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Colloquium on Capital Gains: Commentary

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Commentary

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George Zodrow's article[1] is extremely comprehensive, particularly regarding the empirical literature and how this literature pertains to revenue estimation. It also discusses the theoretical issues involved in modeling capital gains behavior and analyzing welfare effects of tax changes. Perhaps its most important contribution, though, is its emphasis on the difficulty in relating empirical and theoretical results, given the complicated behavioral issues involved.

In addition to being thorough, Professor Zodrow is sensible and evenhanded as well. I found very little in his entire discussion with which I disagreed. My main criticism is of the article's choice of topics. Given the complexity of the subject and the article's length and coverage, Professor Zodrow had to make decisions about what economic considerations not to cover, and he explicitly has omitted a discussion of the costs and benefits of a move to some form of accrual or accrual-equivalent capital gains taxation.

In a sense, this choice simply reflects the nature of the debate. Professor Zodrow focuses on the issues that have received the most attention. Indeed, this is one of the major problems with the existing policy debate: There has been so much discussion about revenues and realizations elasticities, and so little about changes in capital gains taxation beyond whether the rate should be raised or lowered. Yet, it is now known that moving toward a system of accrual taxation, or its equivalent—and eliminating the lock-in effect and timing arbitrage entirely—would not be especially difficult for the bulk of investments. It strikes me that there is probably a bigger social payoff in trying to work out details of a transition to such a system than in getting more reliable estimates of realizations elasticities. Part of this task may be explaining why the political discussion continues to focus on the narrow questions when clearly superior alternatives exist.

Now, let me turn to what *is* covered in the paper. I'll begin by summarizing Professor Zodrow's conclusions, from my perspective. First, modeling realizations behavior is theoretically difficult, because straightforward economic models without transaction costs predict

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[1] George Zodrow, Economic Analyses of Capital Gains Taxation: Realizations, Revenues, Efficiency and Equity, 48 Tax L. Rev. 419 (1993).

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that investors will pay capital gains taxes only insofar as this permits them to avoid paying other taxes. Second, the same modeling conclusions make welfare analysis difficult, because it is not clear what changes in capital gains realizations represent in terms of changes in underlying economic behavior. Unlike a change in labor supply or saving, a change in capital gains realizations is not associated directly with things that produce "utility" for households. This is one reason why realizations can be so responsive to tax changes. Third, these ambiguities notwithstanding, empirical analysis plugs away. Perhaps because economists cannot say much about economic welfare, they focus on revenue. Why? Because the implication is that if a capital gains tax rate cut raises revenue, everyone must be better off; if all are better off, you need not know by how much to conclude that the policy is a good one.

Considering the empirical literature, my fourth summary point is that, although capital gains realizations clearly respond to taxes, there is dispute over whether such responsiveness represents the timing of gains or changes in the long-run level of gains. Professor Zodrow describes the literature's growing sophistication with respect to timing and expectations issues. The most plausible findings are the more recent ones that, in time series studies, account explicitly for expected future tax changes and, in studies with panel data, carefully distinguish between temporary and permanent individual responses. Both of these approaches produce rather low "long-run" elasticities, indicating a long-run revenue loss if the capital gains tax rate is reduced.

Finally, what this evolution of the empirical literature demonstrates is that one really cannot separate theory from empirical research about elasticities. If capital gains tax collections increase in the short run, theory has guided empirical researchers to ask whether these revenues come at the expense of other years' collections. It is also necessary to know the extent to which this is simply the observance of the displacement of other taxes that theory predicts—a phenomenon that empirical research has, as yet, found difficult to measure. Unfortunately, I am not as sanguine as Professor Zodrow that continued progress is possible through a closer connection between theory and empirical research, at least until the theoretical models come closer to describing reality.

Beyond summarizing the state of economic understanding about capital gains behavior, this article illustrates the progress that clear-headed economic reasoning can produce. For example, it is known that the lock-in effect is primarily not one of capital allocation to enterprises, but of risk bearing among individual investors; in fact, higher capital gains taxes can reduce retentions and direct money

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more quickly to new enterprises. Second, encouraging risk taking, per se, is a very poor reason for general capital gains tax reductions, since (even if there is a reason for wanting to encourage risk taking) so little of the tax benefit goes to venture capital. Third, capital gains tax cuts are incentives for saving, not investment, since they accrue to U.S. individuals, the suppliers of funds, and not U.S. businesses, the demanders. Hence, it is necessary to increase the supply of saving to the business sector to increase business investment through a capital gains tax cut.

Going beyond the points made in the article, other simple conclusions worth pointing out include the fact that capital gains tax cuts involve very large windfalls to existing assets (larger than would result from reductions in other, accrual-based capital income taxes). As a result, such tax cuts will have a very large income effect, leading to a reduction in saving that almost certainly will outweigh any substitution effect toward increased saving that the reduced tax wedge itself produces. Or, if there is a real concern about the lock-in effect and an aversion to moving toward accrual taxation, it is better to eliminate the major cause of the lock-in effect, the step up in basis at death, than to simply lower the capital gains tax rate.

In summary, there is a lot to learn from thinking about the structure of capital gains taxation, even if there never will be a certainty as to what realization elasticities are or what they mean. Perhaps economists should devote more time trying to shift the debate toward more relevant issues, or at least to understanding why it continues to focus on the wrong question.

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