

Putting Capital Back to Work for America

By:

Gary & Aldona Robbins
Senior Research Analysts,
TaxAction Analysis

Inside:

Executive Summary	2
Recent Economic Spurt Belies Lackluster Recovery	3
Higher Capital Gains Tax Rates Since 1986	6
Economic and Revenue Effects from Capital Gains Tax Reform	7
Nine Proposals for Capital Gains Tax Reform	8
Ranking the Proposals	18
Appendix A: Treatment of Capital Gains by Major Trading Partners	21
Appendix B: Comparison Tables	23
Appendix C: Methodology	33

Executive Summary

What could be better than news that the economy grew at a 5.9 percent rate in the fourth quarter of 1993? Revised estimates that the growth rate was really 7.0 percent. If every silver lining has a cloud, the bad news is that economic growth, investment, and job creation are only half to two-thirds that experienced in the typical post-WWII recovery. More troubling is the 2.6 percent growth reported for first quarter 1994. In fact, three years after the recession ended in March of 1991:

- The U.S. economy has averaged only 2.4 percent real growth, half the average 5 percent growth experienced at a similar point in other recoveries.
- Employment growth has also been subpar, increasing by only 3 percent, compared with 9 percent for the average recovery.
- Real fixed investment net of depreciation did not take off in March 1991 as it has during other recoveries, and continues to lag historical rates.

One reason the economy is growing more slowly than in other recoveries is that capital gains are taxed at much higher than historical rates, and at rates much higher than those of our trading partners. Ironically, while the Tax Reform Act of 1986 raised capital gains taxes in an effort to increase revenues, capital gains tax receipts have declined every year since 1988.

An estimated \$6 to \$7 trillion in accrued, unrealized capital gains has accumulated since the 1986 tax rate increases. A lower capital gains tax rate would encourage investors to realize some of this appreciation, thus unlocking assets and triggering additional investment and increased capital gains tax revenues.

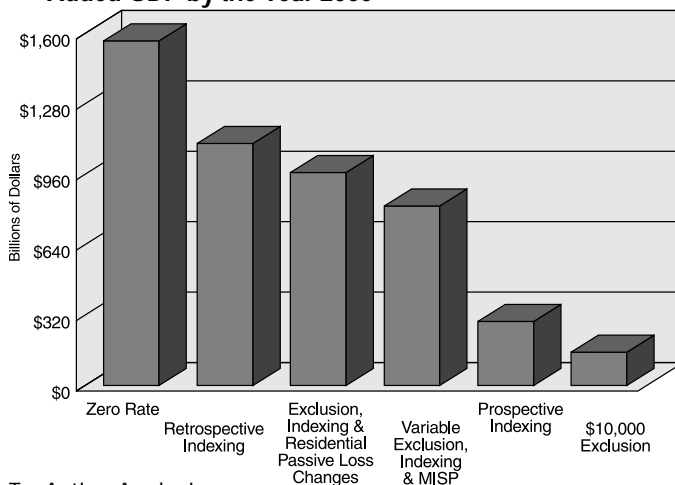
Capital gains taxes don't affect only the wealthy. IRS data shows that 55 percent of taxpayers who report long term capital gains earn \$50,000 per year or less. And 75 percent of taxpayers with long term capital gains earn \$75,000 per year or less.

Because of its potential to spur economic growth and increase federal revenues, capital gains tax relief is the subject of considerable interest on Capitol Hill. In response to requests from seven members of Congress, TaxAction Analysis examined nine capital gains tax reform proposals. To varying degrees, all would lower the tax on capital and promote investment, job creation and economic growth. Most would also significantly increase government revenues.

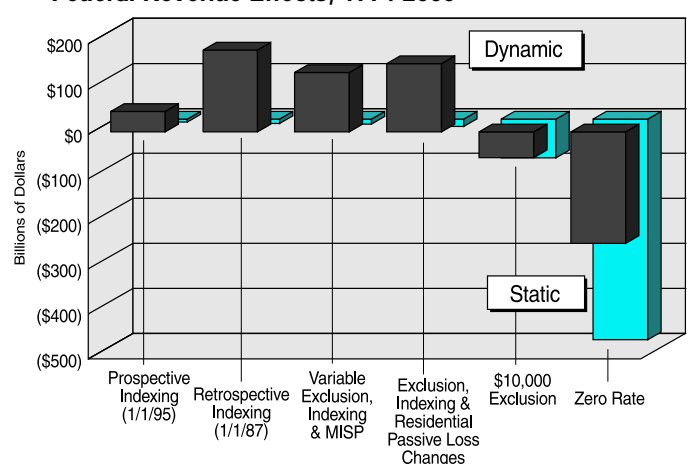
Economic growth, investment, and job creation are only half to two-thirds that experienced in the typical post-World War II economic recovery.

An estimated \$6 to \$7 trillion in accrued, unrealized capital gains has accumulated since the 1986 tax rate increases.

Added GDP by the Year 2000



Federal Revenue Effects, 1994-2000



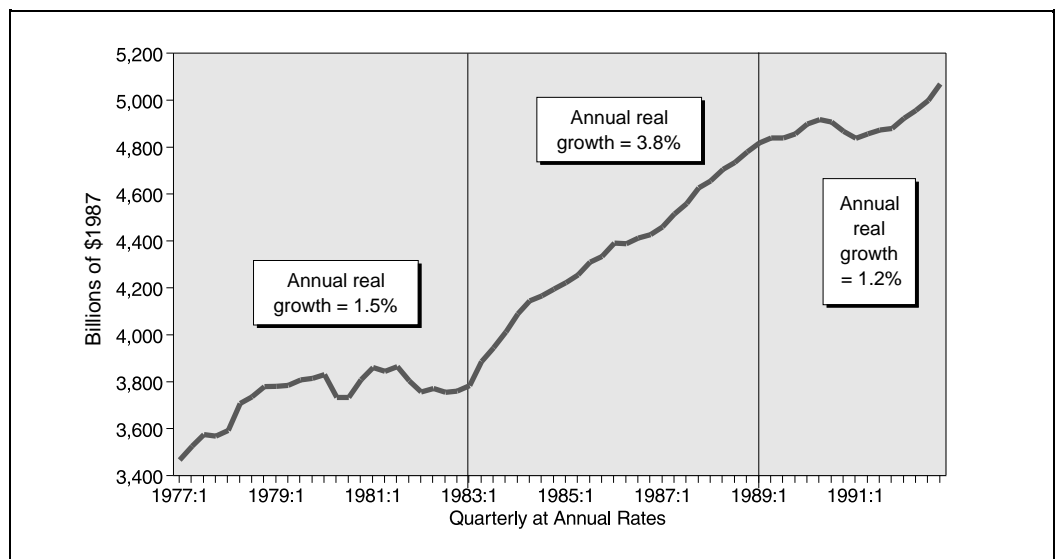
Putting Capital Back to Work for America

Recent Economic Spurt Belies Lackluster Recovery

What could be better than news that the economy grew at a 5.9 percent rate in the fourth quarter of 1993? How about revised estimates that the growth was in fact 7.0 percent! If every silver lining has a cloud, the bad news is that economic growth, investment, and job creation are only half to two-thirds that experienced in the typical post-World War II economic recovery. Even more troubling is news that economic growth fell to 2.6 percent in the first quarter of 1994.

More than three full years after the recession officially ended in March 1991, the U.S. economy has averaged only a lackluster 2.4 percent real growth. This is considerably lower than the average 5 percent growth experienced at a similar point in other economic recoveries, and much less than the strong 3.8 percent average growth posted during the seven years following the 1981-1982 recession (Figure 1).

Figure 1
Growth in GDP:
1977 - 1991



Economic growth in the ten quarters following the trough of the recession has been far below par (see Figure 2). Only recovery from the 1980 recession fared worse—and that was because the economy turned down again in November 1981.

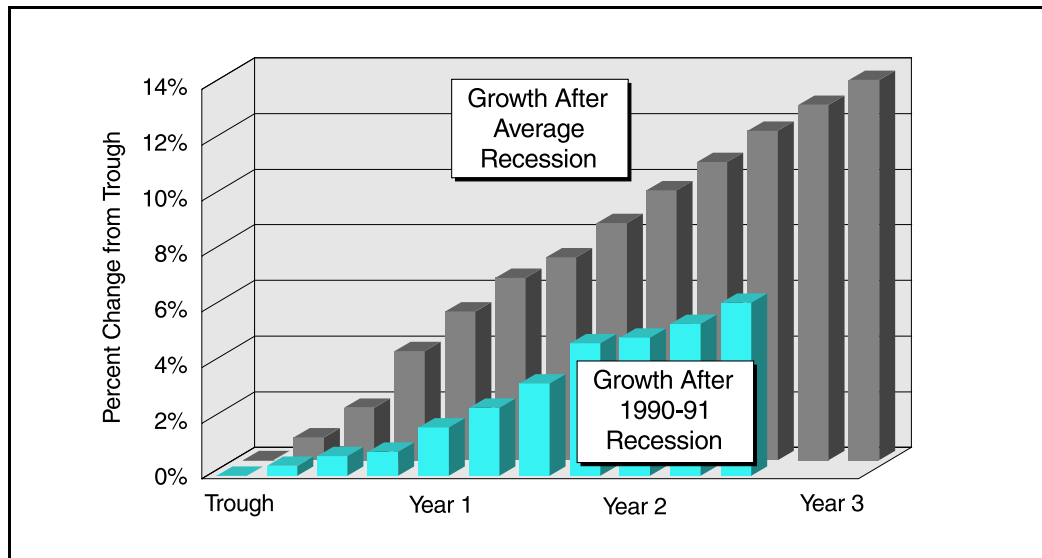


Figure 2
Real GDP After Recession Trough: 1991 vs. Average Recovery

Real GDP has increased by only 5.8 percent since the trough of the last recession—roughly half the progress made in other recoveries (see Figure 3).

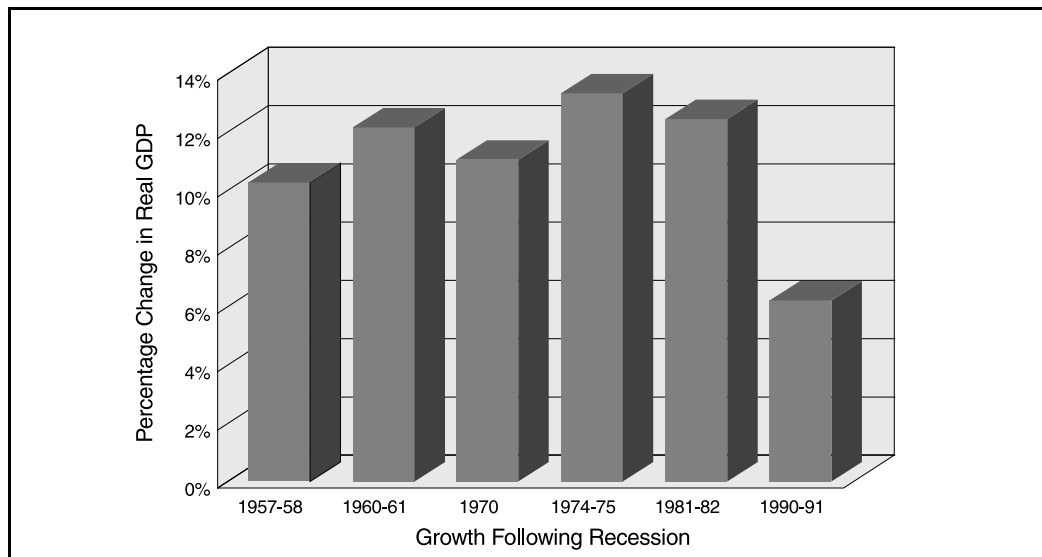


Figure 3
Increase in Real GDP Ten Quarters from Recession Trough

Lagging investment is a major reason for anemic GDP growth. Real fixed investment net of depreciation did not take off in March 1991 as it has during other recoveries. For 18 months following the trough, investment activity continued to sputter (see Figure 4). While now on an upward trend, new investment still lags behind previous recoveries.

Recovery in employment also has been subpar. By historical standards, at this stage of a recovery employment growth levels should be 10 percent higher or more. But since March 1991, employment growth has increased by only 3 percent (see Figure 5). Even if the economy adds the two million jobs a year that President Clinton has promised, job creation will amount to only two-thirds of the three million new jobs averaged annually during the 1980s.

Figure 4

Investment After
Recession Trough:
Real Investment Net of
Depreciation
(Percent Change)

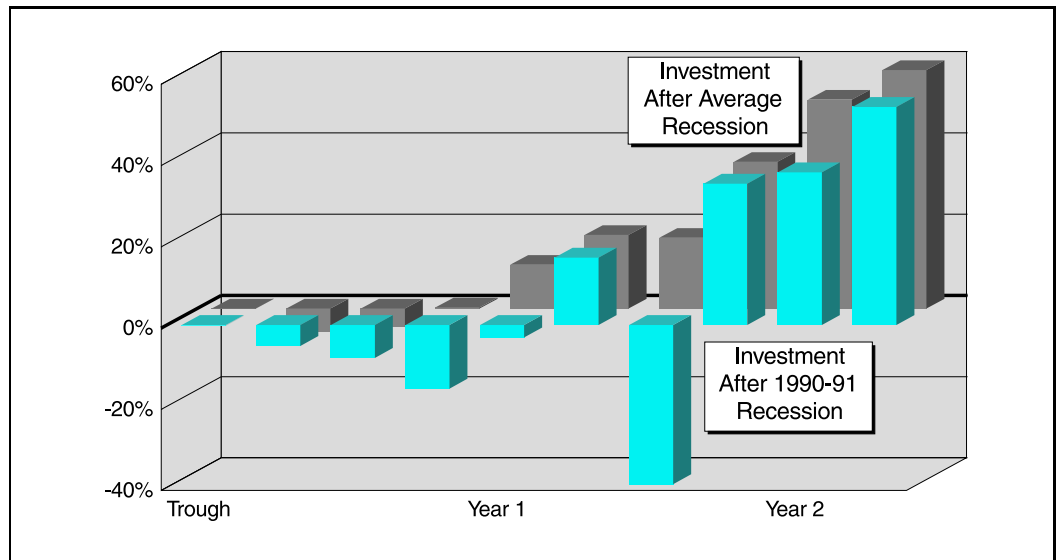
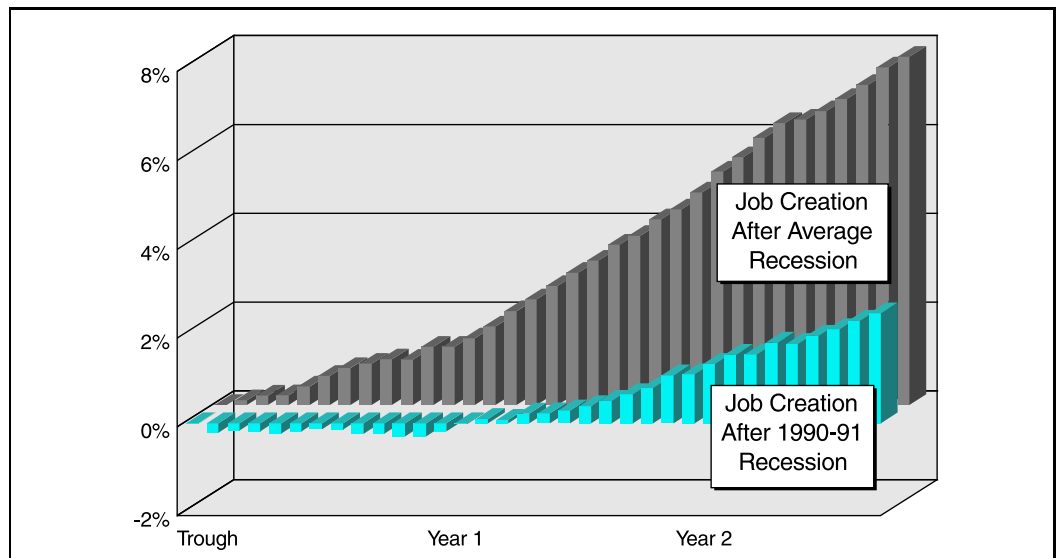


Figure 5

Job Creation After
Recession Trough
(Percent Change)



Capital Gains: A Tax on a Tax

*55 percent of
taxpayers who
report long term
capital gains earn
\$50,000 per year
or less.*

The capital gains tax is a redundant tax. Asset prices are based upon the future income that the asset will earn. That income is already subject to taxation at the corporate and individual levels. Furthermore, capital gains taxes account for about 10 percent of the total tax on capital and add almost that much to the cost of capital.

Much of the price appreciation in long-term capital assets is due to inflation. According to the Treasury Department (*Capital Gains Tax Reductions of 1978*, Office of Tax Analysis, September 1985), inflation accounted for more than 100 percent of the capital gains from corporate stock reported in 1977 and 74 percent of gains from non-business real estate. The current tax system allows no adjustment for asset appreciation due to inflation.

Capital gains taxes don't affect only the wealthy. IRS data (*Statistics of Income-1990*, Internal Revenue Service, Dec. 1993, p. 26) shows that 55 percent of taxpayers who report long term capital gains earn \$50,000 per year or less. And 75 percent of taxpayers with long term capital gains earn \$75,000 per year or less.

Higher Capital Gains Tax Rates since 1986

The Tax Reform Act of 1986 eliminated the 60 percent exclusion for capital gains, effectively raising the maximum tax rate on capital gains income from 20 percent to 28 percent. This change was supposed to help raise revenue to pay for the individual and corporate tax rate reductions. As a revenue raiser, however, it has failed miserably. Despite rosy forecasts by CBO and Treasury (see Figure 6), *instead of raising new federal revenue, capital gains receipts have been declining since 1988*. Capital gains realizations in 1991—the latest year for which complete data is available—were less than they were almost a decade ago when the economy was about half the size it is today (Figure 7).

Almost from the time the capital gains exclusion was eliminated, there have been several attempts to reduce capital gains taxes. In 1989, a bill introduced by Representatives Ed Jenkins (D-GA) and Bill Archer (R-TX) passed the House but failed in the Senate. It would have reduced the capital gains tax rate to 19.6 percent immediately and then introduced inflation indexing for capital gains. After Jenkins-Archer failed, the Bush administration continued to press for lower capital gains tax rates, but was unable to muster sufficient Congressional support. During his campaign, President Clinton supported some proposals for capital gains tax relief, but no major legislation has yet been offered.

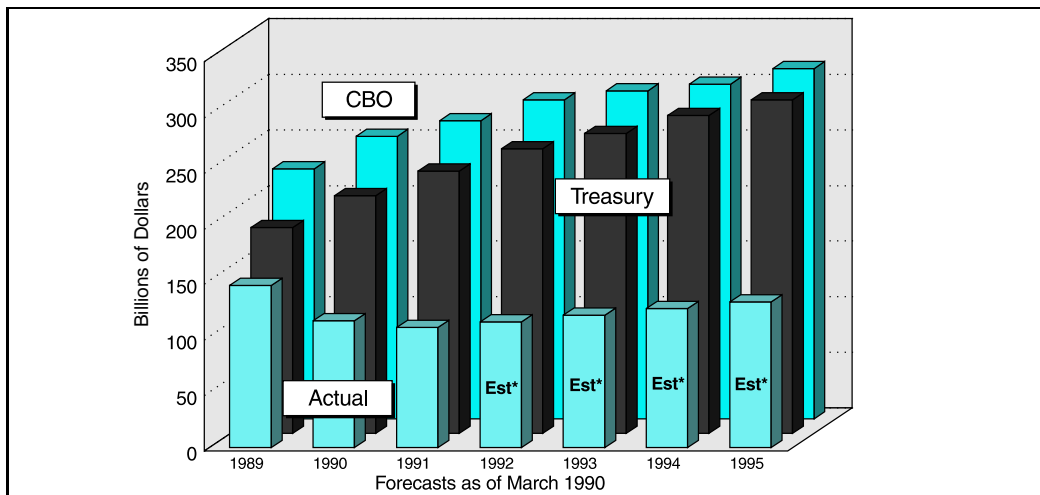


Figure 6
Capital Gains Realizations: Actual Versus Predicted

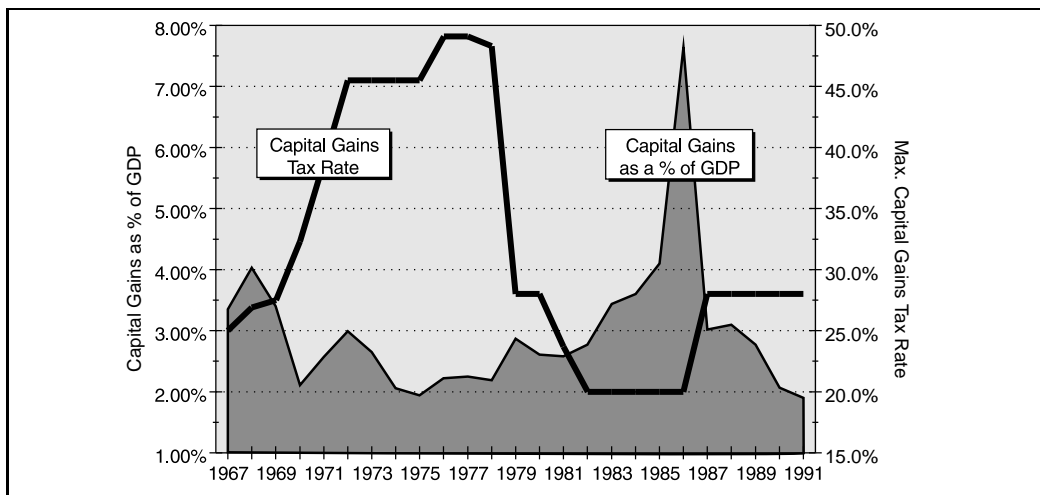


Figure 7
Capital Gains Tax Rates & Realizations as a Percentage of GDP: 1967 to 1991

Economic and Revenue Effects from Capital Gains Tax Reform

Lowering capital gains taxes would have beneficial economic and revenue effects. An estimated \$6 to \$7 trillion in accrued, unrealized capital gains has accumulated since the 1986 tax rate increases. A lower tax rate would encourage investors to realize some of this appreciation, thus unlocking assets and triggering higher capital gains tax revenues.

The combination of economic growth and new revenues would seem to be too good for Washington to refuse.

Because of its potential to stimulate growth and increase government revenues, capital gains tax relief is the subject of considerable interest on Capitol Hill. In response to requests from seven Congressmen—Representatives Bill Archer (R-TX), David Dreier (R-CA), John Kasich (R-OH), Lamar Smith (R-TX), Bill Tauzin (D-LA), and Senators Connie Mack (R-FL) and Richard Shelby (D-AL)—TaxAction Analysis examined nine capital gains tax reform proposals. In varying degrees, all would lower the tax on capital and promote investment, job creation, and economic growth. Most would also significantly increase government revenues. The combination of economic growth and new revenues would seem to be too good for Washington to refuse.

TaxAction Analysis examined the following proposals for capital gains tax relief:

- A) A zero capital gains tax rate;
- B) Retrospective indexing of capital gains for inflation;
- C) A maximum 15 percent capital gains tax rate;
- D) A maximum 15 percent capital gains tax rate with retrospective indexing for inflation;
- E) A 50% exclusion, indexing, and residential passive loss deduction;
- F) A variable capital gains exclusion, indexing capital gains for inflation, and a Middle Income Savings Plan (MISP);
- G) Prospective indexing of capital gains for inflation;
- H) An annual \$10,000 capital gains exclusion; and
- I) The exclusion of capital gains from the sale of a primary residence.

The following summarizes the economic and revenue estimates for each of the nine capital gains proposals studied. Economic effects include the change in the cost of capital, output, jobs, capital formation and growth. Static revenue estimates, which assume that the tax base will remain unchanged regardless of changes in policy, are compared with dynamic estimates, which account for changes in economic behavior caused by changes in tax policy. Six of the proposals are ranked and graphically compared beginning on page 18. Appendix B contains tables showing economic and revenue estimates for calendar years 1994 through 2000 beginning on page 23.

Appendix A (page 21) compares the tax treatment of capital gains by several of our major trading partners, and Appendix C (page 33) summarizes the methodology of this study.

A) Zero Capital Gains Tax Rate

This proposal would eliminate personal income taxes on capital gains. It would reduce the economy-wide marginal tax rate on capital by 7.9 percent and lower the cost of capital by 6.4 percent. By the year 2000:

- Higher investment would lead to an additional \$3.2 trillion in capital formation.
- A larger capital stock would mean over 1.1 million additional jobs.
- More capital and labor would yield an extra \$1.6 trillion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$391 billion higher than otherwise.
- This greater economic activity would add 0.43 percentage points to the long-term annual growth rate.

A larger capital stock would mean over 1.1 million additional jobs.

The federal static revenue loss would be substantial. An annual loss of \$60 billion in 1994 would increase to almost \$81 billion by the year 2000. However, additional income, payroll and excise tax revenues from added economic growth would offset a considerable portion of these static losses:

- In the year 2000, the federal government would raise \$61.6 billion in new revenue, offsetting 76 percent of the annual static loss.
- New revenue would offset almost half the cumulative \$490 billion static revenue loss between 1994 and 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$25 billion a year by the end of the decade.

Figure 8
Federal Revenue Effects

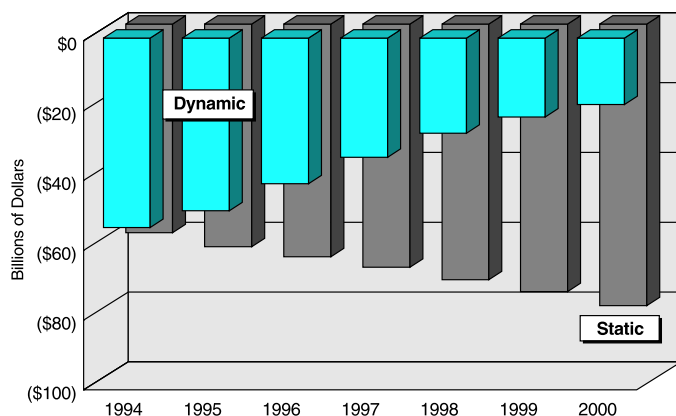
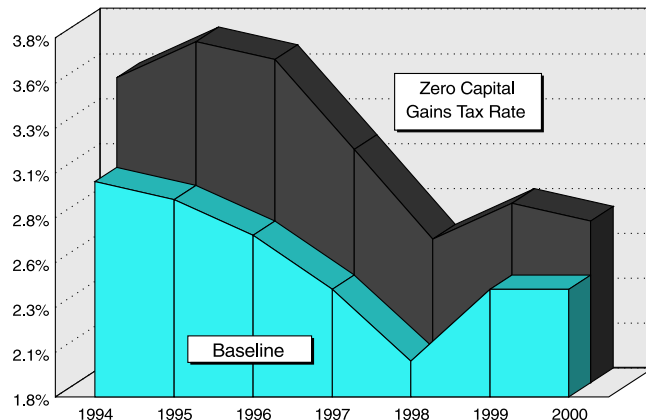


Figure 9
Added Real GDP Growth



B) Retrospective Indexing of Capital Gains

The capital gains tax applies to the difference between an asset's sales price and its original purchase price (or basis). This proposal would index the basis value for inflation from the later of January 1, 1987 or the date of purchase.

In the long-run, indexing would be, on average, equivalent to an 80 percent exclusion of nominal (unadjusted) capital gains. This would reduce the economy-wide marginal tax rate on capital by 6 percent and lower the cost of capital by 5 percent. By the year 2000:

More capital and labor would yield an extra \$1.1 trillion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$286 billion higher than otherwise.

- Higher investment would lead to an additional \$2.3 trillion in capital formation.
- A larger capital stock would mean 803,000 additional jobs.
- More capital and labor would yield an extra \$1.1 trillion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$286 billion higher than otherwise.
- This greater economic activity would add 0.31 percentage points to the long-term annual growth rate.

The federal static revenue loss would be small. Realizations from unlocking would increase capital gains tax revenues by \$18.4 billion over the first two years. The annual static loss would be \$12.4 billion by the year 2000. Additional income, payroll and excise tax revenues from added economic growth, however, would lead to a considerable net gain for the federal government:

- In the year 2000, the federal government would raise \$48.7 billion in new revenue, netting \$36.2 billion above the annual static loss.
- Because of higher growth the federal government would net an additional \$181.2 billion in revenue between 1994 and 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$70 billion more a year by the end of the decade and \$313.6 billion more over the period 1994 and 2000.

Figure 10
Federal Revenue Effects

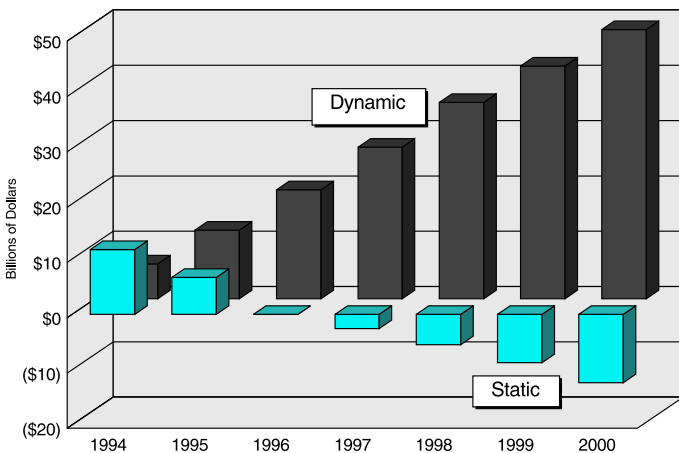
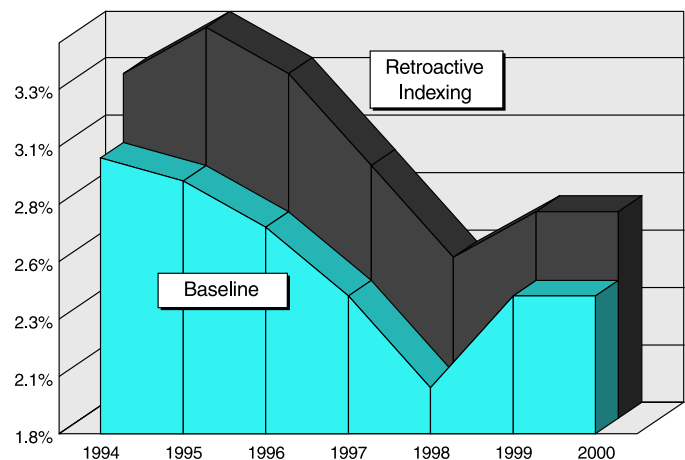


Figure 11
Added Real GDP Growth



C) Maximum 15% Capital Gains Tax Rate

This proposal would lower the maximum tax rate on capital gains from 28 percent to 15 percent, which would reduce the economy-wide marginal tax rate on capital by 3.8 percent and lower the cost of capital by 3.2 percent. By the year 2000:

- Higher investment would lead to an additional \$1.5 trillion in capital formation.
- A larger capital stock would mean 531,000 additional jobs.
- More capital and labor would yield an extra \$752.3 billion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$189 billion higher than otherwise.
- This greater economic activity would add 0.21 percentage points to the long-term annual growth rate.

The federal static revenue loss would be minimal. Realizations from unlocking would increase capital gains tax revenues by \$12.8 billion over the first two years. The annual static loss would be \$7.6 billion by the year 2000. Additional income, payroll and excise tax revenues from added economic growth, however, would lead to a considerable net gain for the federal government:

- In the year 2000, the federal government would raise \$32.3 billion in new revenue, netting \$24.8 billion above the annual static loss.
- Because of higher growth the federal government would net an additional \$126.4 billion in revenue between 1994 and 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$47.2 billion more a year by the end of the decade and \$216.9 billion more over the period 1994 and 2000.

In the year 2000, the federal government would raise \$32.3 billion in new revenue, netting \$24.8 billion above the annual static loss.

Figure 12
Federal Revenue Effects

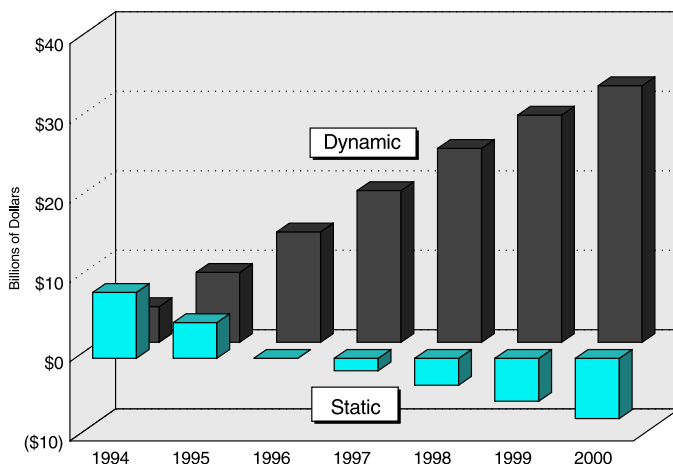
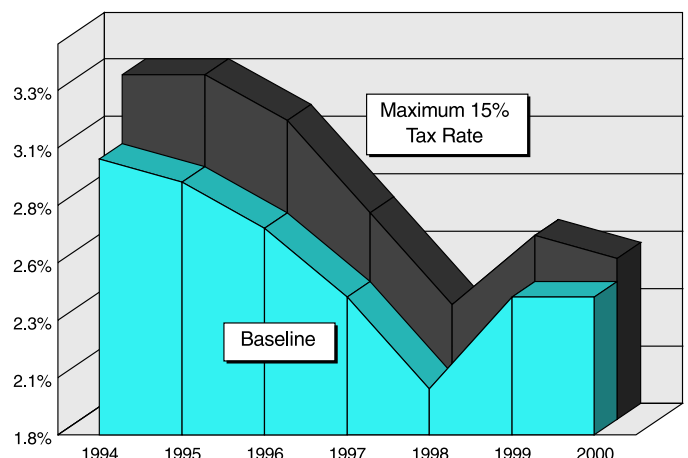


Figure 13
Added Real GDP Growth



D) Maximum 15% Capital Gains Tax Rate Coupled with Retrospective Indexing

This proposal combines inflation indexing with a 15 percent maximum rate. It would reduce the economy-wide marginal tax rate on capital by 6.8 percent and lower the cost of capital by 5.6 percent. By the year 2000:

- Higher investment would lead to an additional \$2.7 trillion in capital formation.
- A larger capital stock would mean 907,000 additional jobs.
- More capital and labor would yield an extra \$1.3 trillion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$326 billion higher than otherwise.
- This greater economic activity would add 0.36 percentage points to the long-term annual growth rate.

Because of higher growth the federal government would net an additional \$211.5 billion in revenue between 1994 and 2000.

The federal static revenue loss would be small. Realizations from unlocking would increase capital gains tax revenues by \$22.6 billion over the first two years. The annual static loss would be \$14.2 billion by the year 2000. Additional income, payroll and excise tax revenues from added economic growth, however, would lead to a considerable net gain for the federal government:

- In the year 2000, the federal government would raise \$55.2 billion in new revenue, netting \$40.9 billion above the annual static loss.
- Because of higher growth the federal government would net an additional \$211.5 billion in revenue between 1994 and 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$79.4 billion more a year by the end of the decade and \$365.2 billion more over the period 1994 and 2000.

Figure 14
Federal Revenue Effects

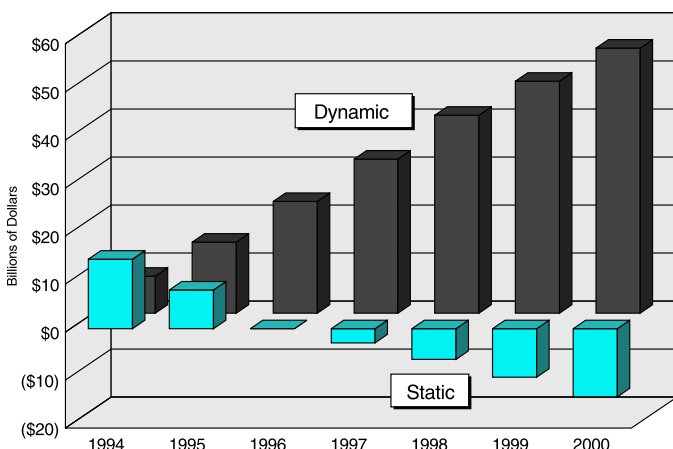
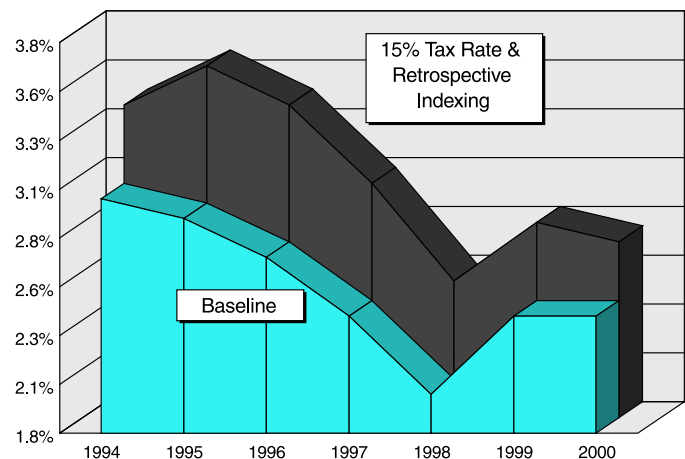


Figure 15
Added Real GDP Growth



E) 50% Exclusion, Indexing, and Residential Passive Loss Deduction

Representative Bill Archer (R-TX) recently introduced legislation (H.R. 3739) that offers a 50 percent capital gains exclusion, indexing capital gains for inflation, and a deduction for capital loss on sale of a principal residence. Archer's bill would reduce the economy-wide marginal tax rate on capital by 6 percent and lower the cost of capital by 5 percent. By the year 2000:

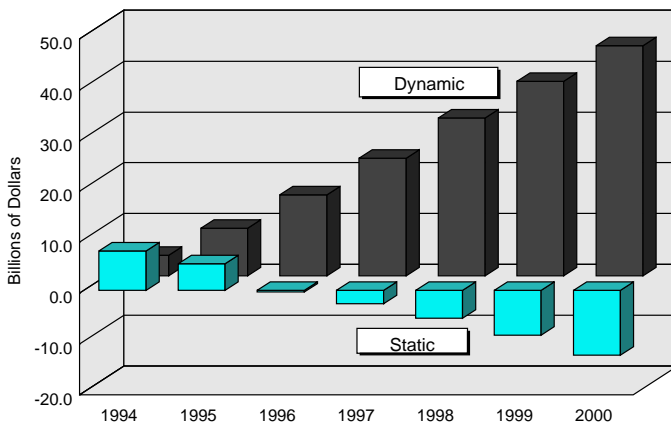
- Higher investment would increase capital formation in the U.S. by \$2.2 trillion.
- This larger stock of U.S. capital would lead to 721,000 additional jobs.
- More capital and labor would yield an extra \$969 billion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$268 billion higher than otherwise.
- This greater economic activity would boost the long-term annual growth rate by 0.29 percentage points.

The federal static revenue loss would be small. Realizations from unlocking would increase capital gains tax revenues by \$13.1 billion over the first two years. The annual static loss would be \$12.7 billion by the year 2000. Additional income, payroll and excise tax revenues from added economic growth, however, would lead to a sizable net gain for the federal government:

- Ignoring economic effects, the proposal would lose \$16.7 billion in capital gains tax revenues between 1994 and 2000. This estimate does allow for substantial unlocking effects.
- However, federal payroll, corporate, personal income, and excise taxes would be \$167.4 billion higher than otherwise due to greater economic activity generated by the proposal.
- As a result, the net effect on federal revenues would be a gain of \$150.7 billion over 1994 to 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$266.5 billion before the end of the decade.

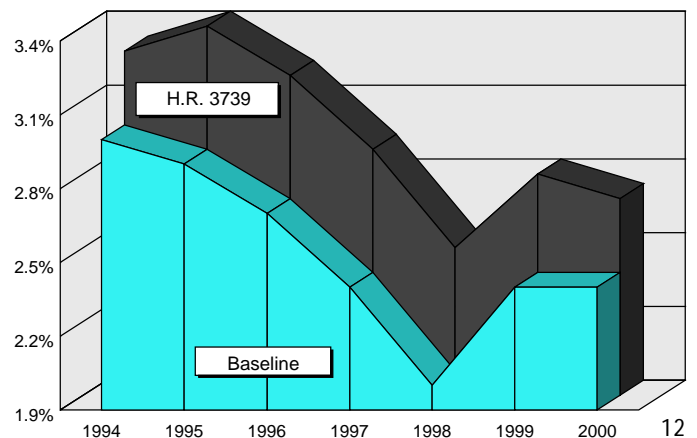
By the year 2000, annual GDP would be \$268 billion higher than otherwise.

Figure 16
Federal Revenue Effects



TaxAction Analysis

Figure 17
Added Real GDP Growth



F) Variable Exclusion, Indexing, and Middle Income Savings Plan (MISP)

Representative Lamar Smith (R-TX) has proposed a tax reduction package that includes a variable capital gains exclusion, indexing capital gains for inflation, and a Middle Income Savings Plan (MISP).

A variable capital gains exclusion would be phased in over three years. In the first year, individuals would exclude 60 percent of capital gains for assets held longer than one year. In the second year, a 60 percent exclusion would apply to assets held longer than two years and a 40 percent exclusion would apply to assets held between one and two years. In the third year and thereafter, a 60 percent exclusion would apply to assets held longer than three years, a 40 percent exclusion would apply to assets held between two and three years and a 20 percent exclusion would apply to assets held between one and two years.

The Middle Income Savings Plan stipulates that beginning on January 1, 1994, individuals with adjusted gross incomes (AGI) under \$40,000 could exclude up to \$500 in savings income. Couples could exclude up to \$1,000. The exemption would phase out between \$40,000 and \$50,000 in AGI.

The proposal would reduce the economy-wide marginal tax rate on capital by 4.2 percent and lower the cost of capital by 2.4 percent. By the year 2000:

- Higher investment would increase capital formation in the U.S. by \$1.7 trillion.
- This larger stock of U.S. capital would lead to 576,000 additional jobs.
- More capital and labor would yield an extra \$816 billion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$212 billion higher than otherwise.
- This greater economic activity would boost the long-term annual growth rate by 0.23 percentage points.

The net effect on federal revenues would be a gain of \$131.6 billion over 1994 to 2000.

Figure 18
Federal Revenue Effects

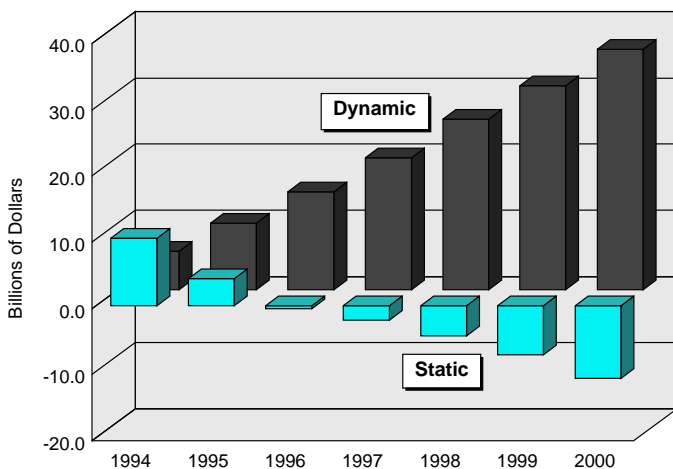
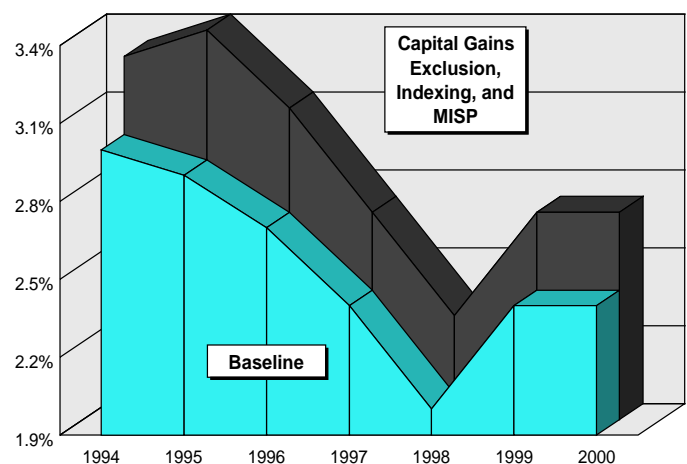


Figure 19
Added Real GDP Growth



The federal revenue loss would be small. Realizations from unlocking would increase capital gains tax revenues by \$14.3 billion over the first two years. The annual static loss would be \$11 billion by the year 2000. Additional income, payroll and excise tax revenues from added economic growth, however, would lead to a sizable net gain for the federal government:

- Ignoring economic effects, the capital gains exemption, indexing and MISP would lose \$11.5 billion in capital gains tax revenues between 1994 and 2000. This estimate does allow for substantial unlocking effects.
- However, federal payroll, corporate and personal income, and excise taxes would be \$143.2 billion higher than otherwise due to greater economic activity generated by the proposal.
- As a result, the net effect on federal revenues would be a gain of \$131.6 billion over 1994 to 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$230 billion between now and the end of the decade.

*Higher investment
would increase
capital formation
in the U.S. by
\$1.7 trillion.*

G) Prospective Indexing of Capital Gains for Inflation

The net effect on federal revenues would be a gain of \$44.8 billion over 1994 to 2000.

Rep. John Kasich has proposed that capital gains from the sale of individual or corporate assets after December 31, 1994, would be adjusted for inflation. Prospective indexing would reduce the economy-wide marginal tax rate on capital by 3.8 percent and lower the cost of capital by 3.2 percent. By the year 2000:

- Higher investment would increase capital formation in the U.S. by \$995 billion.
- This larger stock of U.S. capital would lead to 260,000 additional jobs.
- More capital and labor would yield an extra \$292 billion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$118 billion higher than otherwise.
- This greater economic activity would boost the long-term annual growth rate by 0.13 percentage points.

The federal static revenue loss would be minimal. The annual static loss would be \$5.7 billion by the year 2000. Additional income, payroll and excise tax revenues from added economic growth, however, would lead to a considerable net gain for the federal government:

- Ignoring economic effects, indexing would lose \$7.3 billion in capital gains tax revenues between 1994 and 2000.
- However, federal payroll, corporate, personal income, and excise taxes would be \$52 billion higher than otherwise due to greater economic activity.
- As a result, the net effect on federal revenues would be a gain of \$44.8 billion over 1994 to 2000.
- Including higher state and local revenues from added growth means government at all levels would net \$80.3 billion between now and the end of the decade.

Figure 20
Federal Revenue Effects

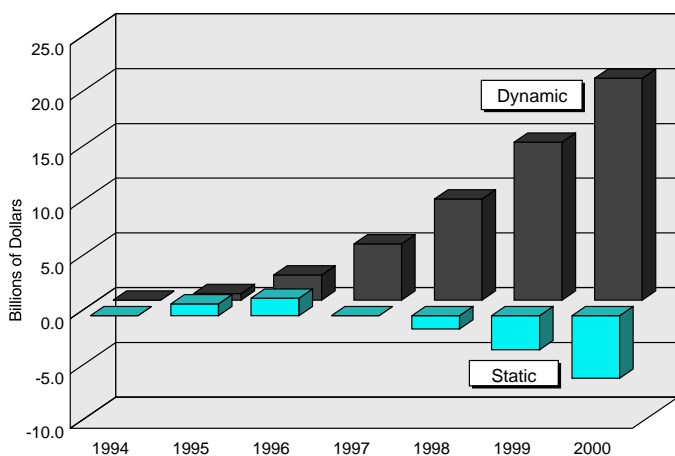
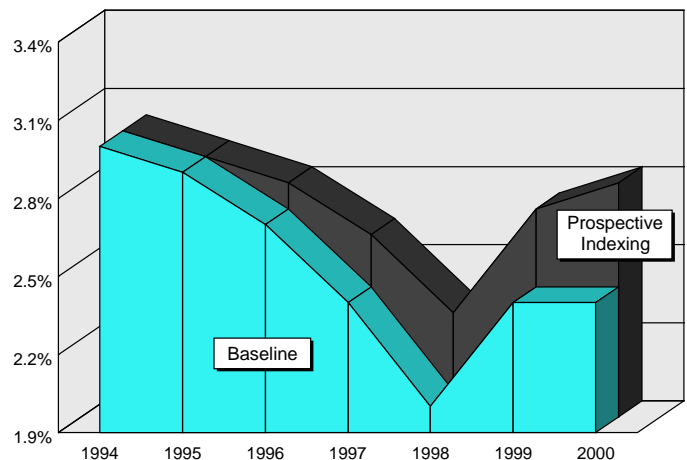


Figure 21
Added Real GDP Growth



H) \$10,000 Capital Gains Exclusion

This proposal would allow taxpayers an annual capital gains exclusion of \$10,000. Currently, taxpayers are allowed no exclusions. An annual \$10,000 exclusion would have limited economic effects, however. It would reduce the economy-wide marginal tax rate on capital and the cost of capital by only 0.3 percent. By the year 2000:

- Higher investment would lead to an additional \$193 billion in capital formation.
- A larger capital stock would mean 87,000 additional jobs.
- More capital and labor would yield an extra \$151.6 billion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$25 billion higher than otherwise.
- This greater economic activity would add 0.03 percentage points to the long-term annual growth rate.

The federal static revenue loss would be considerable. An annual static loss of \$11.3 billion in 1994 would rise to \$13.4 billion by the year 2000. Modest economic gains would mean little dynamic revenue pick-up:

- In the year 2000, the federal government would raise \$4.4 billion in new revenue, offsetting only 33 percent of the annual static loss.
- New revenue would offset only one-third of the cumulative \$87 billion static revenue loss between 1994 and 2000.
- Even including higher state and local revenues from added growth, government at all levels would still lose \$38.1 billion over the decade.

Even including higher state and local revenues from added growth, government at all levels would still lose \$38.1 billion over the decade.

Figure 22
Federal Revenue Effects

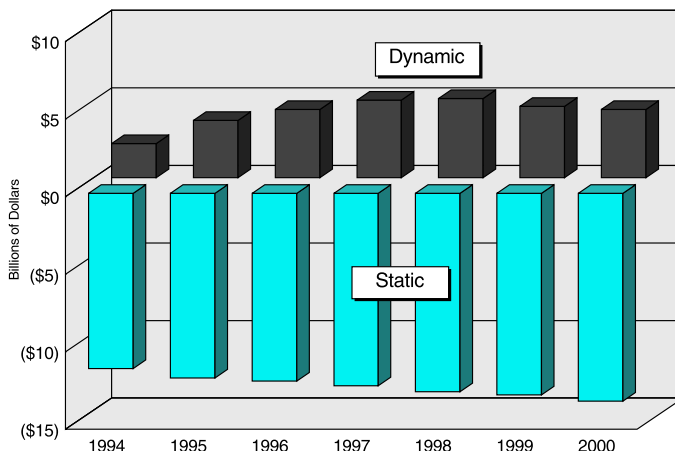
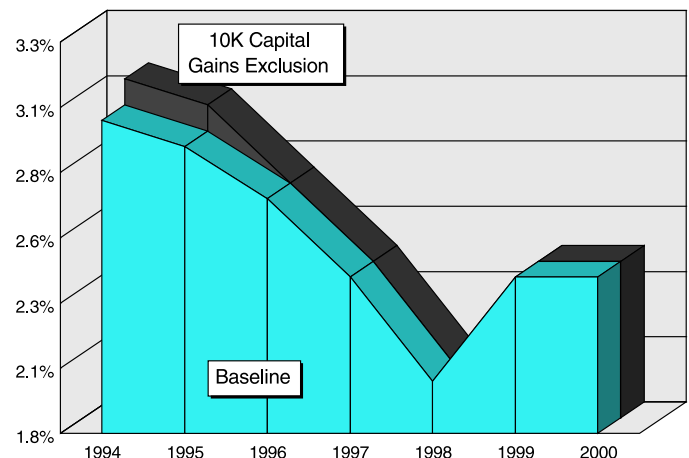


Figure 23
Added Real GDP Growth



I) Capital Gains Exclusion from Sale of Principal Residence

Modest economic gains would lead to little dynamic revenue pick-up.

This proposal would allow taxpayers to exclude all capital gains from the sale of a principal residence. Currently, taxpayers age 55 and over receive a one-time exclusion of \$125,000. Like the \$10,000 exclusion, this proposal would have minimal economic effects. It would reduce the economy-wide marginal tax rate on capital and the cost of capital by only 0.1 percent. By the year 2000:

- Higher investment would lead to an additional \$44 billion in capital formation.
- A larger capital stock would mean 16,000 additional jobs.
- More capital and labor would yield an extra \$21.2 billion in gross domestic product between 1994 and 2000. By the year 2000, annual GDP would be \$5.5 billion higher than otherwise.
- This greater economic activity would add 0.01 percentage points to the long-term annual growth rate.

The federal static revenue loss would be negligible. The annual static loss would only be \$0.5 billion by the year 2000. Modest economic gains would lead to little dynamic revenue pick-up:

- In the year 2000, the federal government would raise \$0.9 billion in new revenue.
- Because of higher growth the federal government would only net an additional \$0.5 billion in revenue between 1994 and 2000.
- Including higher state and local revenues from added growth means government at all levels would net another \$3.1 billion over the decade.

Figure 25
Federal Revenue Effects

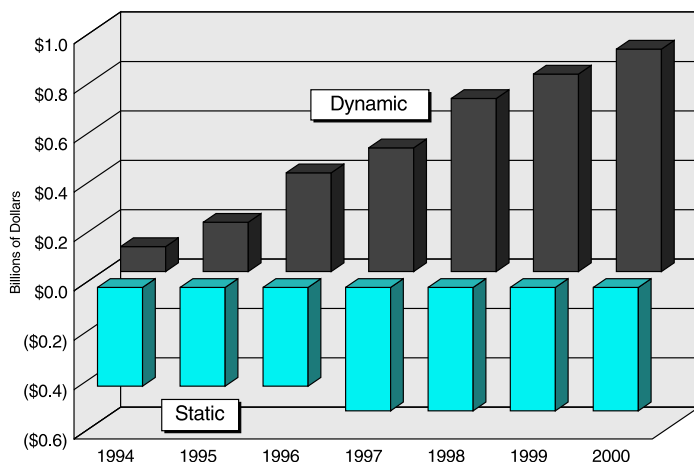
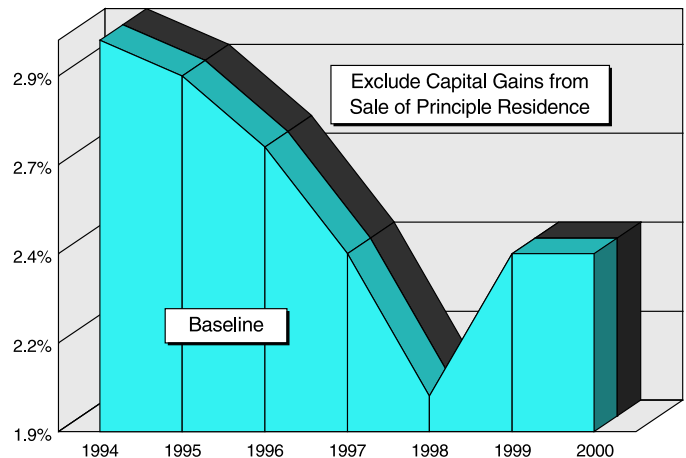


Figure 24
Added Real GDP Growth



Ranking the Proposals

The capital gains proposals vary in their economic and revenue effects. Relative desirability depends upon whether concern is with higher growth, static federal revenues, dynamic revenues or some combination. Figures 26 through 29 compare the cumulative economic effects by the year 2000 for the six of the nine proposals. Whatever the economic indicator— cost of capital, capital formation, GDP or jobs—the zero capital gains tax rate causes the most growth, followed by retrospective indexing. The \$10,000 exclusion always produces the least economic growth.

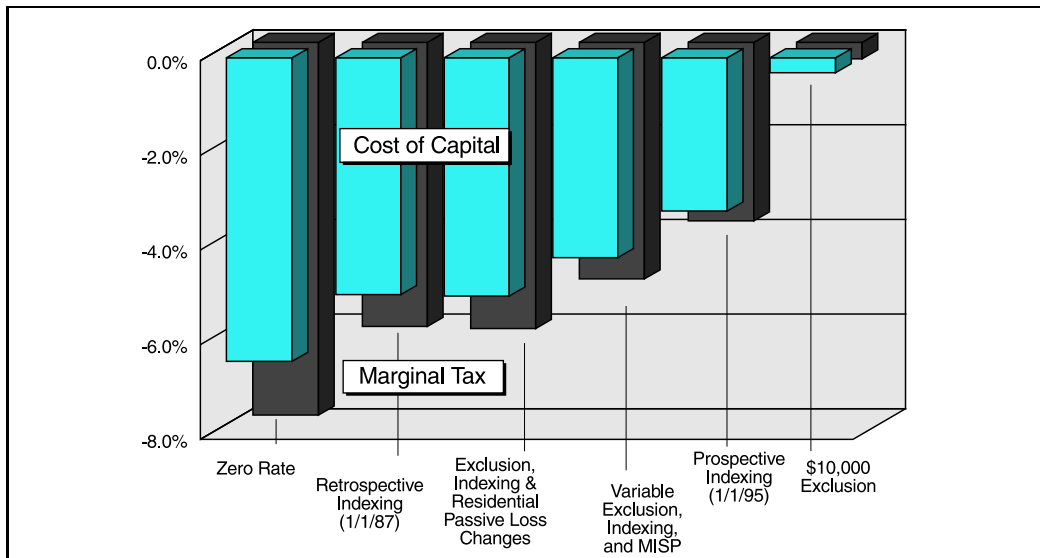


Figure 26
Effect on Capital Taxes and Costs
Reduction by the Year 2000

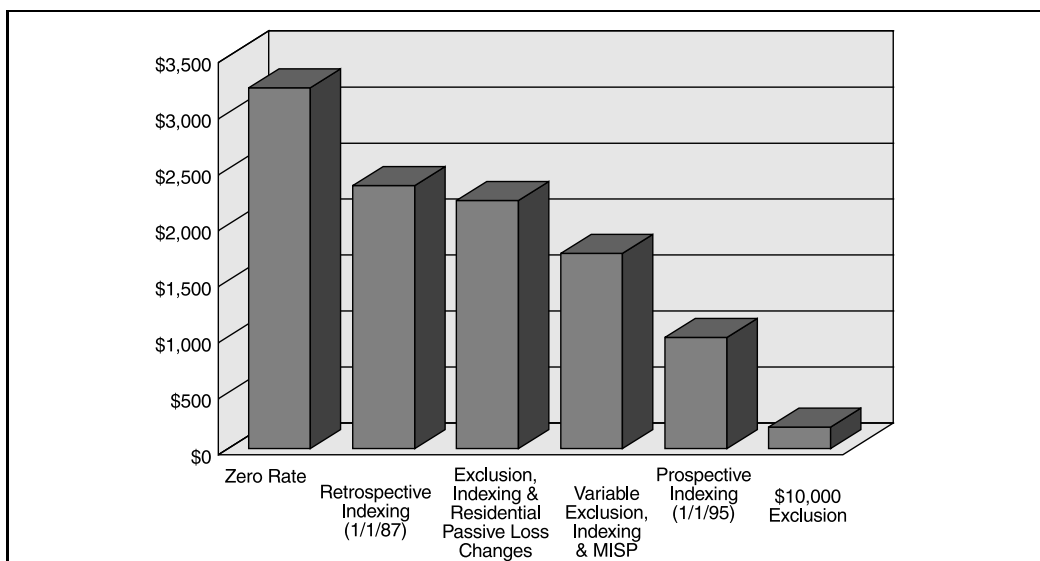


Figure 27
Added Capital by the Year 2000

Figures 30 and 31 compare the cumulative revenue effects and produce different rankings. Whether the indicator is static federal revenue, dynamic revenue or

Figure 28
Added GDP by the
Year 2000

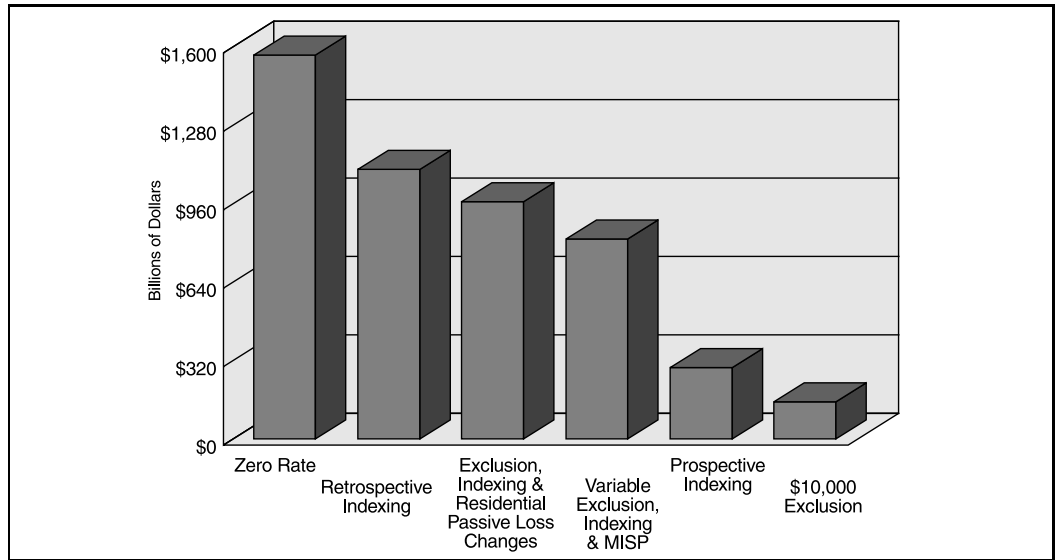
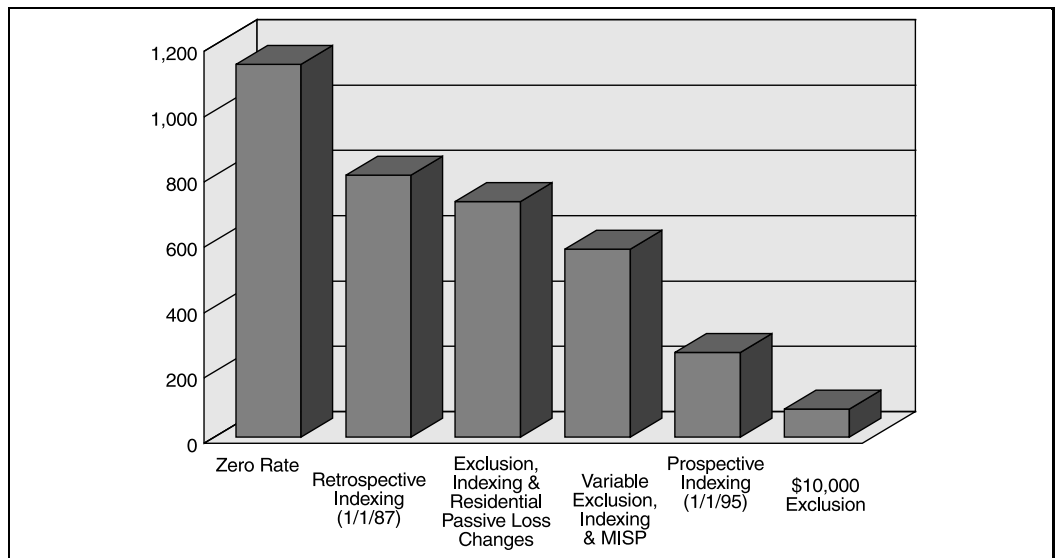
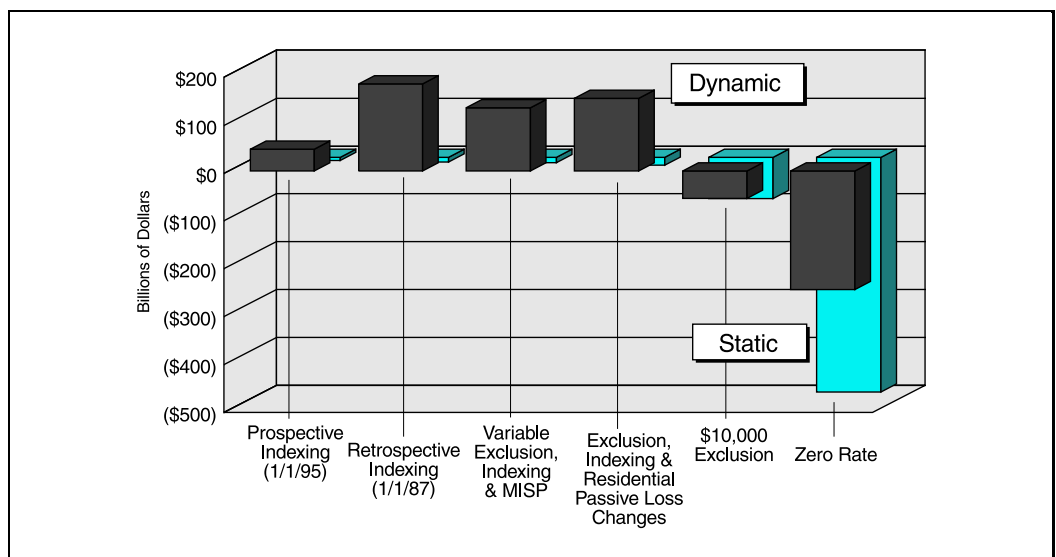


Figure 29
Job Creation by the
Year 2000



all government, the zero capital gains tax ranks last. Eliminating the tax rate on capital gains puts the proposal in an enormous static revenue hole from which it is difficult to climb out. Furthermore, there are none of the positive revenue effects from unlocking that help the indexing and rate reduction proposals in the early years. However, the real revenue losses decrease faster and faster over time.

Figure 30
Total Revenue Effects,
1994-2000
Includes State and Local
Governments



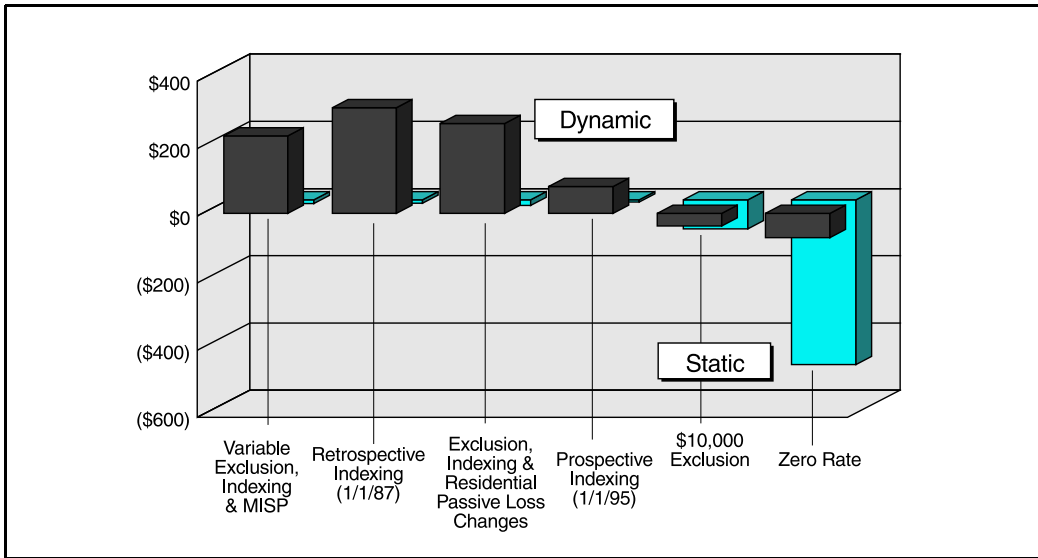


Figure 31
Federal Revenue Effects,
1994-2000

Looking at only static revenue effects, prospective indexing loses the least. But, its beneficial economic effects are also limited. Retrospective indexing or the package that contains a 50% exclusion, indexing, and residential passive loss deduction do the best in terms of dynamic revenue.

The table below ranks six proposals using four different indexes. The first takes only growth into consideration; the second looks at static revenue alone. The last two rankings combine growth and federal revenue concerns. Index 3 weights growth more heavily (70 percent) and net revenue less heavily (30 percent) while index 4 does the reverse.

If growth is the primary target, eliminating the capital gains tax is the best strategy. If revenue is a concern as well as growth, retrospective indexing or the package that contains a 50% exclusion, indexing, and residential passive loss deduction would be best.

Retrospective indexing or the package that contains a 50% exclusion, indexing, and residential passive loss deduction do the best in terms of dynamic revenue.

	100% Growth	100% Static Revenue	70% Growth, 30% Revenue	30% Growth, 70% Revenue
Zero Tax Rate	1	6	1	4
50% Exclusion, Indexing, and Residential Passive Loss Changes	3	3	3	1
Retrospective Indexing (1/1/87)	2	2	2	2
Prospective Indexing (1/1/95)	5	1	5	5
\$10,000 Exclusion	6	5	6	6
Variable Exclusion, Indexing, and MISP	4	4	4	3

Growth and Revenue
Rankings

Appendix A: Treatment of Capital Gains by Major Trading Partners

In general, the United States taxes capital gains more heavily than most other countries. Following is a description of how three U.S. trading partners — the United Kingdom, Germany and Japan — treat capital gains for tax purposes.

United Kingdom



The United Kingdom first started taxing capital gains realizations in 1965. Having previously implemented indexation, the capital gains tax is now only assessed on net gains earned after April 1982. Asset bases held at that time were adjusted to fair market value and since that time have been increased to take account of monthly movements in the retail price index. Liabilities, however, are not indexed.

Tax is levied on the total amount of taxable gains less allowable losses arising in the year. Although no deduction is permitted for capital losses in excess of capital gains, unused losses may be carried over for offset against gains arising in future years. Capital gains are added to taxable income and may be taxed at rates up to 40 percent—the maximum individual income tax rate. The first 5,500 pounds (\$8,126 at current exchange rates) of an individual's annual net gains, however, are exempt from tax. Furthermore, some asset sales, such as that of a principal residence or tangible personal property under 6,000 pounds, are not subject to the capital gains tax.

In sum, Britain taxes capital gains far less than the United States. As discussed earlier, indexing the basis for inflation removes most nominal capital gains from tax. The annual exempt amount and exempt transactions further reduce capital gains taxation in the UK.

Germany



Germany taxes short-term capital gains above an annual exempt amount of DM 1,000 (\$585 at current exchange rates) at ordinary rates. Short-term is a holding period of six months or less for investment securities and two years or less for real estate.

Gains classified as business income are taxed at half the regular rate. Business income includes gains from sale of an unincorporated business, sale of a partner's interest in a business partnership and sale of stock in a corporation in which the taxpayer held an interest in excess of 25 percent for more than six months. Similar rules apply to the sale of a professional practice.

Other capital gains on securities and real estate investments are exempt from income tax. Thus, compared to the current U.S. system, Germany does not tax most capital gains, particularly those associated with direct investment activities.

Japan

Until recently, capital gains were essentially free of tax in Japan. In 1988, however, Japan's major reform of its individual income tax system eliminated the tax-exempt status of many small savings accounts and introduced a capital gains tax on securities.

Taxation of income from capital gains generally depends upon its source. Forestry income which usually includes a significant capital gains element receives favorable treatment. Long-term gains from the sale of land and buildings are eligible for a 50-percent exclusion. Short-term gains from the sale of land and buildings, along with business income from the short-term sale of land (but not buildings) are taxed at higher rates than apply to ordinary income to reduce land speculation. A 50-percent deduction after a generous statutory exclusion based on years of service for pension income effectively excludes 50 percent of capital gains held until retirement. Net sale of corporate stock and other securities generally are taxable at the flat rate of 20 percent and are otherwise excluded from taxable income. Taxpayers trading through securities companies may elect a flat tax rate of 1 percent (0.5 percent in the case of convertible bonds) on gross proceeds. Gains on the sale of ordinary coupon bonds are exempt from tax.

Due to generally favorable treatment, taxation of capital gains in Japan is considerably less than that in the United States. In particular, capital gains from direct investment are essentially free of tax.



Appendix B: Comparison Tables

A) Zero Capital Gains Tax Rate

Table A1
CHANGES IN THE
ECONOMY
Zero Capital Gains
Tax Rate

* Baseline forecasts
from Clinton
administration
mid-session review of
the budget assume real

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-6.7%	-6.2%	0.59%	0.11%	1.46%	0.15%
1995	-6.9%	-6.2%	1.50%	0.24%	3.84%	0.30%
1996	-7.2%	-6.3%	2.42%	0.41%	6.16%	0.40%
1997	-7.4%	-6.3%	3.16%	0.59%	7.98%	0.45%
1998	-7.5%	-6.3%	3.79%	0.75%	9.51%	0.47%
1999	-7.7%	-6.4%	4.11%	0.86%	10.25%	0.45%
2000	-7.9%	-6.4%	4.36%	0.95%	10.82%	0.43%

Table A2
CHANGES IN THE
ECONOMY
Zero Capital Gains
Tax Rate

Figures for changes
from baseline in jobs
and capital are running
totals, i.e., the data for
the year 2000 reflects
1994 through 2000.

Change from Baseline in:			
Year	GDP (\$ bil. Nom.)	Jobs (mil.)	Capital (\$ bil. Nom.)
1994	35.5	0.124	318.0
1995	97.1	0.264	882.0
1996	167.0	0.462	1,490.8
1997	233.2	0.682	2,032.5
1998	297.8	0.877	2,548.5
1999	345.3	1.023	2,893.9
2000	391.0	1.141	3,220.2
1994-2000	1,567.0	#	#

Table A3
DYNAMIC REVENUE
CHANGES
Zero Capital Gains
Tax Rate
(\$ bil. nominal)

Year	Federal Social Security Tax	Federal Corporate Income Tax	Fed. Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Gov't
1994	3.0	0.3	1.7	0.5	5.5	4.0	9.4
1995	8.2	0.7	4.1	1.3	14.3	10.6	25.0
1996	14.1	1.3	7.2	2.3	24.9	18.4	43.3
1997	19.7	2.1	10.5	3.2	35.5	25.9	61.5
1998	25.2	3.0	13.8	4.1	46.0	33.4	79.4
1999	29.2	3.8	16.3	4.7	54.0	38.9	92.9
2000	33.0	4.6	18.6	5.3	61.6	44.2	105.8
1994-2000	132.4	15.9	72.3	21.3	241.8	175.4	417.2

Table A4
TOTAL REVENUE
CHANGES
Zero Capital Gains
Tax Rate
(\$ bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	-59.7	5.5	-54.2	-50.2
1995	-63.7	14.3	-49.4	-38.8
1996	-66.6	24.9	-41.7	-23.3
1997	-69.6	35.5	-34.1	-8.1
1998	-73.2	46.0	-27.2	6.2
1999	-76.6	54.0	-22.6	16.3
2000	-80.6	61.6	-19.0	25.2
1994-2000	-490.0	241.8	-248.1	-72.8

B) Retrospective Indexing of Capital Gains for Inflation

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-4.5%	-4.3%	0.37%	0.04%	0.97%	0.09%
1995	-4.8%	-4.4%	0.99%	0.12%	2.58%	0.20%
1996	-5.1%	-4.6%	1.63%	0.23%	4.20%	0.27%
1997	-5.3%	-4.7%	2.17%	0.36%	5.53%	0.31%
1998	-5.6%	-4.8%	2.65%	0.49%	6.68%	0.33%
1999	-5.8%	-4.9%	2.95%	0.59%	7.35%	0.32%
2000	-6.0%	-5.0%	3.19%	0.67%	7.89%	0.31%

Change in Baseline in:			
Year	GDP (\$ bil. Nom.)	Jobs (mil.)	Capital (\$ bil. Nom.)
1994	22.2	0.040	211.8
1995	63.9	0.131	594.3
1996	112.4	0.263	1,017.3
1997	160.0	0.414	1,407.5
1998	208.6	0.569	1,792.1
1999	247.5	0.699	2,074.7
2000	285.7	0.803	2,349.9
1994-2000	1,100.3	#	#

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Gov't
1994	1.9	0.1	4.0	0.4	6.3	3.7	10.0
1995	5.4	0.3	5.7	0.9	12.4	8.2	20.6
1996	9.5	0.8	7.9	1.6	19.7	13.6	33.4
1997	13.5	1.3	10.3	2.2	27.4	19.1	46.5
1998	17.6	2.0	12.9	2.9	35.5	24.7	60.2
1999	20.9	2.7	15.0	3.5	42.1	29.3	71.4
2000	24.1	3.4	17.1	4.0	48.7	33.8	82.4
1994-2000	93.0	10.7	72.9	15.5	192.1	132.3	324.4

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	11.7	6.3	18.0	21.7
1995	6.7	12.4	19.1	27.3
1996	0.0	19.7	19.7	33.4
1997	-2.6	27.4	24.8	43.9
1998	-5.5	35.5	30.0	54.7
1999	-8.7	42.1	33.4	62.7
2000	-12.4	48.7	36.2	70.0
1994-2000	-10.8	192.1	181.2	313.6

Table B1
CHANGES IN THE ECONOMY
Retrospective Indexing of Capital Gains (1/1/87)

* Baseline forecasts from Clinton administration mid-session review of the budget assume real

Table B2
CHANGES IN THE ECONOMY
Retrospective Indexing of Capital Gains (1/1/87)

Figures for changes from baseline in jobs and capital are running totals, i.e., the data for the year 2000 reflects 1994 through 2000.

Table B3
DYNAMIC REVENUE CHANGES
Retrospective Indexing of Capital Gains (1/1/87) (\$ bil. nominal)

Table B4
TOTAL REVENUE CHANGES
Retrospective Indexing of Capital Gains (1/1/87) (\$ bil. nominal)

C) Maximum 15% Capital Gains Tax Rate

Table C1
CHANGES IN THE
ECONOMY
Maximum 15% Capital
Gains Tax Rate

* Baseline forecasts
from Clinton
administration
mid-session review of
the budget assume real

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-3.2%	-3.2%	0.27%	0.03%	0.71%	0.07%
1995	-3.3%	-3.1%	0.71%	0.08%	1.86%	0.14%
1996	-3.4%	-3.2%	1.15%	0.16%	2.97%	0.19%
1997	-3.5%	-3.2%	1.51%	0.25%	3.83%	0.21%
1998	-3.6%	-3.2%	1.82%	0.34%	4.55%	0.23%
1999	-3.7%	-3.2%	1.99%	0.40%	4.91%	0.22%
2000	-3.8%	-3.2%	2.11%	0.44%	5.19%	0.21%

Table C2
CHANGES IN THE
ECONOMY
Maximum 15% Capital
Gains Tax Rate

Figures for changes
from baseline in jobs
and capital are running
totals, i.e., the data for
the year 2000 reflects
1994 through 2000.

Change from Baseline in:			
Year	GDP (\$ bil. Nom.)	Jobs (mil.)	Capital (\$ bil. Nom.)
1994	16.3	0.031	154.8
1995	45.9	0.092	427.1
1996	79.6	0.186	718.0
1997	111.4	0.291	975.1
1998	143.2	0.395	1,221.1
1999	166.8	0.478	1,386.7
2000	189.0	0.531	1,544.1
1994-2000	752.3	#	#

Table C3
DYNAMIC REVENUE
CHANGES
Maximum 15% Capital
Gains Tax Rate
(\$ bil. nominal)

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Gov't
1994	1.4	0.1	2.8	0.3	4.5	2.7	7.2
1995	3.9	0.2	4.0	0.7	8.8	5.9	14.7
1996	6.7	0.6	5.5	1.1	13.9	9.6	23.5
1997	9.4	1.0	7.1	1.6	19.1	13.3	32.3
1998	12.1	1.5	8.8	2.0	24.4	17.0	41.4
1999	14.1	1.9	10.2	2.3	28.6	19.8	48.4
2000	16.0	2.3	11.4	2.6	32.3	22.4	54.7
1994-2000	63.6	7.6	49.8	10.6	131.6	90.6	222.2

Table C4
TOTAL REVENUE
CHANGES
Maximum 15% Capital
Gains Tax Rate
(\$ bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	8.3	4.5	12.8	15.4
1995	4.5	8.8	13.3	19.2
1996	0.0	13.9	13.9	23.5
1997	-1.6	19.1	17.4	30.7
1998	-3.4	24.4	21.0	37.9
1999	-5.4	28.6	23.2	43.0
2000	-7.6	32.3	24.8	47.2
1994-2000	-5.2	131.6	126.4	216.9

D) Maximum 15% Capital Gains Tax Rate with Retrospective Indexing

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-5.4%	-5.1%	0.44%	0.04%	1.17%	0.11%
1995	-5.7%	-5.2%	1.18%	0.14%	3.10%	0.24%
1996	-5.9%	-5.3%	1.93%	0.27%	5.00%	0.32%
1997	-6.2%	-5.4%	2.55%	0.42%	6.52%	0.36%
1998	-6.4%	-5.4%	3.09%	0.57%	7.82%	0.38%
1999	-6.6%	-5.5%	3.40%	0.68%	8.50%	0.37%
2000	-6.8%	-5.6%	3.64%	0.75%	9.06%	0.36%

**Table D1
CHANGES IN THE
ECONOMY
Maximum 15% Capital
Gains Tax Rate &
Retrospective Indexing**

* Baseline forecasts from Clinton administration mid-session review of

Change from Baseline in:			
Year	GDP (\$ bil. Nom.)	Jobs (mil)	Capital (\$ bil. Nom.)
1994	26.8	0.048	255.5
1995	76.3	0.153	712.3
1996	133.3	0.310	1209.8
1997	188.1	0.488	1,659.3
1998	243.4	0.666	2,095.6
1999	285.4	0.801	2,402.1
2000	326.2	0.907	2,696.1
1994-2000	1,279.6	#	#

**Table D2
CHANGES IN THE
ECONOMY
Maximum 15% Capital
Gains Tax Rate &
Retrospective Indexing**

Figures for changes from baseline in jobs and capital are running totals, i.e., the data for the year 2000 reflects

Year	Federal Social Security Tax	Federal Corporate Income Tax.	Fed. Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Gov't
1994	2.3	0.1	4.9	0.5	7.7	4.5	12.2
1995	6.5	0.4	6.8	1.1	14.8	9.8	24.6
1996	11.3	0.9	9.3	1.9	23.3	16.1	39.4
1997	15.9	1.6	12.0	2.6	32.1	22.4	54.4
1998	20.6	2.3	14.9	3.4	41.2	28.8	70.0
1999	24.1	3.1	17.2	4.0	48.3	33.7	82.0
2000	27.6	3.8	19.3	4.5	55.2	38.4	93.6
1994-2000	108.1	12.1	84.3	18.0	222.6	153.6	376.2

**Table D3
DYNAMIC REVENUE
CHANGES
Maximum 15% Capital
Gains Tax Rate &
Retrospective Indexing
(\$ bil. nominal)**

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	14.5	7.7	22.3	26.8
1995	8.1	14.8	22.9	32.7
1996	0.0	23.3	23.3	39.4
1997	-3.0	32.1	29.1	51.4
1998	-6.4	41.2	34.8	63.6
1999	-10.1	48.3	38.3	71.9
2000	-14.2	55.2	40.9	79.4
1994-2000	-11.0	222.6	211.5	365.2

**Table D4
TOTAL REVENUE
CHANGES
Maximum 15% Capital
Gains Tax Rate &
Retrospective Indexing
(\$ bil. nominal)**

E) 50% Exclusion, Indexing, and Residential Passive Loss Deduction

Table E1
CHANGES IN THE ECONOMY
50% Exclusion, Indexing, and Residential Passive Loss Deduction

* Baseline forecasts from Clinton administration mid-session review of

Percentage Change from Baseline* in						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-3.2%	-3.1%	0.26%	0.03%	0.70%	0.07%
1995	-4.0%	-3.8%	0.76%	0.09%	1.98%	0.15%
1996	-4.5%	-4.1%	1.32%	0.18%	3.41%	0.22%
1997	-5.0%	-4.4%	1.84%	0.29%	4.69%	0.26%
1998	-5.4%	-4.6%	2.33%	0.41%	5.88%	0.29%
1999	-5.7%	-4.9%	2.69%	0.52%	6.73%	0.30%
2000	-6.0%	-5.0%	2.99%	0.60%	7.44%	0.29%

Table E2
CHANGES IN THE ECONOMY
50% Exclusion, Indexing, and Residential Passive Loss Deduction

Figures for changes from baseline in jobs and capital are running totals, i.e., the data for the year 2000 reflects

Change from Baseline in:			
Year	GDP (billions of nominal \$)	Jobs (millions)	Capital (billions of nominal \$)
1994	16.0	0.030	152.0
1995	48.9	0.096	455.4
1996	91.0	0.206	823.8
1997	135.6	0.340	1,195.2
1998	183.3	0.484	1,577.8
1999	226.0	0.616	1,901.1
2000	267.9	0.721	2,215.8
1994-2000	968.6	#	#

Table E3
DYNAMIC REVENUE CHANGES
50% Exclusion, Indexing, and Residential Passive Loss Deduction (\$ bil. nominal)

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
1994	1.4	0.1	2.4	0.3	4.1	2.5	6.6
1995	4.1	0.3	4.3	0.7	9.4	6.3	15.7
1996	7.7	0.6	6.4	1.3	16.0	11.0	27.0
1997	11.5	1.1	8.7	1.9	23.2	16.1	39.3
1998	15.5	1.8	11.3	2.6	31.1	21.7	52.8
1999	19.1	2.4	13.7	3.2	38.3	26.7	65.0
2000	22.6	3.1	15.9	3.7	45.3	31.6	76.9
1994-2000	81.8	9.3	62.6	13.6	167.4	115.8	283.2

Table E4
TOTAL REVENUE CHANGES
50% Exclusion, Indexing, and Residential Passive Loss Deduction (\$ bil. nominal)

Year	Static Federal Tax Revenue	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	7.8	4.1	11.9	14.4
1995	5.3	9.4	14.7	20.9
1996	-0.2	16.0	15.7	26.7
1997	-2.6	23.2	20.6	36.7
1998	-5.5	31.1	25.6	47.3
1999	-8.8	38.3	29.5	56.2
2000	-12.7	45.3	32.6	64.2
1994-2000	-16.7	167.4	150.7	266.5

F) Variable Exclusion, Indexing, and Middle Income Savings Plan (MISP)

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-4.1%	-4.0%	0.34%	0.03%	0.90%	0.09%
1995	-3.4%	-3.2%	0.84%	0.10%	2.18%	0.17%
1996	-3.0%	-2.8%	1.25%	0.18%	3.21%	0.21%
1997	-3.6%	-3.2%	1.57%	0.27%	3.96%	0.22%
1998	-4.1%	-3.6%	1.90%	0.36%	4.75%	0.24%
1999	-4.6%	-3.9%	2.12%	0.43%	5.26%	0.23%
2000	-5.0%	-4.2%	2.36%	0.48%	5.85%	0.23%

Table F1
CHANGES IN THE ECONOMY
Variable Exclusion, Indexing, and MISP

* Baseline forecasts from Clinton administration mid-session review of the budget assume real

Change from Baseline in:			
Year	GDP (billions of nominal \$)	Jobs (millions)	Capital (billions of nominal \$)
1994	20.6	0.038	196.7
1995	54.0	0.110	502.0
1996	86.4	0.209	776.7
1997	115.8	0.313	1,008.9
1998	149.5	0.417	1,273.4
1999	178.2	0.506	1,484.7
2000	211.8	0.576	1,742.4
1994-2000	816.3	#	#

Table F2
CHANGES IN THE ECONOMY
Variable Exclusion, Indexing and MISP

Figures for changes from baseline in jobs and capital are running totals, i.e., the data for the year 2000 reflects 1994 through 2000.

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
1994	1.7	0.1	3.6	0.3	5.8	3.4	9.2
1995	4.6	0.3	4.3	0.8	10.0	6.8	16.7
1996	7.3	0.6	5.6	1.2	14.7	10.3	25.0
1997	9.8	1.1	7.4	1.6	19.9	13.8	33.7
1998	12.6	1.5	9.4	2.1	25.7	17.8	43.5
1999	15.1	2.0	11.2	2.5	30.8	21.3	52.0
2000	17.9	2.5	12.9	3.0	36.3	25.1	61.4
1994-2000	69.0	8.2	54.5	11.5	143.2	98.4	241.6

Table F3
DYNAMIC REVENUE CHANGES
Variable Exclusion, Indexing, and MISP (\$ bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	10.2	5.8	16.0	19.4
1995	4.1	10.0	14.1	20.8
1996	-0.5	14.7	14.2	24.5
1997	-2.2	19.9	17.6	31.4
1998	-4.6	25.7	21.1	39.0
1999	-7.4	30.8	23.3	44.6
2000	-11.0	36.3	25.3	50.4
1994-2000	-11.5	143.2	131.6	230.0

Table F4
TOTAL REVENUE CHANGES
Variable Exclusion, Indexing, and MISP (\$ bil. nominal)

F) (cont.) Middle Income Savings Plan (MISP)

Table F5
CHANGES IN THE
ECONOMY
Middle Income
Savings Plan

* Baseline forecasts
from Clinton
administration
mid-session review of
the budget assume real

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-0.1%	-0.1%	0.00%	0.00%	0.01%	0.00%
1995	-0.1%	-0.1%	0.01%	0.00%	0.03%	0.00%
1996	-0.1%	-0.1%	0.02%	0.00%	0.06%	0.00%
1997	-0.1%	-0.1%	0.03%	0.00%	0.07%	0.00%
1998	-0.1%	-0.1%	0.04%	0.01%	0.09%	0.00%
1999	-0.1%	-0.1%	0.04%	0.01%	0.10%	0.00%
2000	-0.1%	-0.1%	0.05%	0.01%	0.12%	0.00%

Table F6
CHANGES IN THE
ECONOMY
Middle Income
Savings Plan

Figures for changes
from baseline in jobs
and capital are running
totals, i.e., the data for
the year 2000 reflects
1994 through 2000.

Change from Baseline in:			
Year	GDP (billions of nominal \$)	Jobs (millions)	Capital (billions of nominal \$)
1994	0.3	0.000	2.7
1995	0.8	0.002	7.8
1996	1.5	0.003	13.5
1997	2.2	0.006	19.0
1998	2.9	0.008	24.8
1999	3.6	0.010	29.4
2000	4.2	0.012	34.3
1994-2000	15.6	#	#

Table F7
DYNAMIC REVENUE
CHANGES
Middle Income
Savings Plan
(\$ bil. nominal)

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
1994	0.0	0.0	0.0	0.0	0.1	0.0	0.1
1995	0.1	0.0	0.1	0.0	0.2	0.1	0.3
1996	0.1	0.0	0.1	0.0	0.3	0.2	0.5
1997	0.2	0.0	0.1	0.0	0.4	0.3	0.6
1998	0.2	0.0	0.2	0.0	0.5	0.3	0.9
1999	0.3	0.1	0.2	0.1	0.6	0.4	1.0
2000	0.4	0.1	0.3	0.1	0.7	0.5	1.2
1994-2000	1.3	0.2	1.0	0.2	2.7	1.9	4.6

Table F8
TOTAL REVENUE
CHANGES
Middle Income
Savings Plan
(\$ bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	-0.3	0.1	-0.3	-0.2
1995	-0.4	0.2	-0.2	-0.1
1996	-0.5	0.3	-0.2	0.0
1997	-0.5	0.4	-0.1	0.1
1998	-0.6	0.5	-0.1	0.3
1999	-0.7	0.6	0.0	0.4
2000	-0.7	0.7	0.0	0.5
1994-2000	-3.7	2.7	-0.9	0.9

G) Prospective Indexing of Capital Gains for Inflation

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	0.0%	0.0%	0.00%	0.00%	0.00%	0.00%
1995	-0.4%	-0.4%	0.03%	0.00%	0.09%	0.01%
1996	-1.2%	-1.2%	0.15%	0.02%	0.40%	0.03%
1997	-1.9%	-1.8%	0.37%	0.04%	0.95%	0.05%
1998	-2.6%	-2.3%	0.65%	0.09%	1.67%	0.08%
1999	-3.2%	-2.8%	0.98%	0.15%	2.49%	0.11%
2000	-3.8%	-3.2%	1.32%	0.22%	3.34%	0.13%

Table G1
CHANGES IN THE ECONOMY
Prospective Indexing of Capital Gains (1/1/95)

* Baseline forecasts from Clinton administration mid-session review of the budget assume real

Change from Baseline in:			
Year	GDP (billions of nominal \$)	Jobs (millions)	Capital (billions of nominal \$)
1994	0.0	0.000	0.0
1995	2.2	0.003	21.0
1996	10.6	0.018	97.2
1997	27.0	0.052	241.8
1998	51.2	0.106	447.4
1999	82.4	0.181	704.1
2000	118.3	0.260	994.6
1994-2000	291.6	#	#

Table G2
CHANGES IN THE ECONOMY
Prospective Indexing of Capital Gains (1/1/95)

Figures for changes from baseline in jobs and capital are running totals, i.e., the data for the year 2000 reflects 1994 through 2000.

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Government
1994	0.0	0.0	0.0	0.0	0.0	0.0	0.0
1995	0.2	0.0	0.4	0.0	0.6	0.4	0.9
1996	0.9	0.1	1.2	0.2	2.3	1.5	3.8
1997	2.3	0.2	2.3	0.4	5.2	3.4	8.6
1998	4.3	0.4	3.8	0.7	9.3	6.3	15.5
1999	7.0	0.8	5.5	1.2	14.4	9.9	24.4
2000	10.0	1.2	7.4	1.7	20.3	14.1	34.4
1994-2000	24.6	2.7	20.6	4.1	52.0	35.6	87.6

Table G3
DYNAMIC REVENUE CHANGES
Prospective Indexing of Capital Gains (1/1/95) (\$ bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	0.0	0.0	0.0	0.0
1995	1.1	0.6	1.7	2.0
1996	1.6	2.3	3.9	5.4
1997	0.0	5.2	5.2	8.6
1998	-1.2	9.3	8.0	14.3
1999	-3.1	14.4	11.3	21.3
2000	-5.7	20.3	14.6	28.7
1994-2000	-7.3	52.0	44.8	80.3

Table G4
TOTAL REVENUE CHANGES
Prospective Indexing of Capital Gains (1/1/95) (\$bil. nominal)

H) \$10,000 Capital Gains Exclusion

Table H1
CHANGES IN THE
ECONOMY
\$10,000 Capital Gains
Exclusion

* Baseline forecasts
from Clinton
administration
mid-session review of
the budget assume real

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-0.6%	-0.6%	0.13%	0.05%	0.27%	0.03%
1995	-0.5%	-0.5%	0.27%	0.11%	0.56%	0.05%
1996	-0.5%	-0.4%	0.33%	0.11%	0.73%	0.05%
1997	-0.4%	-0.3%	0.35%	0.12%	0.78%	0.05%
1998	-0.3%	-0.3%	0.35%	0.11%	0.79%	0.04%
1999	-0.3%	-0.3%	0.30%	0.09%	0.69%	0.03%
2000	-0.3%	-0.3%	0.28%	0.07%	0.65%	0.03%

Table H2
CHANGES IN THE
ECONOMY
\$10,000 Capital Gains
Exclusion

Figures for changes
from baseline in jobs
and capital are running
totals, i.e., the data for
the year 2000 reflects
1994 through 2000.

Change from Baseline in:			
Year	GDP (\$ bil. Nom.)	Jobs (mil.)	Capital (\$ bil. Nom.)
1994	7.9	0.060	59.0
1995	17.4	0.119	129.7
1996	22.8	0.123	177.2
1997	25.9	0.135	197.6
1998	27.5	0.123	212.2
1999	25.3	0.102	195.2
2000	24.9	0.087	193.2
1994-2000	151.6	#	#

Table H3
DYNAMIC REVENUE
CHANGES
\$10,000 Capital Gains
Exclusion
(\$ bil. nominal)

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Gov't
1994	0.7	0.2	1.3	0.1	2.2	1.3	3.5
1995	1.5	0.4	1.6	0.3	3.7	2.3	6.1
1996	1.9	0.4	1.8	0.3	4.4	2.9	7.3
1997	2.2	0.5	1.9	0.4	5.0	3.3	8.2
1998	2.3	0.5	1.9	0.4	5.1	3.4	8.5
1999	2.1	0.4	1.7	0.4	4.6	3.1	7.7
2000	2.1	0.4	1.6	0.3	4.4	3.0	7.4
1994-2000	12.8	2.7	11.8	2.2	29.4	19.3	48.7

Table H4
TOTAL REVENUE
CHANGES
\$10,000 Capital Gains
Exclusion
(\$ bil. nominal)

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	-11.3	2.2	-9.0	-7.7
1995	-11.9	3.7	-8.2	-5.8
1996	-12.1	4.4	-7.7	-4.8
1997	-12.4	5.0	-7.5	-4.2
1998	-12.8	5.1	-7.7	-4.3
1999	-13.0	4.6	-8.4	-5.3
2000	-13.4	4.4	-8.9	-5.9
1994-2000	-86.8	29.4	-57.4	-38.1

I) Capital Gains Exclusion from Sale of Principle Residence

Percentage Change from Baseline* in:						
Year	Tax on Capital	Cost of Capital	GDP	Jobs	Capital	Real Growth
1994	-0.1%	-0.1%	0.01%	0.00%	0.02%	0.00%
1995	-0.1%	-0.1%	0.02%	0.00%	0.05%	0.00%
1996	-0.1%	-0.1%	0.03%	0.00%	0.08%	0.01%
1997	-0.1%	-0.1%	0.04%	0.01%	0.11%	0.01%
1998	-0.1%	-0.1%	0.05%	0.01%	0.13%	0.01%
1999	-0.1%	-0.1%	0.06%	0.01%	0.14%	0.01%
2000	-0.1%	-0.1%	0.06%	0.01%	0.15%	0.01%

Change from Baseline in:			
Year	GDP (\$ bil. Nom.)	Jobs (mil.)	Capital (\$ bil. Nom.)
1994	0.4	0.000	3.9
1995	1.2	0.002	11.3
1996	2.2	0.005	19.6
1997	3.1	0.008	27.2
1998	4.1	0.011	34.3
1999	4.8	0.014	39.3
2000	5.5	0.016	43.9
1994-2000	21.2	#	#

Year	Federal Social Security Tax	Federal Corporate Income Tax	Federal Personal Income Tax	Other Federal Taxes	Federal Total	State and Local	Total Gov't
1994	0.0	0.0	0.1	0.0	0.1	0.1	0.2
1995	0.1	0.0	0.1	0.0	0.2	0.2	0.4
1996	0.2	0.0	0.1	0.0	0.4	0.3	0.6
1997	0.3	0.0	0.2	0.0	0.5	0.4	0.9
1998	0.3	0.0	0.3	0.1	0.7	0.5	1.2
1999	0.4	0.1	0.3	0.1	0.8	0.6	1.4
2000	0.5	0.1	0.3	0.1	0.9	0.7	1.6
1994-2000	1.8	0.2	1.4	0.3	3.7	2.6	6.3

Year	Static Federal Tax Change	Dynamic Federal Tax Change	Net to Federal Government	Net to All Governments
1994	-0.4	0.1	-0.3	-0.2
1995	-0.4	0.2	-0.2	0.0
1996	-0.4	0.4	-0.1	0.2
1997	-0.5	0.5	0.1	0.5
1998	-0.5	0.7	0.2	0.7
1999	-0.5	0.8	0.3	0.9
2000	-0.5	0.9	0.4	1.1
1994-2000	-3.2	3.7	0.5	3.1

Table I1
CHANGES IN THE ECONOMY
Capital Gains Exclusion from Principle Residence

* Baseline forecasts from Clinton administration mid-session review of the budget assume real

Table I2
CHANGES IN THE ECONOMY
Capital Gains Exclusion from Principal Residence

Figures for changes from baseline in jobs and capital are running totals, i.e., the data for the year 2000 reflects 1994 through 2000.

Table I3
DYNAMIC REVENUE CHANGES
Capital Gains Exclusion from Principle Residence (\$ bil. nominal)

Table I4
TOTAL REVENUE CHANGES
Capital Gains Exclusion from Principle Residence

Appendix C) Methodology

The Fiscal Associates Model

The economic and revenue effects of these capital gains proposals were estimated using the Fiscal Associates general equilibrium model of the U.S. economy. The Model explicitly incorporates detailed information on tax policy and how it affects the economy, capital investment, output and jobs. Taxes on labor income consist of personal income taxes, payroll taxes, and labor's share of indirect business taxes, such as sales and excise taxes. Taxes on capital consist of those levied on assets directly, on the output produced by assets, and on the return accruing to owners. The tax treatment for the 20 capital classifications in the Fiscal Associates Tax Model is the average of 5,000 specific assets, weighted by their capital stocks.

Simulating the economic effects of the capital gains proposals is done in two stages. First, the Model produces a *baseline* using the latest government forecast of economic performance. We used the economic assumptions contained in the Clinton administration's mid-session review of the budget. This baseline provides a forecast of future GDP, employment, and investment if there are no policy changes. Next comes a *dynamic* simulation that forecasts how the economy will behave if a policy change were made.

A Word on Static vs. Dynamic Analysis

A decrease in the tax on capital gains lowers the cost of capital and raises the rate of return to capital. In response, there will be an upward adjustment in the amount of capital services offered for use in the production process, and an associated increase in the amount of labor services hired. These additional labor and capital inputs will lead to a higher output and rate of economic growth.

Because lowering the tax rate on capital gains would reduce federal revenues from the personal income tax, government estimates would show a substantial loss in federal revenue. But these *static forecasts* would be wrong. Static analysis ignores behavioral adjustments by individuals and businesses to policy changes. A static world assumes that the work, saving, and investment decisions of individuals and businesses are the same whether taxes are raised, lowered, or remain unchanged. As a result, although fundamental laws of economics and experience show otherwise, *the static framework assumes the level of economic activity and the tax base will remain unchanged by either a tax increase or decrease.*

Dynamic revenue projections, which take economic effects into account, present a much different picture than static ones. Lowering the cost of capital leads to an upward adjustment in the amount of capital services offered for use in the production process, and an associated increase in the amount of labor services hired. These additional labor and capital inputs will lead to a higher output and rate of economic growth. An economy generating more and more output each year would mean larger tax bases for government. More output would mean more excise tax revenue; more capital would mean higher corporate income tax revenue; and more jobs would mean higher personal income and payroll tax revenue.

About the Authors

Gary Robbins is President of Fiscal Associates, a Washington D.C.-based economic consulting firm, and Senior Research Associate of TaxAction Analysis. Mr. Robbins has developed a general equilibrium model of the U.S. economy that specifically incorporates the effects of taxes and government spending. He was Chief of the Applied Econometrics Staff at the U.S. Treasury Department from 1981 to 1982, and Assistant to the Director of the Office of Tax Analysis from 1976 to 1981. Recent publications include IPI Policy Report #105: Will Raising Taxes Reduce the Deficit?, and IPI Policy Report #111: Playing Politics with Government Forecasts. Mr. Robbins' articles and analysis frequently appear in the financial press. He received his master's degree in Economics from Southern Methodist University.

Aldona Robbins, Vice President of Fiscal Associates and Senior Research Associate of TaxAction Analysis, has extensive experience with public and private retirement programs. As senior economist in the Office of Economic Policy, U.S. Department of the Treasury from 1979 to 1985, Dr. Robbins' performed staff work for the Secretary in his capacity as Managing Trustee of the Social Security trust funds. Recent publications include IPI Policy Report # 115: *Promoting Growth Through Tax Policy*, and IPI Policy Report #119: *Taxes, Spending and Deficits: The Crisis in Government Finance*. She received a master's degree and doctorate in Economics from the University of Pittsburgh.

About TaxAction Analysis

TaxAction Analysis is the tax policy arm of the Institute for Policy Innovation, a non-profit, non-partisan public policy organization. TaxAction Analysis recognizes that changing tax policy affects incentives to work, save, and invest. These changes in economic behavior are frequently ignored in static government forecasts, resulting in policy decisions that negatively affect economic growth, capital formation, employment, and local, state, and federal revenues. TaxAction Analysis publishes *Economic Scorecard*, a quarterly newsletter, as well as additional commentary on tax policy.

Nothing written here should be construed as necessarily reflecting the views of the Institute for Policy Innovation, or as an attempt to aid or hinder the passage of any bill before Congress.