proposal is usually presented as part of a total budget package, including cuts in expenditures and in the deficit."[10]

Whether the "lock-in" under a three-phase declining rate plan would have induced investment and employment and improved productivity would have been influenced by several considerations. The prospect of ultimately being subject to a tax of 15.4% instead of 28% has to be an inducement to invest: it is like ensuring a higher prospective rate of return on an investment. It does not affect the dollar returns year by year, which would continue to be subject to the regular income tax, but to the prospective pot of gold at the end, when the asset is sold at an expected profit.

Included in any calculation of ultimate outcome must be the possibility of a loss rather than a gain. If there is a capital loss when the investment is liquidated, the tax benefit of the loss is correspondingly reduced by the lower rates because the loss is first offset against gains, saving the tax on those gains; the lower that tax the less the benefit of the loss. The existing offset (up to $3000 a year) against ordinary income is only for a *net* loss after offsetting all capital losses against all capital gains. To the extent that capital investment is induced by the expected annual income rather than an ephemeral pot of gold at the end, the lower tax rates on gain may have very little effect. In other words, in the decision to invest, high probabilities may be attached to the annual income and very low probabilities to the possibility of a gain when the asset, or what is left of it, is ultimately sold.

Authors Hallman and Haubrich (1992) also point out, "Cutting the capital gains tax rate...would increase [the] bias against dividends."[11] The reference is to the fact that the preferential tax treatment of capital gains discourages dividends and encourages retained earnings since the latter will ultimately have to pay only the preferential capital gains tax rather than the higher tax on dividend income. A reduction in the capital gains tax (especially with higher income tax rates) would strengthen this effect.

A Capital Gains Tax Cut Will Take Time to Work

Whatever its merits, no-one should be deluded into thinking that a capital gains tax cut will work wonders overnight. Herbert Stein, as quoted above, has quite rightly cautioned that it is a long-run proposition, not a remedy for cyclical unemployment. This is not to belittle the provision but rather to direct attention to other changes that might have to be relied on to solve the short run problems.

Targeted Capital Gains Tax Reductions

When President Clinton's capital gains plan finally came out, at the end of February 1993, it provided that investors in the business could exclude 50% of the gain on any original-issue small-business stock held for at least five years. It also imposed a "cap" in that the provision was limited to the greater of 10 times the original price of the stock or $1 million. The original proposal of Senator Dale Bumpers (D., Ark), which inspired the Clinton plan, contained no such limitation. Another cap put the ceiling of eligible businesses at $25 million capitalization in debt and equity (compared with $100 million under Sen. Bumpers' legislation).

As an inferior alternative, an owner might wait out the five-year period by leasing the business to others and then enjoying the tax benefit at the end of the five-year period.

During the 1992 election campaign it had become evident that a "targeted" reduction in the capital gains tax was within the prospectus of both major parties, hence was likely to be enacted no matter who won. The target could be investment in a small business or any investment in an "enterprise zone", or both, or only those small businesses located in an enterprise zone or "empowerment zone".

An adviser to Governor Clinton had written during the campaign, "He will provide tax incentives where markets fail: a tax exemption on half of the capital gains from investments in new businesses; and an incremental investment tax credit for firms that increase their rates of investment in plant and equipment".[12] The investment tax credit was later dropped.

Serious doubts have been raised about the effectiveness of a small-business capital-gains tax cut unless the general business environment is favorable. The mere prospect of an iffy capital gain and a reduced tax on that gain at some distant time down the road (and who knows what changes will be made in the meantime) is not likely to be a strong inducement to invest. In the context of a euphoric business environment, however, it may give an added fillip to investment. The capital-gains tax rate was not raised even though the regular income tax rates were raised.

The subject of retroactivity has provoked much discussion after the income tax rate increases were made retroactive to January 1, 1933. For future use, it should be pointed out that retroactivity for any *cuts* in taxation would be essential to prevent a halt in private spending and investment. In the post-election period prior to the State of the Union message it was reported: "The White House said President Clinton plans to include an investment tax credit retroactive to Dec. 3, 1992, in the economic proposal he is to unveil later this month." [13] We were also informed:

"With indications that businesses were delaying equipment purchases so that they would be eligible for a tax credit, Lloyd Bentsen, then chairman of the Senate Finance Committee, and his House counterpart, Dan Rostenkowski, said last month they would make sure any investment tax credit would be retroactive to Dec. 3, 1992."[13] This commitment to retroactivity of benefits back to Dec. 3, 1992 was repeated a few days later. The investment tax credit, though, was dropped along the way.

A Major Reform: Indexing for Inflation

One of the persistent proposals for reform of the capital gains tax is indexing for inflation. Some of the present tax is on gains that merely reflect a general rise in the price level. In a particular case there may be nothing else or even a loss in real terms though a tax is due under the capital-gains tax.

The simplest approach would be to impose the tax only on the gain that has occurred in excess of inflation during the holding period. For instance, if the asset rose in price from $100 to $150 during the holding period, while the general price level rose 20%, the taxable portion of the gain would be only $30. The basis was raised from $100 to $120 and the gain was measured from that number.

A problem arises if the taxable portion of the gain is then subjected to the regular income tax brackets. Some of the latter are themselves indexed for inflation. Would this mean that some capital gains would be doubly indexed for inflation? This could be handled by having a separate calculation for capital gains, with each asset having its own index, depending on the length of the holding period. Moreover, instead of using the conventional cost of living or producer price index, something along the lines of a "wealth price index" (Alchian 1977) should be used as the deflator. (Consideration would also have to be given to the deduction and exemption adjustments at some income levels).

In commenting on President Bush's 1989 plan, Herbert Stein mentioned two problems in 1990. First, he proposed that the inflation adjustment apply only to assets acquired after the inflation adjustment was adopted. His reasoning was, "Since the motive for the change is primarily to increase the incentive to make a certain kind of investment, there is no point in rewarding the investments that already have been made. The adjustment should apply to assets hereafter acquired." [14]

A response might be that an additional aim of the rate reduction was to encourage the immediate unlocking of gains, hence revenue contribution, in old assets that have appreciated in value.

(The later, 1991, Administration proposal primarily stressed the the growth aspects rather than revenue consequences.)

A second comment by Stein in the 1990 article was, "... if we are going to relieve inflationary gains from taxation, what are we going to do about inflationary losses?" He expressed the opinion that there should be a tax credit for an inflationary loss, i.e. a loss in real value at the time of redemption [or, perhaps, any market sale before then?]. The "credit" would presumably not be a "credit" against tax liability but more like the present loss offset against gains and, to a limited extent ($3000/yr), against ordinary income. He pointed out that the real burden of the public debt would have correspondingly been reduced to the Treasury. He acknowledged that the nominal interest rate would have been inflated to a level higher than the real rate (e.g., 10% as compared with a 5% real rate) if inflation had been anticipated. As he pointed out, however, the entire income had been subject to annual income tax.

The key is whether the inflation was anticipated. An investor who unexpectedly experiences inflation may not have a built-in cushion to reimburse himself for a rise in the general price level, hence for the decline in real value that he might experience at redemption.

Some lawyers have argued that the President already has the authority to order the Treasury to institute indexing of capital gains, without benefit of Congress. One of these was Charles J. Cooper, formerly an assistant attorney general in the Reagan administration. He has said:

"Unless clearly forbidden by Congress, Treasury can interpret the Tax Code to define cost as adjusted for inflation; that is, it can index capital gains." [15] He has presented a plausible legal case for this position.

On the executive decision he has said:
"...If there are responsible legal arguments on both sides of the issue, shouldn't the lawyers retreat from the field and free the president to make the decision that, in his view, best serves the nation's interests?"[16]

Strong public presssure was put on President Bush to index gains by executive action. In an open letter, about twenty experts said:

"To decrease tax rates on capital and to stimulate investment, we urge you to:

"*1. Direct the secretary of treasury to index capital gains and depreciation for inflation.* For both capital gains and depreciation, the "cost basis" is determined not in legislation but in regulation. The secretary of treasury could cut tax rates on capital simply by defining the cost basis as the original cost adjusted for inflation. This not only would promote economic growth but would end the practice of requiring people to pay taxes on phony gains attributable to inflation."[17]

The Justice Department finally issued an opinion that the President did not have the power to index the capital gains tax by executive action.

Treatment of Cash and Bank Deposits

The question arises: Should not those who "invest" in cash and bank deposits also be protected against inflation? The logic is a little twisted here since the indexing procedure is to avoid taxing investors on what they nominally gained from inflation. Cash does not provide a taxable profit or loss. But why not a "loss offset" to compensate for the real value loss suffered from investing in cash? In 1990 Herbert Stein [18] suggested a loss offset equal to the inflationary loss of purchasing power. For instance, in case of a 5% inflation, a $5 loss offset would be recognized per annum for every $100 of cash or non-interest bearing deposits.

This might be a little hard for revenue-seeking legislators to swallow. A person who chooses cash rather than an earning asset is going for the various advantages of cash (such as liquidity and the chance to time an earning investment). Should the Treasury bear part of the cost of this decision?

A more serious consideration, though, is this: If everyone is protected against inflation, who will fight it? With no-one left to fight inflation, what would prevent a runaway inflation? The Federal Reserve can pursue its goal of price stability only because it has a large supporting constituency in that objective. Tax indexing penalizes the government for inflationary policies and simultaneously weakens the public's opposition to such policies.

A Radical Reform: Taxing Accruals Rather than Sales

The holding period and indexing problems are not the only matters that warrant attention. The declining- rate proposals and the indexing of the capital gains tax for inflation may appear to be sufficiently radical reforms of the capital gains tax. Yet there is another even more radical change that has been proposed.

By way of background, we may refer to a review by the I. M. F. in which the treatment of capital gains in the American tax system is summarized as follows:

"...although the 1986 Tax reform Act raised the tax rate on capital gains to that levied on ordinary income [later kept at a 28% limit despite other rate increases], capital gains still receive preferential tax treatment because (1) only capital gains actually realized (as opposed to those accrued) are taxed, (2) capital gains on inherited assets are not taxed [but the full market value at death is subject to estate tax]; and (3) the effective tax rate on capital gains from owner-occupied housing is close to zero."[19]

The first two of these points are dealt with here. The third point (alluding to the taxability of home capital gains, though with various deferrals and deductions) reflects a strong public policy in favor of private home ownership and is generally not a subject of controversy except in the related areas of whether imputed rent on home ownership should be taxed or at least considered in calculating the tax burden.

The first two points could be remedied by the conversion of the tax to an "accrual" basis. By accrual in this context is meant that the tax is computed each year on the gain that occurred that year, though no sale has occurred. It would be paid that year at the time of that year's taxes or on realization (in which case it is paid with interest). In some years there may be a net loss which would be used as an offset, depending on any limitation that may be imposed.

The main difference from the prevailing law is that at present the tax is due only when realization occurs and only on the gain between the beginning and the end of the holding period as a whole. No interest is now charged for the holding period.

Since the tax is paid only on sale or realization, there is currently a tax inducement to postpone realization:

the investor has the use of the tax money until realization even if the aim is not to hold until death. There is an inducement to pick a time for realization for tax reasons (whenever the effective tax is expected to be lowest) rather than for economic reasons. These tax considerations must have a welfare cost by distorting the optimal timing decision somewhat.

To tax a gain when it occurs or accrues rather than on sale or realization would impose formidable costs of compliance and enforcement because of the problem of valuation of an unsold asset; and it would impose problems of liquidity, to pay tax on an unsold asset. Vickrey's plan [e.g., 1947, 1992] would leave the tax payable on realization but would take account of the accruals during each year of the entire holding period, not just at the end. Auerbach [1991, 1992] has proposed a modification that would avoid the knotty problem of annual appraisal.

An accrual system would ideally avoid a lock-in by making the tax the same whenever the asset is sold: there would be no incentive to hold the asset longer merely to postpone the day when the tax money has to be handed to the Treasury. The idea is to make the tax burden the same for a given inherent gain whenever the asset is sold.

In summary, an accrual system could involve (1) an annual tax obligation on the basis of the net growth in value that occurred during the year and payment on realization based on the accumulated obligations, accrued at interest; or (2) the same idea except that hypothetical figures are used for the annual valuations, where the risk-free interest rate and the assumption of "portfolio optimization" [20] are used to estimate annual valuation.

Treatment of Capital Gains at Death

The exemption from capital gains tax at death remains as a factor to consider in any comprehensive tax change: The exemption provides the ultimate incentive for a lock-in.

A balancing of competing objectives is involved here. On the one hand, there is the perceived need to avoid a lock-in, with its consequences for revenue and for the optimal allocation of resources for growth. On the other, is the burden of searching for old records and the knowledge that some tax may be imposed on the estate anyway. The problem of records was partly responsible for the fate that befell the short-lived taxation of capital gains at death in the 70's. [See Pechman 1977]. The exemption leads to an inequity compared with living sales, especially sales just before death; and as for the estate tax, the exemptions and deductions might mean that in many cases the capital gain meets no tax at all [Somers 1966].

The exemption of capital gains at death remains as the ultimate lock-in. Alan Reynolds has pointed out that if we tax capital gains at death we would have to repeal the estate tax; otherwise people will lose their family businesses and farms [21]. Certainly some integration of the two taxes would have to be achieved. The exemption causes a lock-in but the estate tax alone does not, since death is (generally) not a matter of selection or voluntary choice. The preferred policy would then appear to be in favor of eliminating the exemption, with the problem of excessive burden to be worked out in the estate tax.

Problems to be Solved

If the capital gains tax is to be overhauled, these are the changes that call for attention: (1) institution of an accrual system that removes the tax as a factor influencing the timing of the sale of an asset; (2) indexing the tax for inflation in a manner that does not discriminate for or against other types of income; and (3) some method of eliminating the ultimate source of lock-in, the exemption at death, such as a full credit against any estate taxes.

Conclusions

The new provision that cuts the capital gains tax rate in half in targeted cases would tend to both lock and unlock gains. The reduction in rates would tend to unlock gains after five years that might not have been realized because of the old tax rates; yet a tax schedule that reduces rates drastically after a holding period of five years' duration would tend to induce a five-year holding. To what end? Why do we want any tax-induced lock-in of the financial investment at all? It is hard to develop a reasonable economic rationale for such a policy.

The aim is presumably to induce a real investment in plant, equipment and jobs. There is no point in wasting any incentives on holding onto the pieces of paper that signify ownership. Who cares how many times some of the pieces of paper change hands after the real enterprise--the purchase of plant and equipment and the hiring of employees--is well underway? Only in case of a complete takeover and restructuring (which happened often enough even under the more conventional capital-gains structure) is employment likely to be jeopardized. Merely changing the ownership of equity paper does not imply loss of jobs. Incentives without holding period, such as the Investment Tax Credit, could also be used.

Apart from the new small-business provision, there is still a one-year lock-in for the 28% rate. A shorter net holding would be subject to the regular income tax rates that could go as high as 36% or 39.6% or even more for some income ranges under prevailing provisions dealing with deductions and exemptions.

The targeted requirement that investors wait for five years before getting the reduced rate introduces a new lock-in. It will encourage the postponement of realization, hence will discourage an owner of the company's securities from selling to another prospective owner. This lock-in, in itself, has no economic rationale. Worse, the inherent impairment of liquidity might discourage the investment in the first place. To what end? In what way is this good for the economy? It discourages the free flow of capital to its highest and best use. If the original investors sell out in a year or two, the new buyers can still continue the business and even improve and expand it. If the business is profitable and capital gain is generated, the Treasury may be getting some of the capital-gain revenue in the early years rather than waiting for five years.

From this point of view, it would be far better to go immediately to a 14% rate after one year than to delay it for five years. This would reduce the prevailing lock-in without introducing a new one. The increased liquidity would also be an attraction to prospective risk-takers. It would increase the inducement to make the financial investment in the first place without jeopardizing the durability of the real investment in plant, equipment and employment. Though the short-run revenue effect is yet to be determined, the change would surely encourage growth and long-run revenue.

This conclusion merely says that a cut to 14% without an extended holding period would be welfare-preferable to the the five-year requirement: The holding period in itself is welfare-negative, plain and simple. Whether any capital gains tax is inferior to an equal-revenue alternative, such as a dividend or general income tax, is a separate and more speculative matter.

Endnotes

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