The capital gains tax threat

Chris Edwards

February 20, 2020

The splashy tax idea coming out of the Democratic nomination race has been an annual wealth tax. That far-left idea would be so unworkable and damaging that it would never pass Congress. That is the good news.

The bad news is that Democrats are pushing many other tax hikes that are more viable. One terrible idea supported by all the top vote-getters in Iowa and New Hampshire-Sanders, Warren, Biden, Buttigieg, and Klobuchar-is to hike the top capital gains tax rate from 24 to 40 percent. Capital gains taxes may seem obscure but limiting them is crucial to U.S. economic growth.

Congress has kept capital gains tax rates below ordinary rates for most of the past century, and nearly all other advanced economies provide favorable rules for gains.

One reason is inflation. If you buy a stock for $10 and sell it years later for $15, a share of the $5 gain is inflation, not a real return. A lower tax rate is a simple way to offset this unfair "inflation tax."

Another issue is double taxation. Corporate share values generally equal the present value of expected future profits. If expected profits rise, share prices will increase, creating an individual capital gain. But future profits will also be taxed at the corporate level. This double tax on corporate equity biases companies to favor debt, which has the side effect of destabilizing the economy during recessions.

International competitiveness is also a concern. Capital is mobile across borders, so higher capital gains taxes would prompt investment outflows. The U.S. federal-state capital gains tax rate of about 28 percent is already higher than the average rate in other high-income countries of just 18 percent, so we should be cutting our rate, not increasing it.

Statistical studies, such as here and here, find that higher capital gains taxes produce lower investment. Furthermore, governments lose revenues from capital gains taxes when the rate is above about 20 percent because the tax base shrinks. Thus both the economy and the government would lose under proposed Democratic tax hikes.

The rubber hits the road on capital gains when it comes to entrepreneurial finance. The reward that "angel investors" receive for putting their time and money into startup companies is a capital gain five or 10 years down the road. These are high-risk investments, but the economy needs a diversity of startups to discover new products and technologies.

Raising the capital gains tax would induce angels to shift their money to safer investments and the economy would be starved of the funding that high-growth companies and technology industries rely on.

Higher capital gains taxes would also reduce entrepreneurship. People considering launching startups would instead take safer wage jobs. The chance to earn a capital gain from a high-growth startup would not be worth all the extra stress, risk, and hard work.

When technology companies are acquired or go public, it generates a "wealth waterfall" as investors and employees sell shares and use their after-tax gains to invest in new startups. Such wealth recycling has been central to Silicon Valley's growth for decades. But Democratic plans would kill this reinvestment cycle and drain cash out of innovation hubs such as Silicon Valley.

For the U.S. economy, startups are crucial because 8 percent of all companies go out of business each year. Startups fill the void, especially high-growth and innovative startups called "gazelles." From Apple Computer in the 1970s, to Amazon in the 1990s, to Airbnb today, gazelles are fueled by risk capital and favorable capital gains taxes have kept the fuel flowing.

Some Democrats used to understand these ideas. Arguing in favor of capital gains tax cuts at June 1978 hearings, Sen. Lloyd Bentsen (D-Texas) said, "This country has prospered because we have had a free enterprise system that has encouraged the entrepreneur, the small businessman, to take a risk with the understanding that he was going to be able to keep some of it, if he won."

But Democrats today want to hike the capital gains tax rate and further increase the burden by taxing gains on an accrual basis. No other OECD country imposes such punishing capital gains tax treatment.

What's the best capital gains tax policy? Federal Reserve chair Alan Greenspan got it right at 1997 Senate Banking Committee hearings. He said, "While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale." The proper rate for capital gains taxes, Greenspan concluded, is zero.

Chris Edwards is director of tax policy studies at the Cato Institute.