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Republican Tax Cuts: Are They Fair?

During the House of Representatives debate on the tax bill that was part of the Republican Contract With America, the principal argument made against it was that its tax cuts were "unfair." The main evidence opponents presented was that in the first year the largest benefits in dollar terms would accrue to taxpayers with incomes above $200,000. By contrast, just 2 percent of the benefits would go to taxpayers earning less than $50,000.

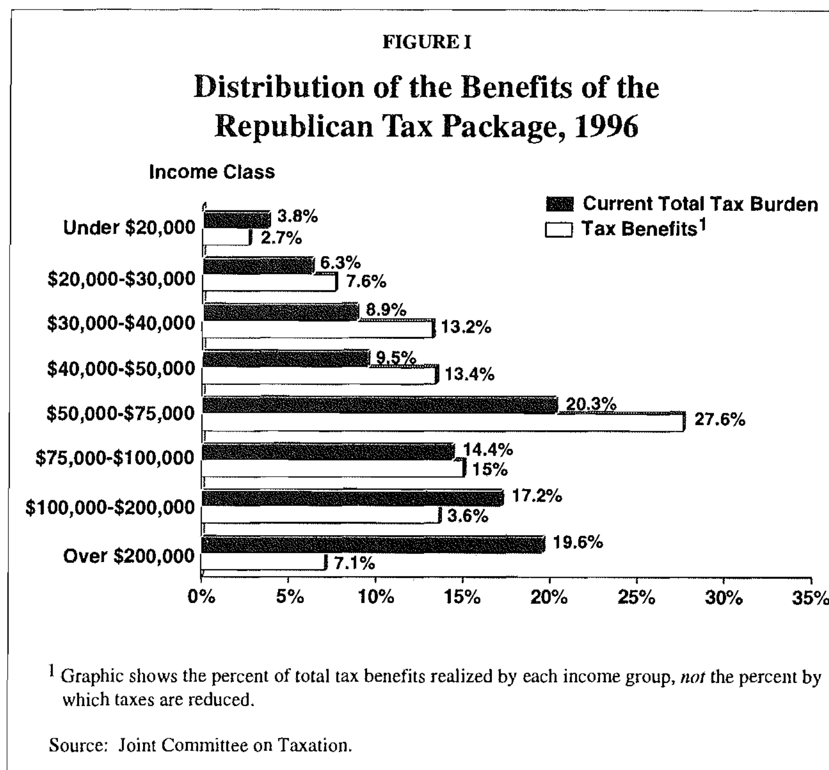
On the surface, this is a damning indictment. But the appearance is deceiving. First, the timing of parts of the tax bill distorts its true impact. Second, the way revenue estimators make their calculations results in a highly misleading picture. Further, most taxes are paid by taxpayers with high incomes while the poor pay almost none, so tax cuts generally appear to benefit the wealthy more than the poor.

The Timing of the Tax Cuts. The first-year effects of the tax bill are skewed by the fact that the 50 percent cut in the capital gains tax takes effect in 1995, whereas the $500 per child credit does not take effect until 1996. Some additional provisions of the bill take effect now and others next year. Generally speaking, the provisions most beneficial to the middle class take effect later, while those most beneficial to the wealthy take effect immediately. The reason: the tax cuts that encourage investment and stimulate the economy are needed in order to produce more revenue to "fund" the child tax credit next year.

Therefore, looking only at the immediate effect of the tax bill rather than its fully-implemented impact does not provide an accurate picture. Figure I — which shows the distribution of benefits in 1996, when all the provisions of the bill will have taken effect — presents a very different picture than the critics would have us believe. According to the Joint Committee on Taxation, 64.5 percent of the benefits go to taxpayers with incomes below $75,000, even though these taxpayers pay just 48.8 percent of all federal taxes.

FIGURE I

Distribution of the Benefits of the Republican Tax Package, 1996



[1] Graphic shows the percent of total tax benefits realized by each income group, *not* the percent by which taxes are reduced.

Source: Joint Committee on Taxation.

This emphasis on helping middle-income taxpayers is even more apparent in Figure II, which shows the distribution of the benefits of the $500 child credit, the most criticized element of the Republican package. In this case, 75 percent of the benefits go to taxpayers with incomes below $75,000.

Thus the primary impact of the tax bill is to support those with middle incomes. So why does a cursory glance at the accompanying figures of the benefits from the bill make them appear to be directed toward the rich? The answer has to do with the nature of capital gains and the erroneous method of estimating the benefits from reducing capital gains taxes utilized by Congressional bureaucrats.

Realizing Capital Gains. Capital gains — the increase in value of stocks or other assets — are only taxed

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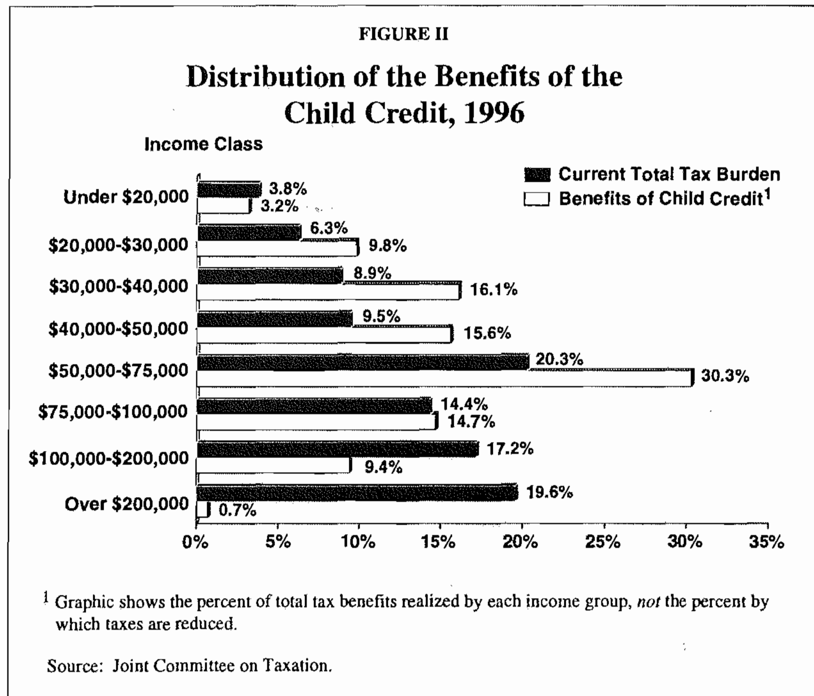
if the asset is sold. Some assets may be held for many years before gains are realized, and the total amount of capital gains available in those assets may be very large relative to the amount of gains that actually are realized in any one year. These gains may reflect many years' worth of appreciation, so owners of assets may be reluctant to realize them because of the amount of capital gains taxes they would have to pay. Thus there is a "lock-in" effect; investors hold on to assets, thereby postponing the payment of any taxes on such gains indefinitely.

For this reason, a reduction in the capital gains tax may induce people to realize their gains because they will get to keep more of them.



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Source: Joint Committee on Taxation.

Capital Gains and Revenue Estimates. When revenue estimators calculate total revenue, they assume that a reduction in the capital gains tax rate will have some unlocking effect, in which a larger number of realizations occur. But they ignore this effect when they calculate how the gains are distributed. Instead, they assume that the same amount of capital gains would be realized whether the capital gains tax rate was cut or not. Therefore, they assert, cuts in the tax rate merely reward investors who would have sold the same assets and paid taxes at the previous, higher tax rate anyway.

For example, let's say you have 10,000 shares of stock that you bought some years ago for $1 a share. Now it's worth $11 a share, but you don't want to sell it because you would have to pay $28,000 in taxes (28 percent of the $100,000 gain). Thus the government gets no revenue, because you elect to hold onto the stock.

But now Congress reduces the capital gains tax rate to 19.8 percent, so you decide to sell the stock because you will only have to pay $19,800 in taxes. When you do so, the government gets $19,800 it would not have had if it had not lowered the tax rate. That is not how the revenue estimators see it, though. In their view, the government in effect suffers an $8,200 *revenue loss* — or to look at it another way the revenue estimators see it, you get an $8,200 *tax benefit* from the sale.

In other words, the revenue estimators unrealistically assume that you — and everybody else with assets — would have made the same realizations at the 28 percent rate as the 19.8 percent rate. Because they make this kind of comparison, and because affluent people own most capital assets — and tend to keep them unless motivated to realize their gains — cuts in the capital gains tax always appear to massively benefit the rich even when the realizations from such a tax cut increase government tax revenues.

When the tax bill is put in perspective, we can conclude that the bill is fair. The arguments against it are based on faulty analysis.

This Brief Analysis was prepared by NCPA Senior Fellow Bruce Bartlett.

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