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THE WHITE HOUSE

WASHINGTON

February 3, 1989

MEMORANDUM FOR ROGER PORTER

FROM: LARRY LINDSEY

SUBJECT: CAPITAL GAINS TAXES

Recent debate on the subject of capital gains taxation has focussed on the issue of tax revenue. While the revenue implications are an important consideration, they are not the primary reason why the capital gains tax rate should be lowered. We need to lower capital gains tax rates from their current levels because they are unfair, out of line with historic experience, retard capital formation and economic growth, and play mischief with our financial markets by encouraging leveraged buyouts.

The Revenue Issue

The plain truth is that the economics profession cannot predict with any degree of precision what the revenue implications of a reduction in the capital gains tax rate would be. Even economists who are in basic agreement regarding the effects the capital gains tax might differ by as much as $5 billion regarding the revenue effects of a tax cut. Still, the economic literature is sufficiently clear that we can draw several important conclusions.

There is virtually no doubt that the current maximum capital gains tax rate of 33 percent is too high from a revenue point of view. Even the CBO study of capital gains, which the press has widely cited as critical of the President's campaign pledge to cut the top capital gains tax rate, shows that 33 is too high. The CBO study places the revenue maximizing top tax rate tax rate in the 25 percent to 32 percent range. To my knowledge, NO study produces a revenue maximizing rate of over 32 percent.

The consensus view is that the revenue maximizing capital gains tax rate is about 20 percent. Again, studies differ. Some put the revenue maximizing rate in the low teens. The study which has tracked our experience since 1986 the best was done by Auten and Clotfelter. It implies a revenue maximizing rate of 21 percent. Minarik and CBO imply rates in the high 20s. My own best guess is 18 percent.

But, only a very foolish government would set tax rates at their revenue maximizing level. At the revenue maximizing rate the government is soaking the taxpayers for every cent it can without regard to the consequences. In economic terms, the excess burden on the economy of raising the last dollar of tax revenue at the revenue maximizing rate is infinite. The revenue maximizing rate is to be avoided, not sought. Sensible political debate should focus on how much below the revenue maximizing rate we can afford to set tax rates.

Policy evaluation therefore requires cost-benefit analysis. We must way the revenue costs of rate reduction (if any) against the economic benefits to be gained. Even using the most extreme of the CBO assumptions, the revenue cost of substantial rate reduction is quite small. For example, a cut from 33 to 25 percent would only cost $1 billion. A cut to 20 percent would cost less than $4 billion and a cut to 15 percent would cost under $8 billion. By contrast, the Treasury and academic investigators find that reducing the rate to 15 percent will produce an increase tax revenue of several billion dollars. Given the uncertainty involved and the relatively small size of the possible revenue effect in either direction, the revenue implications of a change in the capital gains tax rate should be viewed as a minor consideration in crafting capital gains tax changes.

Distributional Considerations

One of the key concerns expressed by opponents of a capital gains tax cut is its effect on the distribution of the tax burden. It is true that capital gains are received disproportionately by upper income taxpayers. However, opponents of capital gains tax cuts (including Governor Dukakis in the recent campaign) exaggerate these distributional problems in two ways.

Opponents of capital gains tax cuts do not take feedback effects into account in arguing that the tax cut favors the rich. The economic evidence suggests that a capital gains tax cut will increase the capital gains taxes paid by upper income individuals, not decrease them. Thus, the distribution of taxes paid will fall more on upper income taxpayers, not less.

Opponents avoid this fact by talking about the distribution of the tax burden, not the distribution of tax revenues. Clearly well-to-do taxpayers are better off with lower capital gains tax rates even though they pay more in tax revenue.

Both the government and the taxpayer gain from lower rates because the distorting effect of capital gains taxes is lowered when the rate is cut. Thus, the burden of the tax falls even though revenue is increased.

We should be sure to stress that the distribution of tax revenue, not the distribution of the tax burden is what is important. For example, a 100 percent tax rate on high income taxpayers would obviously be quite burdensome. It also would produce no revenue. Do we really want to have taxes just to burden people or do we want to raise revenue to pay the costs of government? Our analysis should stress who pays the cost of government and not whether we are making taxes sufficiently burdensome for those who must pay them.

Opponents also exaggerate the distributional effects of capital gains by counting one time gains in their distribution of income. Many of the so-called "rich" are classified as receiving a high income only because of their capital gains. For example, a small businessman who typically earned $50,000 per year might sell his business for $300,000 and retire. The year he retires, he is classified as having an Adjusted Gross Income (AGI) of $350,000, a figure which clearly exaggerates his true economic situation.

Instead, we should focus on taxpayers' recurring income; that is their income except for capital gains. The following table shows just how dramatically the definition of income affects the perceived distribution of capital gains.

Distribution of Capital Gains for 1985

Income Class	AGI Definition	Recurring Income
under $20,000	12.2%	26.0%
$20,000 - $50,000	13.5%	18.9%
$50,000 - $100,000	16.1%	17.6%
$100,000 - $200,000	13.7%	12.8%
over $200,000	44.5%	24.7%

The data show that when we use the tax return definition of income, AGI, nearly half of all capital gains are reported by taxpayers earning over $200,000. But, when capital gains are excluded from the definition of income, this figure drops to less than one quarter of all gains. Similarly, while the tax return definition of income indicates that only about one quarter of all gains accrue to taxpayers with AGI under $50,000, nearly half of all gains accrue to people with incomes under $50,000 if the recurring income definition is used.

These data reinforce the concept that a cut in the capital gains tax rate will benefit taxpayers at all points in the income distribution and not just a few wealthy taxpayers. One group which will benefit particularly will be the elderly who realize capital gains at a rate nearly two and one half times as great as taxpayers under 65. These are people who are selling off their assets in order to finance their retirement and who should not be considered "rich" by the usual definition of the term.

Current Tax Rates on Capital Gains are at Historic Highs Particularly for Low and Moderate Income Taxpayers

The income tax recognized the special nature of capital gains income for more than half a century before the passage of the Tax Reform Act of 1986. That tax bill enacted the largest capital gains tax rate increase in the history of the income tax. Most low and moderate income taxpayers saw their tax rates more than double. Many saw their tax rates more than triple. By contrast, very top earners saw a much more modest, 40 percent, increase in their tax rates.

Current high rates out of line with historical experience and represent a dangerous experiment. By contrast, a 15 percent top rate would return capital gains tax rates to roughly their historic level. Between 1960 and 1984, the weighted average marginal tax rate on capital gains was 18.5 percent. Over that period it ranged from a low of 16.2 percent in 1982 to a high of 20.7 percent in 1969. By contrast, current law increases that rate to a weighted average 26.3 percent.

Inflation and Capital Gains

One of the major problems with capital gains taxation is that much of the income on which the tax is levied does not represent real income to the taxpayer. Instead, it represents purely inflationary increases in the overall level of prices. This violates the principle of income taxation as income is supposed to produce a rise in the taxpayer's well being. In effect we are asking people who have no income to pay a tax.

Consider a taxpayer who purchased one unit of the Dow Jones Industrial Average in 1967 for $879. Furthermore, the investor was smart enough to sell on August 25, 1987 at the very top of the market -- $2722. Under the current tax law, that investor would have a capital gain of $1843 and be subject to a tax of $516. But, prices rose 238 percent between 1967 and 1987. To have the same real purchasing power, the taxpayer's $879 would have had to have grown to $2966. So, instead of being better off by $1843, the taxpayer was actually worse off by $244. Yet, capital gains taxes were still due.

Obviously the taxpayer in the above example did better than most other investors. Most people do not pick the exact high of the market to sell their securities. Substantial evidence exists from studies by Feldstein and others that, on average, the nominal capital gains on which people pay tax actually represent real capital losses.

The best way to solve this problem would be to index the cost, or basis, of investment assets and have people pay taxes only on their real capital gains. But, given that real capital gains may be negative, the revenue cost of this option is enormous. Instead, a partial rate reduction for capital gains has been used historically as a compromise solution to this problem. <u>Taxing capital gains without adjusting for inflation at regular tax rates unfairly overtaxes this form of income.</u>

<u>Investment and Entrepreneurship</u>

Capital gains also discourages investment in new plant and equipment by taxing the return available to investors. While the precise effect of capital gains taxes on the cost of capital is a matter of some dispute, the effect is clear cut.

The most obvious impact of capital gains on the cost of capital is the "double taxation" effect. A corporation pays tax on its profits which it retains in the firm in order to build its capital stock. Every dollar retained by the company makes its stock worth more. So, investors in common stock are forced to pay capital gains tax on the increase in the value of their holdings due to retained earnings as well as the corporation income tax on the initial profits of the company.

The capital gains tax also particularly discourages investment by those firms which provide the bulk of job creation in the country: start up companies. These entrepreneurs often have difficulty attracting new investment through established sources because they lack a track record. They rarely have any collateral to offer investors aside from a share in the enterprise. The return to these entrepreneurs and to their investors is largely in the form of capital appreciation.

Unfortunately, the new tax law is not symmetric in its tax treatment of gains and losses. The tax law makes Uncle Sam a full partner with these investors and entrepreneurs if they are successful but limits their ability to apply their losses to their income for tax purposes if they fail. By taxing winners and abandoning losers, the tax system effectively places an extra tax on risk taking.

Current rules against taking investment losses against other income were designed to reduce tax sheltering opportunities for rich investors. It may not be advisable to make Uncle Sam an equal partner with winners and losers as high income investors may find ways of producing losses in economically unproductive ways. Still, it is bad tax policy to place an extra tax burden on risk taking an entrepreneurship. One way to solve this problem is to offer a lower tax rate on successful investments by lowering the capital gains tax rate.

Capital Gains and Leveraged Buyouts

One area of recent concern among economists and political decision makers has been the tax motivated buyout of firms by other investors. The tax system offers an incentive for this activity because debt finance is favored over equity finance. Borrowers may deduct the interest cost of their capital but the return to equity -- dividends and capital gains -- is fully taxed.

High capital gains tax rates encourage leveraged buyouts by raising the cost of equity finance relative to tax finance. It is not a coincidence that the recent rash of leveraged buyouts followed the record increase in the tax rate on capital gains enacted in the Tax Reform Act of 1986.

To see how this works, assume that you have $1000 invested in a company which pays no dividends buy reinvests its proceeds in the company to produce a stock price which rises over time. The company earns 20 percent on its equity capital. It then pays the 34 percent corporate tax on its profits, leaving the company with an after-tax return of 13.2 percent, which is reinvested. Your stock is rising 13.2 percent per year. After capital gains tax you are earning 9.5 percent per year. You figure that, adjusted for risk, this is about as good a return as the 8 percent you can earn tax free in municipal bonds A leveraged buyout company offers you $1200 for your stock. The offer is good for you because putting that money in municipals gives you $96 dollars in income whereas you were only earning $95 after tax on the stock. Besides, you have no risk.

How can the buyer of the firm do it? First, the deal is financed by issuing junk bonds which yield 15 percent. The buyer had to issue $1200 in junk bonds for every $1000 of stock outstanding. So, the net interest cost dollar of equity purchased is 18 percent. As long as the company continues to earn 20 percent on its equity capital, the debt payments are covered and the buyer is making a 2 percent margin to spare without ever having put up any of his own money.

Reducing the capital gains tax rate will make this type of buyout more difficult because long term investors will keep a larger share of the return on their investments, after tax. For example, if the capital gains tax was cut to 15 percent, the investor would be taking home 11.2 percent instead of 9.5 percent. The take over artist could not make the deal profitably.

Conclusion

Reducing the capital gains tax rate involves a comparison the costs and the benefits of such a move. The evidence suggests that the costs, in terms of revenue and distribution of the tax burden are minimal. Instead of focussing on these costs, the debate should turn to the benefits of capital gains taxation. They include returning rates to historic levels, taking care of the part of the problem of taxing inflationary gains, encouraging risk taking, investing, and entrepreneurship, and discouraging leveraged buyouts. Taken as a whole, the benefits of such a move so greatly outweigh the costs that Congress would be foolish not to enact a substantial reduction in the capital gains tax rate.

c: Jim Pinkerton

THE FUTURE OF AMERICAN BUSINESS
AND
THE EFFECTS OF LBOs ON THE AMERICAN ECONOMY

There has been much ado about the fervor of activity in the financial markets during the past few years. From Ivan Boesky, insider trading, the Crash, merger & acquisition mania, hostile takeovers, to leveraged buy outs (LBO's), much attention has been focused on Wall Street -- why? More than anything else, it is a foster child of the media. Lest we forget the popularity of the television show, Lifestyles of the Rich & Famous, it is not only sex that sells on TV, but equally money.

While the economy marches steadily onward up the plateau of the greatest peace-time expansion in the history of the United States, there is relatively little economic news to report. There are no food lines, and there are no revolutions. There is peace and prosperity.

Perhaps what there is not is innovation. Aside from the personal computer, there have been no new U.S. products introduced into the marketplace. Most of the growth in the U.S. has been an expansion and modernization of its base industries, as well as an enormous explosion in the service industry. We have been 'tending shop,' stocking the shelves, and feathering our nest. We are far and away the leading economic power in the world and our strength merits our self-service, yet we have mortgaged the perception of our strength to the innovation of foreign economies -- we are transfixed by the brilliance of the rising sun.

In devaluing the dollar, we, in effect, cut our currency to equal that of youthful, growing economies in hopes of improving exports. The result has been that Japan, and countries like it, have been able to woo the American consumer with the products of a post WWII chartered technologic industry while reaping the benefits of a pre-WWII agricultural foundation. Their growing economies have flourished while we have been hypnotized by their technology, taking it all for granted.

We must not be drowned by perceptions. The United States is the most resilient economy ever -- probably way beyond the marvels of Ronald Reagan and his supply-side economists. The machine works. What we have been doing is trying to bring the rest of the world up to speed. In those attempts, we have stooped down to aid our trading partners, and pursuing their own interests, they have hopped upon our shoulders. Thus, in the world of perceptions, countries like Japan stand taller than us. Yet, where have the Japanese made their money? Where to the Japanese invest? What giant's shoulder do they stand upon?

Japan would be nowhere without the market economy of the United States. Their economy is nearly entirely based upon the desires of the American consumer.

Business in America has been out hustled by the steroid fed hyper-economy of Japan. The distinct advantages of the Japanese economy are that it started from scratch in 1950, re-evolving industry and business to meet the needs of the post World War era, as well as the fact that while we devalued the dollar, Japan's economy was in such a state of virgin growth that it was able to absorb the devaluation while maintaining domestic growth and expansion.

This brings us back to the domestic front: where is there money to be made? Where does a company with $10 billion in annual sales make money? Not in the same places it did fifty years ago.

American business as we know it has exhausted its big money revenue outlets. Giant conglomerates have nearly mastered the marketplace, and they can deliver nearly any product. Through advertising, the United States is bombarded with pin point accuracy, and the consumer robotically responds. In such an environment, new products are often squelched by the overpowering giants of the marketplace. Innovation is lost to efficiency.

Through the power of conglomeration, business and industry are able to braid together several revenue streams to create a more powerful corporation. These small companies (revenue streams) are pared of their waste, and their resulting success helps pay off the debt the parent company used to buy them. The parent company then benefits from increased capital. The new products of the parent company benefit from the use of that capital in their favor (marketing, distribution, reduced production costs, etc..)

What results is a more efficient company with a bigger revenue stream and greater capital. This new company has the power to expand and develop in way which it could not before. Minding its bottom line, the new company might expand into an area which could benefit several or all of its acquired parts. (e.g. Hundreds of employees need to travel between Boston, New York, and Washington every week. Instead of paying commercial carriers, the new company might use its capital to build a commuter shuttle between the cities -- one as a way to get employees to and fro, and two, to act as a new revenue stream.) In this way, large conglomerated companies can be a good thing.

In a micro sense, one can look at the situation as products coming under the 'regulation' of a parent organization. In the long run, this is not always beneficial to the child companies. While they benefit from the power of the capital, they are also tied to the bottom line. An acquired company often has even more potential than the buyer is aware. When that 'over-achiever' reaches its budget constraint, the effect often results in ripening the parent company as a takeover candidate.

As the parent company is dependent on the revenue of all its children, it cannot logically favor one over all the rest. As a consequence, there is a serious lack of dynamic use of capital, an essential tool in keeping a company fit. As the times change, industry needs to change as well. If a parent company does not let its 'children' develop to their potential, no matter how much better off the parent is, the combined potential value of the children can creep past the value of the parent company as a whole. In addition, if market trends fall, the lowered stock price of a parent company can price it below the estimated value of its 'separated' parts.

Probably one of the largest factors in expediting this decay, ironic thought it may seem, is the advancement of technology. Because the parent company is tied to its bottom line, it often cannot afford the capital outlays to modernize all its divisions. Each 'unrelated' division might have a separate need, and the initial capital costs could well exceed its budget under the parent company. Additionally, even if debt were a viable option for a division, the revenue demands from the parent company could negate that option.

Enter the leveraged buy-out, or LBO, the 'deregulator' of corporate America. The thrust behind a LBO is to break up the parent company and sell its pieces at a profit much greater than the purchase price. In other words, it creates a lot of little companies from one big one. It can also produce enormous profits for a successful bidder. <u>This</u> is where the money is made.

There are few colossal profit motives left in the U.S. In business, everybody wants to build a better mousetrap, but today's problem is that G.E. already makes mousetraps, mousetraps with the collective backing of some of the largest corporations in the nation. Barring anti-trust implications, this brings us back to the lack of innovation. With corporate power in a few hands, individual innovation is squelched, leaving business up to the 'big guys'. When the 'big guys' stop stirring the pot, the money makers on Wall Street start looking for other ways to make their money. If there is a profit to be made, someone will try and make it, and the leveraged buy out is a prime tool for turning a profit.

The basic concept behind a leveraged buy out is to purchase a company with a small amount of cash, financing the remainder of the purchase with an issuance of junk bonds and then using the company itself as collateral for a massive corporate loan. As a business transaction, the leveraged buy out is a bedrock free-market ideal -- a basic agreement between a lender and a borrower to consume a product. However, as a national economic risk, the recent plethora of LBOs forces the country to cross a gorge of debt supported only by our rope-bridge economy. A land of opportunity awaits on the other side, and while the bridge is strong, it does sway in the breeze, and it is a long way down.

President Reagan provided for a cinematic recovery of the American economy, nursing it back from the strangle hold of the Carter Administration. For eight years, companies, like sick children, were allowed free reign by the government; corporate America was nursed on ice cream and allowed to watch T.V. all day. Notwithstanding the fact that the U.S. economy has recovered, it has been laid-up for eight years while its rivals have been forging the frontier.

The numbers will show that the U.S. has a growing economy, but in what direction? We have been expanding and filling out our base industries. All the while, however, our competitive muscle has atrophied. Are we better off than we were eight years ago? Yes. However, are we better off than we were sixteen years ago? That might be a debatable point; excluding the 'natural technologic' evolutions, we may be right back where we started.

The economic engine is humming, and corporate business is at the wheel -- we are out again for a ride in our Cadillac. However, unlike the drive a decade and a half ago, there are some new cars on the road. A Japanese import and a German performance car have pulled up behind us. "Beep-beep. Beep-beep. His horn went beep-beep-beep." Let's show them that a Cadillac is not a car to scorn.

The advent of leveraged buy outs is a blessing in disguise. The foremost advantage is that stirs up the economy and dynamically remodels business. Yet one can make the analogy that LBOs are like the coming of a heart attack. We are out of shape, and LBOs are a minor heart attack; we will survive, but we will be shaken. After they pass, we will begin with a fresh perspective. In effect they are 'healthy' for the economy -- shock treatment for a greedy ignorant.

Hindsight will prove valuable in this situation. We encouraged businesses to be self-serving; the market is now breaking those business up. We saw the power of the market mechanism, and even though we slipped, we know we can make it the rest of the way across that rope bridge. The challenge now is to keep the economy healthy the rest of the way, and on into the 21st century. We must change greed to investment, and want into inspiration and innovation.

It is too late for the government to interfere in the leveraged buy out process. Doing that will merely rock the boat and dump us overboard. What can we do for insurance, and how might we protect ourselves in the future?

Despite the desires of resident political forces, the U.S. is ripe for a healthy recession. This is not to say that one necessarily needs to happen; however, one may be brought on by the slightest aberration of the market. With such high levels of corporate debt, a recession could seriously injure the banking community, not to mention the corporate subjects of LBOs.

A domino effect is then started: with less confidence in American investment, the dollar would plummet against foreign currencies, skyrocketing the prices of imports which the country has come dependent upon. The Federal Reserve Board would be powerless to act as a relief force -- flooding the market would send inflation soaring, only hurting industry more, and tightening credit would bring about huge unemployment. The political ramifications, no less the economic ones, are enough to make one sit up and take notice.

What to do, what to do? How does one stabilize an indebted society? The answer is as plain as the nose on your face, invest. Investment in America keeps the fires burning, providing for a stable environment for business redevelopment. How does one get the nation to invest? Provide it with the incentive.

Cutting the capital gains tax is one of the leading candidates as an incentive. To maintain and solidify investment levels, the introduction of an increased dividend and interest exclusion would be advisory. On the revenue side, one might limit or cap the amount of tax free interest a company could deduct each year.

Where a leveraged buyout is concerned, or even an acquisition of the magnitude of a significant percentage of the value of the acquirer, a minimum limit should somehow be imposed as to the amount of liquid assets used in a purchase. As was the case in 1929, stocks were purchased with a mere 15% down, because the market was yielding a much higher percentage. Yet, when the market crashed, people with 85% margin calls on suddenly worthless stocks were left on a window sill with only one way to go. Much the same can be said about the LBO's, as they use the acquired company as collateral.

Federal Reserve intervention would seem to be the most logical approach to this 'regulation' - a back-door approach to curbing outrageous corporate borrowing. Member banks could not lend more than an appropriate percentage of their deposits to corporations. This does not necessarily have to be very stringent, but it would put greater responsibilities on the financiers of such immense deals. Perhaps even the introduction of regulations defining the amount of money an institution could lend to any individual endeavor, base on a percentage equation of lender and borrower's assets. In this manner, the government does not directly interfere with the free market mechanism, while it does curb otherwise outrageous debentures.

The final incentive for investment, is to make industry dynamic and fruitful. Innovation is the spark in the engine, and everyone likes to invest in a forward looking enterprise. What ever happened to the R&D laboratories of AT&T, those houses of experiment that inspired thinkers to tinker and advance technology? What this country needs is more research and development, and in the aftermath of LBO's, corporations are too scared to devote valuable resources to such a risky expenditure. Again, without tinkering with the free market mechanism, the government can invest in the future of the American economy at negligible cost.

While we have attempted to embellish the halls of higher learning with grants and equipment, the access and output of such expenditures is limited in the way it benefits the machinery of business. A more effective and productive use of government funds would be to act as the initiator of R&D clearinghouses. Regulated through the Commerce Department, "merit" or "magnet" institutions of innovation could be founded with government grants. This frees corporations from the capital burden of massive investment, and they could invest in attracting brilliant minds. Government provides the facility and equipment -- which must be of the highest quality -- industry provides the incentive to work and receives the fruits of technologic advancement.

All that need be done is dangle the carrot in front of the rabbit.

Let us not forget that, "the business of America is business."