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Advantages of Low Capital Gains Tax Rates

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The capital gains tax is set to increase again, putting it much higher than the average Organization for Economic Cooperation and Development (OECD) rate. Many economists have long argued that the capital gains tax is an impediment to entrepreneurial activity and overall economic growth, says Chris Edwards, director of tax policy studies at the Cato Institute.

- The U.S. capital gains tax rate was 15 percent in 2012 for top-bracket taxpayers.
- However, under the recently passed Fiscal Cliff bill, the rate will increase to 20 percent in 2013 for top-bracket taxpayers.
- In contrast, the average capital gains tax rate of OECD countries is only 16.4 percent.
- Surprisingly, 11 of the OECD countries don't impose a capital gains tax.

Many liberal economists point to the Haig-Simmons definition of income, which argues that income equals consumption plus the rise in market value of all net wealth during a year. Naturally, this would include capital income.

However, there are several flaws with this model. First, it creates the problem of "bunching," which means that realizations have a transitory spike in which a taxpayer may be pushed into a higher tax bracket because of something like a one-time sale of a family business. A second problem is called "lock-in," in which taxpayers delay selling investments to avoid the tax hit.

In addition, an economy with inflation can substantially reduce the amount of returns on an investment. As a result, people are less likely to invest because of the uncertainty of future returns from capital gains.

Moreover, the capital gains tax has hurt U.S. competitiveness. Because capital is highly mobile across borders, the tax base can shrink dramatically and relocate elsewhere to avoid high taxes on capital gains.

More importantly, growth of small companies requires a low capital gains tax. Many companies receive start-up capital from angel investors or venture capitalists. However, a high capital gains tax discourages these investors from taking on risk in small companies because of the prospect of low returns.

If policymakers are willing to cut the capital gains tax, the tax base would expand over time and overall economic activity would be increased. As a result, the wealth of millions of Americans would increase and many new businesses would expand.

Source: Chris Edwards, "Advantages of Low Capital Gains Tax Rates," Cato Institute, December 2012. Laura Saunders, "High Earners Facing First Major Tax Increase in Years," Wall Street Journal, January 1, 2013.