Colloquium on Capital Gains: Commentary

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Recommended Citation
Colloquium on Capital Gains: Commentary, 48 Tax L. Rev. 529 (1993)
Commentary

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George Zodrow's article 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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that investors will pay capital gains taxes only insofar as this permits
them to avoid paying other taxes. Second, the same modeling conclu-
sions 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 am-
biguities notwithstanding, empirical analysis plugs away. Perhaps be-
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 bet-
ter 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 de-
scribes the literature's growing sophistication with respect to timing
and expectations issues. The most plausible findings are the more re-
cent 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 rev-
enues come at the expense of other years' collections. It is also neces-
sary 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. Unfortu-
nately, I am not as sanguine as Professor Zodrow that continued pro-
gress 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 en-
terprises, but of risk bearing among individual investors; in fact,
higher capital gains taxes can reduce retentions and direct money
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.