Thankfully, Obama's Dumb Capital Gains Plan Is Going Nowhere

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President Obama's new tax proposals show that he is not interested in bipartisan tax reform. The plan to be outlined in his State of the Union address is anti-growth, anti-savings, and pro-complexity. Left-wing political consultants might like the plan, but not serious tax reformers. Obama himself has called for simplifying the tax code, but his proposals — including the expansion of tax credits — would make the code more complicated.

Obama's worst idea is raising the top capital gains tax rate from 24 to 28 percent, which would come on top of his previous increase from 15 percent. Low capital gains tax rates are not some sort of unjustified loophole. We've had reduced rates virtually the entire time we've had an income tax, and for very good reasons. Low capital gains rates are crucially important for spurring entrepreneurship, investment, and growth.

Recognizing that, nearly every other high-income nation has reduced capital gains tax rates. The average top long-term rate in the 34 Organization for Economic Cooperation and Development (OECD) nations is just 18 percent, according to Tax Foundation. By contrast, the U.S. rate, including both federal and state taxes, would jump to 32 percent under the Obama plan — far higher than the rate in most other nations.

Congress will likely reject the Obama plan, and here is a quick refresher why it should:

- **Inflation** – If an individual buys a stock for $10 and sells it years later for $12, part of the $2 in capital gains will be inflation. By taxing inflation, the tax code reduces real returns, and thus suppresses investment, particularly in growth companies. A lower statutory rate partly solves the problem.

- **Double Taxation** – Corporate share values generally equal the present value of expected future earnings. If expected earnings rise, share values will rise, creating a capital gain to the individual. But those future earnings will be taxed at the corporate level when they occur, so also hitting individuals with a capital gains tax is double taxation. Dividends are

also double taxed, with the result that our tax system is biased against corporate equity and in favor of debt, which destabilizes companies and the overall economy.

- **Competitiveness –** Capital has become highly mobile, prompting nearly every country over the years to cut taxes on corporations, wealth, estates, dividends, and capital gains. When Canada cut its federal capital gains tax rate to 14.5 percent a number of years ago, a parliamentary report recommended that "international competitiveness be the criterion guiding the choice of a capital gains tax regime." The higher are U.S. tax rates on capital, the more job-creating investments will be scared away.

- **Growth Companies –** Reduced capital gains taxes encourage entrepreneurship because the after-tax capital-gain payoff from a successful start-up is increased. Low tax rates also boost outside investment from angels and venture capitalists because their reward for taking risks on unproven young companies is a possible gain years down the road. The higher the tax rate on gains, the fewer business investments will get the green light. Higher capital gains taxes would particularly hit areas — such as Silicon Valley — that rely on growth-oriented industries.

- **Government Revenue –** A 2012 Congressional Budget Office study found that the longer-term responsiveness of capital gains realizations to the tax rate is quite large. That means that the government's revenue gain from a capital gains tax hike would be only a small fraction of what policymakers might expect. Also, to the extent a capital gains tax hike reduced entrepreneurship and investment, the overall economy would be hurt, which would further suppress revenues.

Aside from raising the tax rate, President Obama is also proposing to tax capital gains at death, instead of the current system that allows a "step-up in basis" for assets passed to heirs. The problem is that the government already has a 40 percent estate tax that separately hits wealth at death. Most nations have either an estate or inheritance tax, or they tax capital gains at death, not both. For example, Canada does not have an estate or inheritance tax, but it taxes capital gains at death at the top federal rate of just 14.5 percent. So Obama's plan to add more taxes at death is a huge overkill.

With the Obama administration, economic policy always seems to be a zero-sum game. The administration dreams up new ways to subsidize some people, piles the tax punishment onto others, and ends up undermining economic growth for everybody. But tax reform should be a win-win proposition. By reducing the most damaging taxes — such as the capital gains tax and the corporate income tax—real reform would spur broad-based growth, which would benefit workers and entrepreneurs alike.

We can help the middle class — as Obama says he wants to — not by hooking them on more federal benefits, but by reducing government hurdles to economic growth. Cutting tax rates, not raising them, is the real way to make economic policy work for all Americans.

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