

Capital gains tax rates benefiting wealthy feed growing gap between rich and poor

By Steven Mufson and Jia Lynn Yang



The K Street office of Mark Bloomfield, president of the American Council for Capital Formation, is full of knickknacks collected in three decades of lobbying for cutting the capital gains tax.

The coffee table has campaign buttons that read “Capital Gains = Better Jobs.” One wall displays a blown-up cartoon retracing the steps that led President Jimmy Carter to reluctantly sign a cut in the capital gains tax rate. On a shelf sits a framed, handwritten note from President George W. Bush in December 2003 that says: “Dear Mark, I got your treatise on taxes — many thanks. I will look it over with keen interest. Merry Christmas.”

For the very richest Americans, low tax rates on capital gains are better than any Christmas gift. As a result of a pair of rate cuts, first under President Bill Clinton and then under Bush, most of the richest Americans pay lower overall tax rates than middle-class Americans do. And this is one reason the gap between the wealthy and the rest of the country is widening dramatically.

The rates on capital gains — which include profits from the sale of stocks, bonds and real estate — should be a key point in negotiations over how to shrink the budget deficit, some lawmakers say.

“This is something that should be on the table,” said Rep. Chris Van Hollen (D-Md.), one of 12 members on the congressional “supercommittee” tasked with reducing the deficit. “There’s no strong economic rationale for the huge gap that exists now between the rate for wages and the rate for capital gains.”

Advocates for a low capital gains rate say it spurs more investment in the U.S. economy, benefiting all Americans. But some tax experts say the evidence for that theory is murky at best. What is clear is that the capital gains tax rate disproportionately benefits the ultra-wealthy.

Most Americans depend on wages and salaries for their income, which is subject to a graduated tax so the big earners pay higher percentages. The capital gains tax turns that idea on its head, capping the rate at 15 percent for long-term investments. As a result, anyone making more than \$34,500 a year in wages and salary is taxed at a higher rate than a billionaire is taxed on untold millions in capital gains.

While it’s true that many middle-class Americans own stocks or bonds, they tend to stash them in tax-sheltered retirement accounts, where the capital gains rate does not apply. By contrast, the richest Americans reap huge benefits. Over the past 20 years, more than 80 percent of the capital gains income realized in the United States has gone to 5 percent of the people; about half of all the capital gains have gone to the wealthiest 0.1 percent.

“The way you get rich in this world is not by working hard,” said Marty Sullivan, an economist and a contributing editor to *Tax Analysts*. “It’s by owning large amounts of assets and having those things appreciate in value.”

Republicans have led the way in pressing for low capital gains tax rates, but they have been able to rely on a significant bloc of Democratic allies to prevent an increase and to protect the preferential treatment of money earned through investments over money earned through labor.

President Obama and leading Democrats want to allow the tax cuts passed under Bush to expire. That would raise the capital gains tax rate from 15 percent to 20 percent. But that would still be lower than the rate under President Ronald Reagan — who raised the tax in 1986.

“Capital gains . . . veers onto theology for Republicans, but it has always been a bipartisan issue,” Bloomfield said.

A poll this spring by the nonprofit Public Religion Research Institute showed that Americans, by a 2-to-1 margin, think the wealthy should pay more taxes than the middle class and the poor.

Billionaire Warren Buffett has become one of the loudest and most frequently cited proponents of the wealthy paying more in taxes.

“The truth is, I have never had it so good in terms of taxes,” Buffett said in an interview with Charlie Rose. “I am paying the lowest tax rate that I’ve ever paid in my life. Now that’s crazy, you know. And if you look at Forbes 400, they are paying a lower rate, counting payroll taxes, than their secretary or whomever around their office, on average.”

How the wealthiest Americans managed to get Congress to treat money made from investments differently from salaries or wages involved a variety of lobbyists, economists and lawmakers.

“Capital gains is economics, theology and politics wrapped together,” Bloomfield said.

The Greenspan effect

The theory justifying low capital gains taxes has many philosophical fathers but none as influential as Alan Greenspan, the former Federal Reserve chairman who was treated as an economic seer for decades.

Greenspan said capital gains taxes made people reluctant to move out of one investment and into other, more-promising ones.

In 1997 congressional testimony, Greenspan said the “major impact” of the capital gains tax, “as best I can judge, is to impede entrepreneurial activity and capital formation.”

“The appropriate capital gains tax rate was zero,” he added.

Greenspan’s thinking had been around for decades. The same approach was adopted in 1921, just before a stock market boom, when the U.S. government lowered the capital gains rate for the first time. Over the decades, the rate fluctuated but remained lower than the rate on wage income.

Then in 1986, under a far-reaching tax bill, Democrats cut a deal with Reagan to raise the tax on investments and lower the one for salaries. For the first time in 65 years, both forms of income would be taxed at the same rate: 28 percent.

But that moment was brief.

In 1990 and 1993, the top tax rates on other forms of income rose, while the tax on capital gains stayed put, a disappointment to President George H.W. Bush, who wanted even lower capital gains rates.

After the Republicans took control of Congress in 1994, they again pressed for capital gains rate cuts.

Greenspan was then near the peak of his credibility in Washington. In 1993, he promised Clinton that he would lower interest rates if Clinton backed a deal to narrow the budget deficit. Both men delivered, building trust.

By 1997, the GOP leaders were turning to Greenspan for economic cover and inspiration.

“Now I agree with Steve Moore and Alan Greenspan that the correct rate is zero if you want maximum economic growth,” House Speaker Newt Gingrich (R-Ga.) said at the Cato Institute on July 16, 1998. “If you really wanted the most wealth created over the next 20 years, you would have a zero rate for the capital gains tax, which is a tax on job creation.”

Other GOP lawmakers formed the Zero Capital Gains Caucus, with 92 House members and 15 senators. The group’s chairman, Rep. David Dreier (R-Calif.), said on his Web site: “Federal Reserve Chairman Alan Greenspan has said we should reduce it. So what are we waiting for?”

The group included many members of the powerful tax-writing House Ways and Means Committee. One was Rep. James Otis “Jim” McCrery (R-La.). He formed the Committee for the Preservation of Capitalism, a political action committee that he used to give money to candidates favoring lower capital gains rates.

Treasury Secretary Robert Rubin wasn’t enthusiastic, but Clinton, seeking compromises with Congress, agreed to cut the capital gains tax rate to 20 percent.

“The irony is that Reagan got rid of the preferential rates for capital gains and Clinton put them back in,” Sullivan said.

Six years later, congressional Republicans and President George W. Bush teamed up to cut the tax rate again, this time to a historic low of 15 percent.

These changes drove down the overall tax rate paid by the wealthy. In 1996, before the capital gains cut under Clinton, millionaires paid an effective rate of 30.8 percent. By 2007, it was 22.1 percent.

Many tax experts contest the benefits of a low capital gains rate.

Jane Gravelle, a tax expert at the Congressional Research Service, says a rate cut could generate more government revenue for a year or two as investors take advantage of lower rates or a rising

stock market, but she says that initial bump in tax revenue would fade. And the government, over time, would collect more overall if it kept the rate higher.

Greenspan would not comment for this story. But while he and others argue that the wealthy would save and reinvest their gains, thus spurring economic growth, other analysts say that result is not clear.

“Lower capital gains [taxes] are a mixed bag even if you’re just looking at efficiency,” said Leonard Burman, a professor at Syracuse University and former head of tax analysis at the Treasury Department. “It might encourage more risk-taking, but it also creates huge opportunities for tax shelters aimed at converting ordinary income to capital gains. People would make investments only because of the tax benefits.”

Moreover, he notes, given the recent financial crisis, it’s not clear that an absence of risk-taking is what’s ailing the economy.

Now, a new generation of presidential hopefuls — including Republicans Mitt Romney and Jon Huntsman Jr. — have begun rolling out their plans to lower or eliminate the capital gains tax.

Backing from Democrats

While Democrats have decried the GOP for protecting the wealthy from tax hikes, they have been champions of keeping taxes on investors relatively low.

Last year, Obama proposed allowing Bush’s tax cuts to expire, which would have raised the capital gains rate from 15 percent to 20 percent for individuals making more than \$200,000 a year and couples making \$250,000 or more.

Yet as Congress debated the fate of the Bush tax cuts, a group of 47 Democrats wrote a letter to then-House Speaker Nancy Pelosi (D-Calif.) opposing any hike in the tax on capital gains or dividends.

“Raising taxes on capital gains and dividends could discourage individuals and businesses from saving and investing,” the letter said, adding that the economy was too “fragile.”

Congress ultimately voted to extend the tax cuts through 2012. (By then, roughly half the Democrats who had signed the letter to Pelosi had lost their re-election campaigns.)

“If you can’t get a nickel out of the most egregious people at the top of the heap, then there’s no political will [to raise the capital gains tax] and nothing’s going to happen,” said Rep. Jim McDermott (D-Wash.), who has spoken out repeatedly on income inequality.

This summer, Sen. Patty Murray (D-Wash.) bashed Republicans for defending “the most generous tax rates wealthy Americans have enjoyed in 60 years.” Yet last year she joined three other Senate Democrats — Mark R. Warner (Va.), Robert P. Casey (Pa.) and Jeanne Shaheen (N.H.) — and GOP Sen. Scott Brown (Mass.) in fighting to exempt venture capital firms from

any capital gains tax increase, saying in a joint letter that it would hurt “job creation and innovation.” The bill, which would have spent the added revenue in part to extend unemployment benefits, later failed.

Spokespeople for Murray, who is a co-chair of the congressional debt-reduction supercommittee, declined to comment.

“You need some advantage of capital gains to incentivize patient capital,” Warner said. “It probably doesn’t need to be what we’ve got right now, which is a 20-point differential.”

Leading Democrats have also repeatedly defended a class of investment managers who get special benefits from the tax rate on investment profits because their income, known as “carried interest,” is counted not as wages but as capital gains. Instead of paying a 35 percent rate, these executives pay 15 percent. Private-equity managers from firms such as Apollo, Blackstone and the Carlyle Group save billions of dollars every year in this way — and lobby fiercely to keep it that way.

Some GOP lawmakers have been even more aggressive. In 2007, Rep. Eric Cantor (R-Va.) formed the Coalition for the Freedom of American Investors and Retirees to block legislation that would raise taxes on private-equity profits. Dozens of lobbyists rushed to join up.

Now House majority leader, Cantor is even more central in the tax debate and is still courted by the financial industry.

“Leader Cantor believes in lower taxes across the board for workers, small-business people and job creators,” said Cantor’s spokeswoman, Laena Fallon.

Last year, his two fundraising committees hauled in nearly \$2 million from securities and investment firms and real estate companies. Cantor has also received substantial campaign contributions from private equity firms. KKR was his fifth-largest contributor in the last election cycle, giving \$52,600.

“Wall Street loves the preferential capital gains rate. All of America’s 20- or 30 million wealthy small investors love capital gains rates,” Sullivan said. “It’s just a tremendously popular item with political contributors. It’s something that directly impacts every wealthy household in America.”

Some lawmakers who have backed low tax rates on capital gains have later been hired by the financial industry.

After leaving Congress, McCrery, for example, joined the lobbying firm Capitol Counsel, where one of his major clients in 2010 was the Alliance for Savings and Investment, a coalition including the Business Roundtable, the Financial Services Forum and AT&T.

McCrery said he hopes to represent them again. Preferential treatment of capital gains “will encourage risk-taking, capital formation and therefore investment and job creation and . . . the

kinds of things we have valued in this country in terms of people starting their own businesses,” he said.

But others said that regardless of the economic arguments, the steady cutting of the capital gains tax rate reflects the political power of the rich, who are more likely to contribute to politicians and benefit from the work of lobbyists. In other words, inequality of wealth can lead to inequality of representation.

“Capital gains taxes is actually pretty foreign to the experience of most voters,” said Jacob Hacker, political science professor at Yale University and co-author of the book “Winner-Take-All Politics.” “These are things that are only a concern for those who itemize [their tax returns], which most Americans don’t.”

The 400 richest taxpayers in 2008 counted 60 percent of their income in the form of capital gains and 8 percent from salary and wages. The rest of the country reported 5 percent in capital gains and 72 percent in salary.

The result, Hacker says, is that the lobbying winds up being lopsided, too.

“The amount of lobbying that takes place on tax policy from the deep-pocketed interests that have the most at stake is enormous,” Hacker said. “There’s very little representation on the other side.”

“Don’t forget,” he added, “that members of Congress themselves, particularly senators, are well off and they’re more likely to be sympathetic to the argument for low capital gains.”

© The Washington Post Company