

---

# Rethinking How We Score Capital Gains Tax Reform

**Natasha Sarin**, *US Treasury Department, United States of America*

**Lawrence Summers**, *Harvard University and NBER, United States of America*

**Owen Zidar**, *Princeton University and NBER, United States of America*

**Eric Zwick**, *University of Chicago Booth and NBER, United States of America*

## Executive Summary

We argue the revenue potential from increasing tax rates on capital gains may be substantially greater than previously understood. First, many prior studies focus primarily on short-run taxpayer responses, and so miss revenue from gains that are deferred when rates change. Second, the rise of pass-throughs and index funds has shifted the composition of capital gains in recent years, such that the share of gains that are highly elastic to the tax rate has likely declined. If some components are less elastic, then their elasticity should get more weight when scoring big changes because they will comprise more of the remaining tax base. Third, closer parity to income tax rates would provide a backstop to the rest of the tax system. Fourth, additional base-broadening reforms, like eliminating stepped-up basis, making charitable giving a realization event, reforming donor advised funds, and limiting opportunity zones to places with the highest poverty rates, will decrease the elasticity of the tax base to rate changes. Overall, we do not think the prevailing assumption of many in the scorekeeping community—that raising rates to top ordinary income levels would raise little revenue—is warranted. A crude calculation illustrates that raising capital gains rates to ordinary income levels could raise hundreds of billions more revenue over a decade than other leading estimates suggest.

*Tax Policy and the Economy*, volume 36, 2022.

© 2022 National Bureau of Economic Research. All rights reserved. Published by The University of Chicago Press for the National Bureau of Economic Research. <https://doi.org/10.1086/718949>

## I. Introduction

Capital gains taxes are a perennial issue in tax reform debates. Some maintain that preferential rates on capital gains encourage entrepreneurship and capital formation. Others question whether these benefits are sufficiently large to outweigh the equity and fiscal costs of lower rates. Although the direct equity costs of lower rates are clear—the wealthiest 1% account for two-thirds of capital gains realizations in the 2019 Survey of Consumer Finances—the fiscal costs are more uncertain.

The Joint Committee on Taxation (JCT) estimates these costs. In the parlance of policy makers, the JCT is the official “scorekeeper” that decides how tax legislation “scores” if implemented.<sup>1</sup> The prevailing wisdom among some in the scorekeeping community (e.g., Tax Policy Center, Tax Foundation, Penn Wharton Budget Model) has been that the revenue-maximizing capital gains rate is around 30%, such that setting a rate too far above this level could actually reduce the total amount of revenue collected.<sup>2</sup> This “Laffer rate” is well below both current top marginal tax rates on other income and top rates recently under debate. The rationale for a low Laffer rate is that the static revenue gains expected from a high rate will fail to materialize because the dynamic response of taxpayers dramatically shrinks the tax base.

A simple example highlights the role of dynamic responses in revenue estimation. The current “realization elasticity” used by JCT and others in the scorekeeping community is approximately  $-0.7$ , based on historical scores (Joint Committee on Taxation 1990), recent scores (Joint Committee on Taxation 2021), and recent academic research (Dowd, McClelland, and Muthitacharoen 2015). If tax rates increased by 100%, a crude application of this elasticity implies that realizations would fall by 70%.<sup>3</sup> In concrete terms, roughly \$1.25 trillion of annual realizations would shrink to around \$375 billion due to an increase in capital gains tax rates from 20% to 40%. This assumed \$875 billion response is large enough that raising capital gains rates to ordinary income levels could be scored as losing tax revenue.

Accounting for the difference between static and dynamic scores is clearly important. For example, the official score attached to changes in the top income tax rate is perhaps 12% lower than the static score, because some taxpayers will choose to work less or hire tax planners to help avoid taxes more.<sup>4</sup> And it is reasonable that the dynamic effects in the case of capital gains are more pronounced than for other policies: retiming a capital gain realization in an investor’s stock portfolio is easier than changing investment strategy for executives seeking to avoid a

corporate tax increase or reducing labor supply for workers when income tax rates rise.

We suspect that estimates of such large behavioral responses to capital gains rate changes may miss several important factors. For one, medium-term retiming of realizations would offset lost revenues in the short term. For simplicity, consider a 2-year example. Suppose that doubling capital gains rates from 20% to 40% causes realizations to occur half as often: instead of realizing gains every year, individuals realize gains every 2 years. If assets grow at 10% annually, then in the low-tax regime, \$100 of assets yield realizations of \$10 in year 1 and \$10.80 in year 2 (after paying two dollars of tax in year 1). In the high-tax regime, \$100 of assets yield realizations of \$0 in year 1 and \$21 in year 2. Despite the appearance in year 1 of a large elasticity of realizations in response to the tax increase, total revenues over both years increase from \$4.16 in the low-tax regime to \$8.40 in the high-tax regime. In this simple example without other behavioral responses, the short-run revenue score is zero and the medium-run revenue score is double the baseline. Clearly, the latter revenue score is more relevant for policy purposes.

Consistent with this example, we present evidence that suggests medium-term retiming of realizations is empirically relevant. First, in the time series around the reduction in capital gains rates in 2003, the share of assets held for more than 10 years drops and the ratio of sales price to basis falls. Second, we present new cross-sectional evidence from the population of information returns from Smith, Zidar, and Zwick (2021), which shows that high-tax states tend to have longer holding durations and higher price-to-basis ratios in 2016.

It is not clear to what extent these dynamic factors are incorporated in current scorekeeping methods, or if instead the current approach predicts that annual realizations would permanently fall. It is also unclear how much additional base-broadening reforms—stepped-up basis at death, making charitable giving a realization event, reforming donor advised funds, and limiting opportunity zones to places with the highest poverty rates—would affect estimates of lost tax collection due to indefinite deferrals.

Beyond the issue of deferred gains, we highlight three additional considerations that suggest conventional elasticities may be overstated. First, the composition of capital gains has shifted over time, such that the share of capital gains that are highly elastic to the tax rate has likely fallen. In recent years, more than half of capital gains accrue through pass-through and mutual fund distributions outside of the direct control

of taxpayers. For example, around 70% of gains in partnerships come from funds with nonindividual owners who face different incentives to realize gains. If half of capital gains are not sensitive to the tax environment, then for  $e = -0.7$  to be the right average elasticity across all gains, the elasticity for the other half of gains would be  $e = -1.4$ . Even if timeable realizations were so sensitive as to fall to zero in response to a tax increase, a large stock of nontimeable gains would remain to be taxed at the higher rates. Second, the appropriate elasticity for scoring big tax increases should put more weight on the elasticity of the less timeable portion because it will account for more of the remaining tax base. Third, revenue estimates may understate the substitution between capital gains and other forms of income. Closer parity to income tax rates would provide a backstop to the rest of the tax system, which can affect the level of tax avoidance and evasion, as well as the prevalence of recharacterized wages and carried interest compensation.

We conclude with crude estimates of the wide range in revenue potential from raising capital gains rates under different assumptions. According to Joint Committee on Taxation (2021), raising long-term capital gains tax rates by 5 percentage points yields expected revenue of \$123 billion over 10 years. This estimate is only 16% of the mechanical tax revenue (\$759 billion) based on the Congressional Budget Office's (CBO's) forecast. Applying elasticity estimates from Agersnap and Zidar (2020) to the baseline CBO forecast yields \$410 billion, or 3.3 times as much. The gap between the JCT score and other estimates is even larger when considering alternative forecasts. Specifically, CBO's baseline forecast has capital gains as a share of gross domestic product (GDP) falling slightly over the next decade. If the capital gains share of GDP is stable or increasing (due to rising wealth-to-GDP and wealth concentration), then the revenue potential of capital gains taxes would be even larger. If we apply elasticity estimates from Agersnap and Zidar (2020) and hold the realizations-to-GDP ratio fixed at recent levels, then the revenue estimate is \$485 billion. Finally, pairing rate increases with the elimination of loopholes that erode the capital gains tax base—like stepped-up basis and the tax preference for charitable gifts of appreciated assets—would produce larger revenue estimates.

Our point is not to offer an official score, but instead to illustrate the magnitude of potential revenue and how sensitive capital gains revenue estimates are to various assumptions. With our simple calculations, which abstract away many important details, we offer not an official score, but an illustration of how sensitive capital gains revenue estimates are and how reasonable alternatives to the standard set of assumptions suggest large revenue potential.

## II. Short-Run Deferral Increases Medium-Run Realizations

### A. Longer Estimation Window Produces Smaller Elasticity Estimates

Gains deferred when taxes rise need not be deferred indefinitely. Auerbach (1989) provides a helpful model that we describe in the appendix (available online). In the model, rate increases may induce less-frequent asset turnover, but at least some portion of gains deferred will face a tax burden eventually. And when deferred realizations do occur, the gains will be larger, as they will accrue over many years, offsetting transient losses from delays in realization. Working through the long-run dynamic equilibrium properties of whatever elasticity is estimated is quite important. In general, increasing the frequency of realizations means that the average realization will be smaller, and decreasing the frequency of realizations means that when they do occur, they will be larger. The impact on the size of the taxable gain works against this baseline effect and is missed by short-term elasticity estimates.<sup>5</sup>

There is a long line of empirical research on the responsiveness of capital gains realizations to rate changes, relying on different methodologies for estimating taxpayer response, different sample periods, and different rate changes from which to derive estimates (Dowd and Richards 2021). One key reason why realization elasticities vary across studies is that they reflect different horizons over which taxpayer responses are estimated.<sup>6</sup> Due largely to data limitations, much of the literature has estimated a short-run elasticity by studying responses within a short window before and after tax changes.<sup>7</sup> If researchers and professional scorekeepers adopt the short-run elasticity as the relevant statistic for revenue estimation, which is generally calculated over a 10-year budget window, they implicitly presume that realizations that are deferred when rates rise will never take place.

Table 1 summarizes some advantages and disadvantages of different approaches to investigate the effects of capital gains taxes. The first column lists some of the advantages and disadvantages of a recent contribution by Dowd et al. (2015), which uses individual-level panel data from the 2000s to estimate a permanent elasticity of around  $-0.72$ , based on taxpayer responses from the 2 years surrounding tax changes. Specifically, the main estimating equation is

$$\ln g_{it} = \beta_1 \tau_{it-1} + \beta_2 \tau_{it} + \beta_3 \tau_{it+1} + X_{it} \beta_4 + \lambda_{it} + \epsilon_{it}; \text{ if Realization}_{it} > 0, \quad (1)$$

where  $\ln g_{it}$  are log realized capital gains of tax unit  $i$  in year  $t$  (measured as the net long-term personal gains before prior-year carryover losses),

**Table 1**  
Trade-offs of Using Different Approaches to Investigate the Effects of Capital Gains Taxes

	Individual Level	State Level		Aggregate Time Series	Calibrated Models
	Dowd et al. (2015)	Bakija, Gentry (2014)	Agersnap, Zidar (2020)	Eichner, Sinai (2000)	Jakobsen et al. (2020)
Dynamics	X	X	✓	✓	✓
Aggregation	X	✓	✓	✓	X
Selection model	✓	X	X	X	X
Small changes	✓	✓	✓	X	X
Comparison group	✓	✓	✓	X	✓

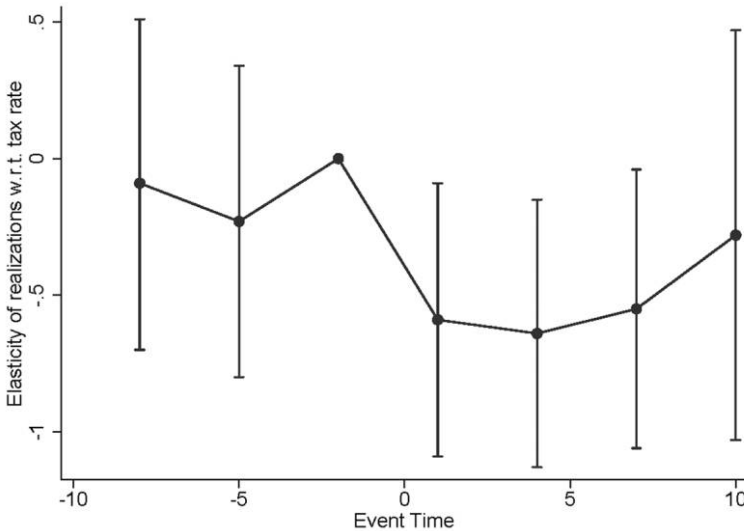
the  $\tau$ 's are the combined federal and state marginal tax rates on long-term gains for the respective year  $t$ ,  $X_{it}$  are controls that include wealth, income, and demographic variables.<sup>8</sup> The resulting elasticity, which is characterized by equation (4) in Dowd et al. (2015), is

$$\begin{aligned} \varepsilon_{DMM} &\approx \hat{\tau}_{it+1}(\beta_1 + \beta_2 + \beta_3) \\ &= 17.4\% \times \underbrace{(0.053 - 0.069 - 0.025)}_{=-0.041} = .71(\pm.22) \end{aligned}$$

A limitation of this approach is that it misses realizations that are deferred when rates change but eventually occur just after the narrow window of years (i.e., years  $t - 1, t, t + 1$ ) immediately surrounding tax changes. Consistent with this idea, Dowd et al. (2015) find that their estimates are exclusively driven by intensive margin effects (i.e., the size of a realized gain), indicating this approach may miss medium-run timing responses that are more likely to appear as extensive margin effects (i.e., the presence of a realized gain). In earlier work, Auten and Clotfelter (1982) also find that short-run effects are larger than long-term effects. A second limitation of the individual-level approach is aggregation. Specifically, possible heterogeneity in the  $\beta$ 's across observed and unobserved investor characteristics, having to specify a selection correction (i.e., if  $\text{Realization}_{it} > 0$ ), and having to weight results to aggregate dollars make mapping this elasticity estimate to a 10-year score quite difficult. A third limitation is that some of the controls in  $X_{it}$ , such as imputed unrealized gains, may be hard to measure and influence the implied impulse response of the path of realizations to a change in the tax rate.

A second type of study uses state-year panel data, which can overcome some of the issues related to aggregation and dynamics. For example, Agersnap and Zidar (2020) capture realizations that occur at the state level within 10 years of a tax change (fig. 1).<sup>9</sup> Consistent with the deferred realization hypothesis, they arrive at an estimate of the behavioral effect of capital gains tax hikes that is much lower than existing estimates (between  $-0.3$  and  $-0.5$ ), and consequently an estimate of the revenue-maximizing rate that is much higher, around 38%–47%. There are issues with this 10-year horizon as well. On the one hand, estimates are less precise in later years because other shocks occur during such a lengthy estimation window. On the other hand, even this more expansive estimation window misses realizations deferred when rates change that occur eventually, just outside of the 10-year horizon.

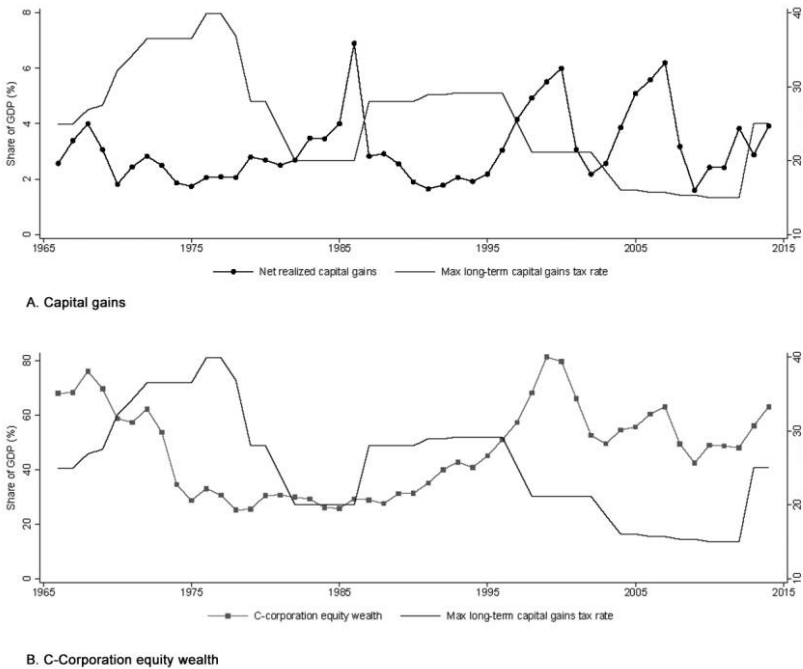
A critique of both Dowd et al. (2015) and Agersnap and Zidar (2020) is that their identification relies on relatively small state-level tax changes. An alternative approach would be to use the time series of large federal changes to examine dynamics around larger reforms. The only comparable



**Fig. 1.** Evolution of realization responses: elasticity estimates by horizon from Agersnap and Zidar (2020). This figure plots tax rate elasticities within 3-year bins defined relative to the year of a tax change. For instance, the rightmost point indicates that the realizations elasticity to a tax change 9 and 11 years previous is  $-0.28$ . This figure is constructed by converting the policy-relevant elasticity ( $\epsilon_{CG} - \epsilon_N$ ) series from Figure 3c of Agersnap and Zidar (2020) to a tax-rate elasticity. We use a conversion factor of  $-0.22/(1 - 0.22)$  so that the result is an elasticity at a tax rate of 22%.

historical episodes in the United States are in the 1970s, when capital gains rates rose following the Tax Reform Act of 1969 to as much as 49% for some taxpayers, before being cut to 29% by the end of the decade. However, the lack of a comparison group and the existence of confounding shocks makes clear how difficult it is to identify the permanent tax-induced component of this change from the federal time series.

Figure 2 plots aggregate realizations and capital gains tax rates and reveals clear issues with extrapolation from the federal time series. First, the time series show clear anticipatory and transient taxpayer timing, providing more evidence of why elasticities based on just a few years



**Fig. 2.** Evolution of net capital gains and C-Corporation equity wealth. These graphs plot net realized capital gains and C-corporation equity wealth as a share of GDP, as well as the maximum long-term capital gains tax rates between 1960 and 2014. The maximum tax rate incorporates the effects of exclusions (which were eliminated in 1986), alternative tax rates, and other provisions. Data on capital gains and C-corporation wealth from Smith et al. (2021). Data on tax rates from the US Treasury (<https://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/Taxes-Paid-on-Capital-Gains-for>Returns-with-Positive-Net-Capital-Gains.pdf>) and the Tax Foundation (<https://taxfoundation.org/federal-capital-gains-tax-collections-1954-2009/>). GDP data from the World Bank (<https://data.worldbank.org/indicator/NY.GDP.MKTP.CD>). A color version of this figure is available online.



of data can be misleading. Second, the base of capital gains is procyclical, so it is hard to disentangle changes in realizations from unrelated market-induced changes in tax collections. The 1970s featured capital gains tax hikes, decreases in capital gains tax collection as a share of GDP, and poor market performance—all of which reversed in the 1980s. Figure 2*b* shows a sharp decline in C-corporation equity wealth as a share of GDP in the 1970s, which confounds inferences about the tax elasticity based solely on time-series fluctuations in rates and realized gains. Looking to state-level changes is thus valuable, as it is a broader sample that allows for separating tax-induced changes from general macroeconomic trends.

A fourth approach is to use a model-based approach with calibrated parameters. Estimates of savings responses with respect to after-tax returns can help inform the plausibility of different realization elasticities.<sup>10</sup> Consider an initial investment of  $W_0 = \$100,000$ , invested for 10 years at a pretax return rate of 7%. The after-tax net return rate  $R$  is a function of the pretax return rate and the capital gains tax rate  $\tau_{CG}$ , which we assume to be 20%:

$$\begin{aligned} R &= [(1.07)^{10} - 1](1 - 0.2) \\ &= 0.97 \cdot 0.8 = 0.77. \end{aligned} \tag{2}$$

Suppose that  $\tau_{CG}$  increases from 20% to 40%. Post-tax-change,  $R = 0.97 \cdot 0.6 = 0.58$ , which implies that the log change in after-tax net return rate  $\Delta \ln(R) = \ln(0.58) - \ln(0.77) = -0.29$ . We can then back out the post-change initial investment  $W'_0$  using our estimated  $\Delta \ln(R)$ , along with the elasticity of wealth with respect to the after-tax return rate. We use an estimate from Jakobsen et al. (2020), which estimates this elasticity at about 0.4 over an 8-year period.

$$\begin{aligned} W'_0 &= (1 - \Delta \ln(R) \cdot \varepsilon_{W,R}) \cdot W_0 \\ &= (1 - 0.29 \cdot 0.4) \cdot \$100,000 = \$88,492 \end{aligned} \tag{3}$$

Now that we have both  $W$  and  $W'$ , we can calculate the post-tax increase change in capital gains realizations:

$$\begin{aligned} \Delta CG &= (W'_{10} - W'_0) - (W_{10} - W_0) \\ &= \$88,492 \cdot [(1.07)^{10} - 1] - 100,000 \cdot [(1.07)^{10} - 1] \\ &\approx \$86K - \$97K = -\$11K \end{aligned} \tag{4}$$

A decrease in capital gains realizations of \$11K given a doubling in the tax rate implies a realizations elasticity with respect to the tax rate of  $\varepsilon_{CG,\tau_{CG}} = -0.11/1 = -0.11$ .

Although this exercise involves several strong assumptions (including abstracting from the decision to realize gains within the 8-year period), it is nonetheless striking that the realizations elasticity it produces is much smaller than the effective elasticity implied by the scorekeepers. In table 2, we show that the wealth elasticities estimated by Jakobsen et al. (2020) over different specifications and time horizons yield similarly small realizations elasticities. Going in the other direction, a  $-0.7$  realizations elasticity would imply a wealth elasticity of 4.2, which is several times larger than the largest wealth elasticity from Jakobsen et al. (2020) (table 2, fig. 3).

The bottom line from this example is that leading wealth elasticity estimates imply much smaller realization elasticities than those used by scorekeepers.

### B. Some Portion of Deferred Gains Are Eventually Realized

A limitation of many empirical estimates in the capital gains literature is that they do not measure relevant medium- and long-term responses. If taxpayers respond to increases in capital gains rates by realizing gains less frequently—but not deferring indefinitely—then these longer-run responses would suggest the impact of rate changes on capital gains tax collection is more temporary than previously believed.

If this were the case, one would expect to observe a few patterns in the data when rates increase. First, the duration that taxpayers hold their gains before realizing would rise. Second, the ratio of sales price to basis

**Table 2**  
Wealth and Capital Gains Elasticities

Source	$\varepsilon_w$	$\tau_{CG} = 20\%$				$\tau_{CG} = 40\%$				$\varepsilon_{CG}$
		$w_0$	$w_{10}$	Gains	$R$	$w'_0$	$w'_{10}$	Gains	$R$	
8-Year couples	.20	100,000	196,715	96,715	.77	94,409	185,716	91,308	.58	.06
8-Year wealthiest	.40	100,000	196,715	96,715	.77	89,130	175,332	86,202	.58	.11
30-Year couples	.77	100,000	196,715	96,715	.77	80,130	157,629	77,498	.58	.20
30-Year wealthiest	1.15	100,000	196,715	96,715	.77	71,832	141,305	69,473	.58	.28
Implied	4.18	100,000	196,715	96,715	.77	30,087	59,186	29,099	.58	.70

Note: We take the first four wealth elasticities from Jakobsen et al. (2020), where the relevant specification is indicated under "Source." The fifth wealth elasticity is calculated by assuming  $\varepsilon_{CG} = .70$  in absolute value.

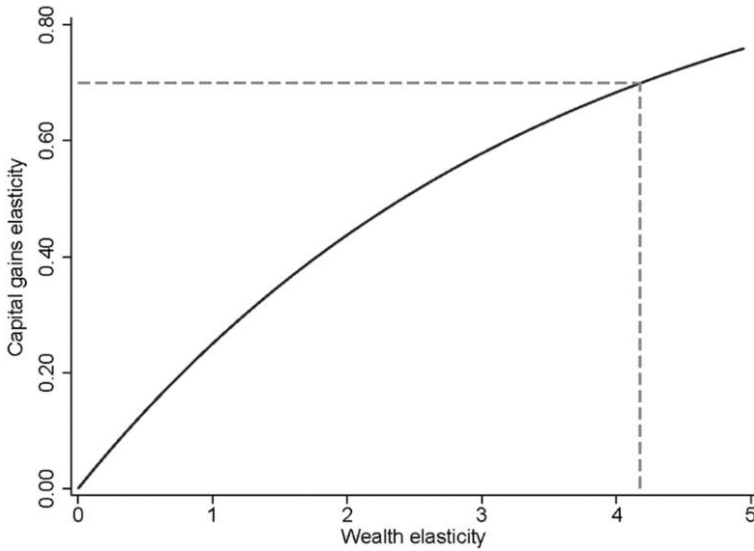
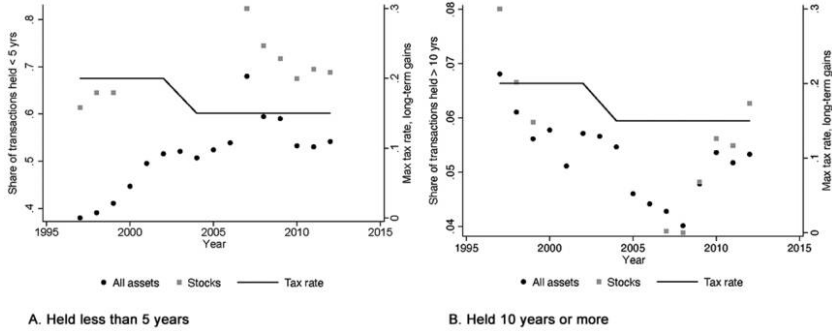


Fig. 3. Capital gains realization elasticities implied by a range of wealth elasticities. Dotted lines indicate a capital gains elasticity of 0.70 and the corresponding wealth elasticity (4.18). See table 2 for details on the underlying calculations.

would be higher: in the Auerbach framework discussed in the appendix,  $\delta$  represents the share of realizations that occur annually. If a capital gains change affects  $\delta$ , the share of annual realizations falls, but when realizations occur, gains relative to purchase basis are higher.

The IRS SOCA (Sales of Capital Assets) study provides some suggestive evidence on these patterns. The SOCA panel data includes the sales price, basis, gain or loss, and the purchase and sales date for capital gains transactions for a representative sample of taxpayers. These data are at the federal level and only for certain years between 1997 and 2012.<sup>11</sup> As such, there is just one federal tax change during the time covered by these data, the 2003 reform, which reduced the top rate from 20% to 15%. This is one of many areas where more recent and comprehensive IRS data would be invaluable: Regular SOCA panels would enable better inference about the extent to which realization behavior has changed over time.

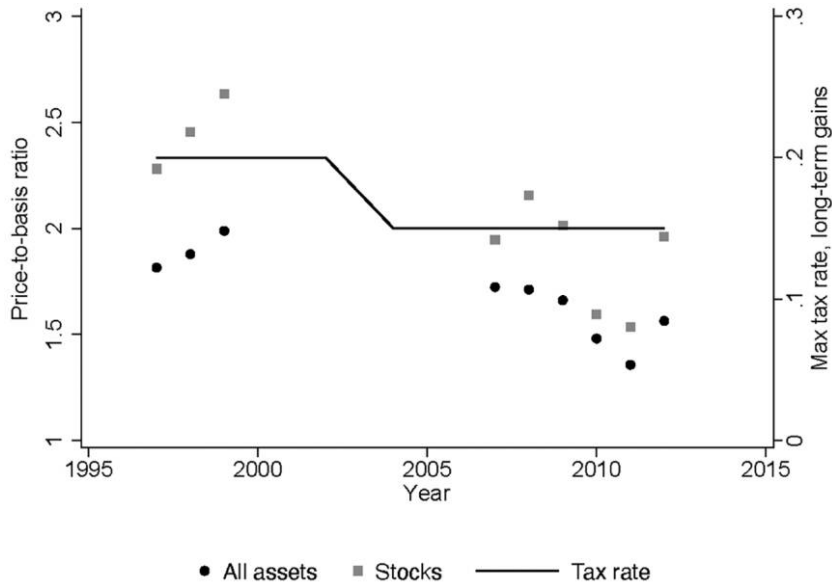
Figure 4 shows that, for all transactions and corporate stock transactions specifically, duration decreases in lockstep with the rate change. In other words, the share of assets held for more than 10 years drops when the rate falls, and the ratio of sales price to basis falls (fig. 5). It is worth noting that this evidence is purely suggestive—these two periods are



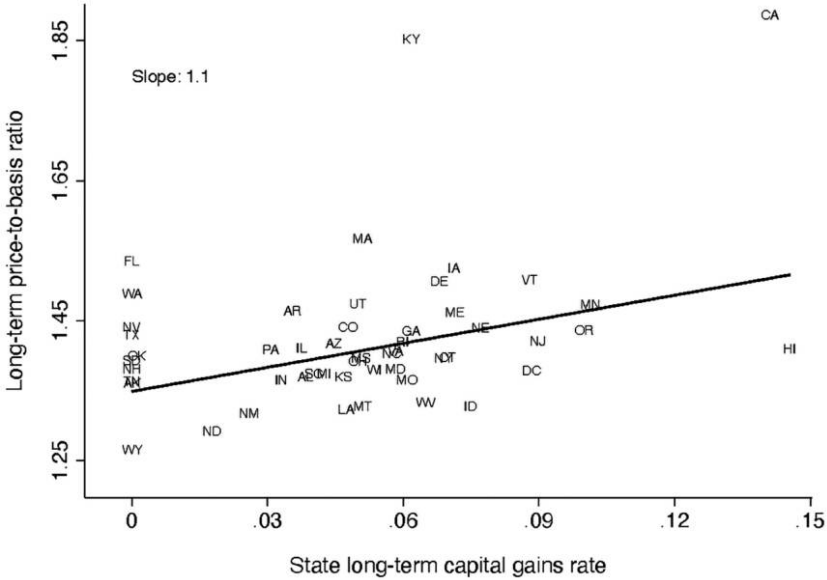
**Fig. 4.** Holding length by asset class. These graphs plot the average share of capital gains realizations that are held for less than 5 years and for more than 10 years. For reference, we also plot the maximum federal long-term capital gains tax rate. Data from the Internal Revenue Statistics, Sales of Capital Assets (IRS SOCA). A color version of this figure is available online.

distinct, and differences in macroeconomic conditions may well be driving the results.<sup>12</sup>

Figures 6 and 7 provide corroborating cross-sectional evidence from 2016. In particular, these figures relate state-level long-term capital gains



**Fig. 5.** Price-to-basis ratio by asset class. This graph plots the ratio of sales price to basis for long-term gain realizations of all assets and for stocks only. For reference, we also plot the maximum federal long-term capital gains tax rate. Data from the Internal Revenue Statistics, Sales of Capital Assets (IRS SOCA). A color version of this figure is available online.



**Fig. 6.** Price-to-basis ratio by state capital gains rate. This graph plots the long-term ratio of sales price to basis by state long-term capital gains tax rate. The best-of-fit line estimates a 1.1 percentage point increase in price-to-basis ratio per percentage point increase in state capital gains rate. Long-term capital gains realization data, including price-to-basis ratios, come from Smith et al. (2021)’s data on the population of 1099-B forms and is weighted by positive realizations in 2016. State capital gains rate data in 2016 come from Agersnap and Zidar (2020). A color version of this figure is available online.

tax rates to the price-to-basis ratio on long-term capital gains realizations and average holding periods for long-term capital gains from the population of 1099-B information returns (Smith et al. 2021). We provide a linear best-fit line that is weighted by realizations. Figure 6 shows that states with long-term capital gains tax rates of around 10% have a price-to-basis ratio that is 0.11 higher than states with 0% rates. In other words, these higher-tax states tend to see larger amounts of deferred capital gains. Figure 7 shows that high-tax states also tend to have higher holding periods. For example, California has a holding period that is about a year longer than lower-tax states. Overall, the duration of holding periods (conditional on realization) in these data has a mean of around three years. Given this short average duration for these investments, it seems unlikely that a change in the capital gains tax rate (of, e.g., 5 percentage points) would cause investors to defer realization indefinitely.

This time-series and cross-sectional evidence is consistent with the notion that at least some of the changes induced by capital gains reforms

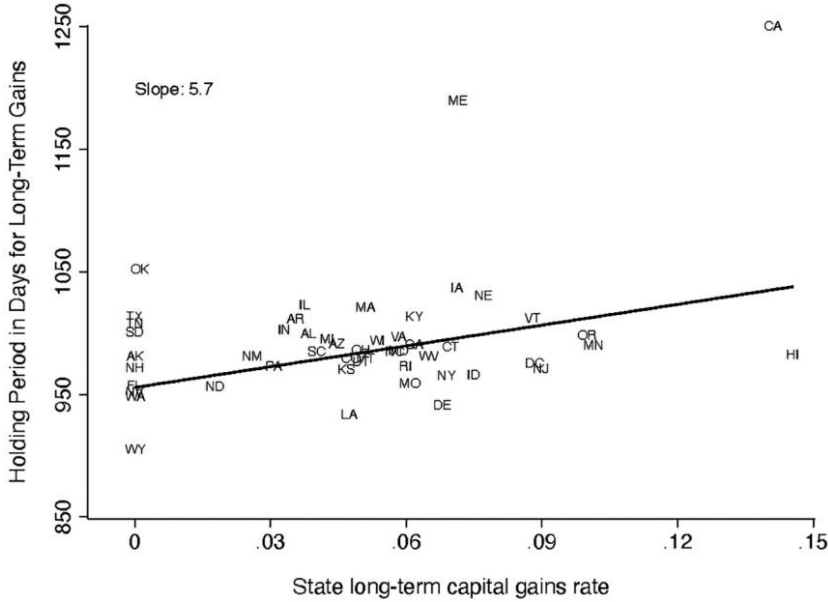


Fig. 7. Long-term gains holding period by state capital gains rate. This graph plots the holding period in days for long-term gains by state long-term capital gains tax rate. The best-of-fit line estimates a 5.7 day increase in holding period per percentage point increase in state capital gains rate. Holding period data come from Smith et al. (2021)'s data on the population of 1099-B forms and is weighted by positive realizations in 2016. State capital gains rate data in 2016 come from Agersnap and Zidar (2020). A color version of this figure is available online.

have to do with the timing of gains and not just the decision of whether or not to realize. Models that assume only the latter channel is operating will miss out on the revenue potential of rate changes.

### C. *Tax Law Changes Make It Unlikely That Taxpayers Can Defer Gains Indefinitely*

An early theoretical paper by Stiglitz (1983) suggests that the avoidance opportunities for capital gains taxes are so rampant that the existence of a tax would have no impact on individual consumption because the tax can be avoided entirely through a range of techniques like the use of derivatives.

Whether the assumptions that underlie this model were ever realistic is debatable. A long line of literature documents that most trading activity is inconsistent with tax-motivated realizations, which pushes against the idea that investors are so active in their tax avoidance strategies.<sup>13</sup>

Furthermore, to the extent that these opportunities did exist, they are more limited today than they were in the 1980s.

For example, Section 1259 of the tax code was adopted in 1997 and required that a constructive sale of property held by a taxpayer be treated for the purposes of recognizing gain and establishing a holding period as if she had sold the property in question for its fair market value. Section 1259 leaves some room for forward contracts designed for the holder to defer tax liability for a period (typically 3–5 years) while receiving cash today. But recent legal precedent makes clear that there are limits to this strategy that make it infeasible for gains periods to be rolled over indefinitely.<sup>14</sup> Thus, this strategy offers only a temporary salve to inevitable capital gains tax liability.

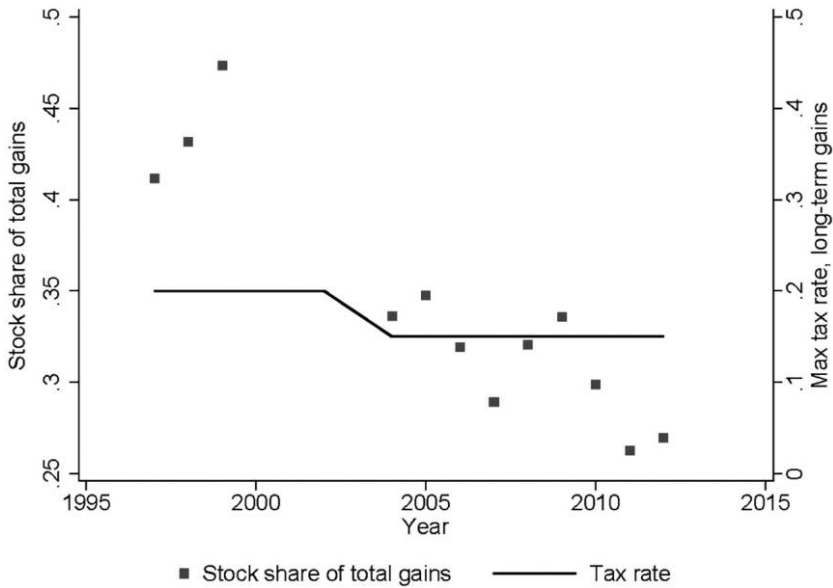
For those at the top of the wealth distribution, diversification needs, rather than consumption, likely drive some realization choices. But for taxpayers who are looking to consume out of their gains, it is plausible that they could borrow against shares that have accumulated in value, thus deferring capital gains liability. However, potential borrowers are likely to face sizable margin calls because of the volatility of their underlying shares. They thus need to have sufficient liquidity on hand, which makes consumption without realization challenging.

Outside of the wealthiest who actively choose not to diversify (e.g., founders with large equity stakes), it seems unlikely that rate changes could conceivably lock-in accrued gains until death. More quantitative work is needed to try to measure the behavior of and share of gains held by taxpayers across the wealth distribution.<sup>15</sup>

### III. A Rising Share of Capital Gains Cannot Be Easily Retimed

Relative to the 1990s, the portion of assets where accumulated capital gains could conceivably be deferred—and thus untaxed—has declined. The prototypical example of a capital gain is a share of corporate stock. An individual who bought a share of Amazon when it IPO-ed at \$18 could sell that share today and pay taxes on more than \$3,100 of its appreciation. Or, if she does not face consumption needs during her lifetime, she could defer the gains indefinitely and bequest the share of stock to her heirs, at which point the basis will adjust and wipe out any tax liabilities for appreciated gains during her lifetime.

Stock transactions are among the most elastic form of capital gains because the taxpayer can proactively decide whether to realize. But, as figure 8 shows, the share of capital gains that stock transactions represent

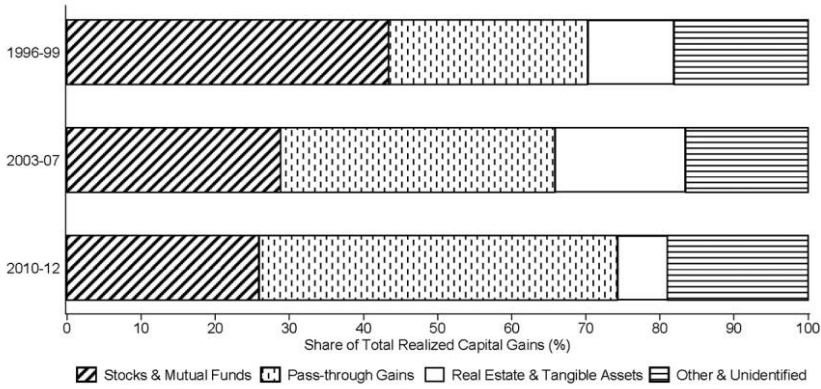


**Fig. 8.** Stock share of gains. Points represent the corporate stock share of total capital gains realized in a given year. These are plotted alongside the maximum federal long-term capital gains rate. Data from the Internal Revenue Statistics, Sales of Capital Assets (IRS SOCA). A color version of this figure is available online.

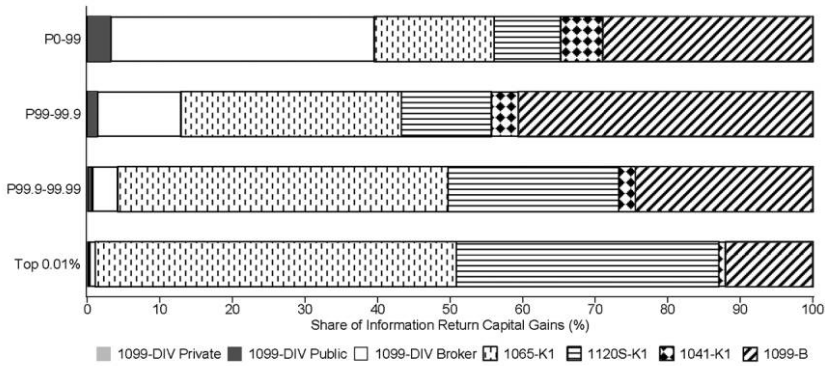
has fallen substantially over the last several decades, whereas more in-elastic gains are growing in import: between 1997 and 2012, the share of long-term gains that involved corporate stock transactions fell from 41.2% to 26.9%.

Figure 9 shows that the largest corresponding growth is in pass-through gains or losses, which rose from just 22.6% of long-term gains to 37.7%. Pass-through gains refer to distributed gains from pass-through entities owned by taxpayers. This category includes the growth of “carried interest” compensation to general partners of hedge funds, venture capital, and private equity firms. Partnership agreements typically require funds to be returned within 10–12 years of the initial commitment. Investors in these structures cannot time realization decisions around favorable tax environments, as their participation is limited; neither can they typically defer their gains indefinitely like stockholders. Instead, they receive—and pay taxes on—gains when the general partners exit underlying investments. Moreover, figure 10 suggests that many of the limited partners in these funds are nontaxable, such that the decision to exit an investment is likely to be less responsive to capital gains tax changes.





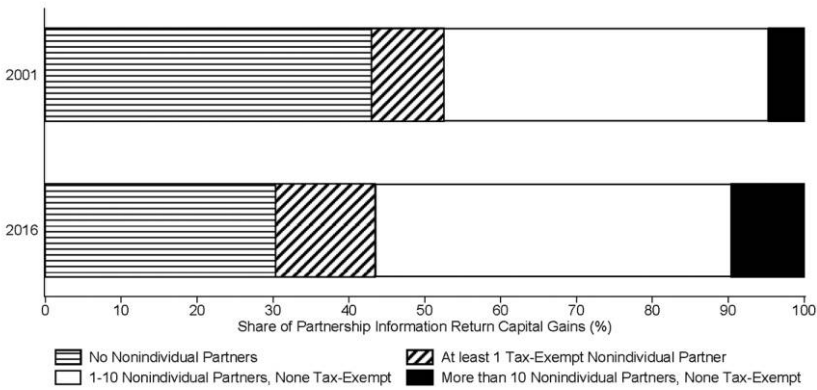
A. The share of capital gains that stock transactions represent has fallen substantially



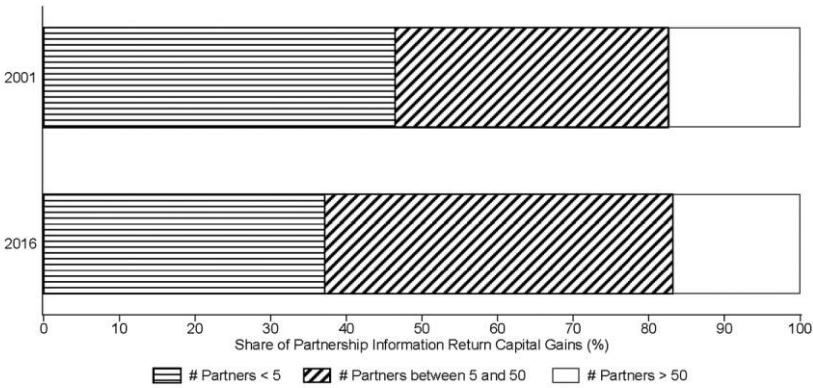
B. Capital gains from pass-throughs are especially large at the top of the AGI distribution

Fig. 9. The composition of capital gains over time and across groups. Data for panel (a) come from Internal Revenue Statistics, Sales of Capital Assets (IRS SOCA). Data on all information returns that generate capital gains in 2016 in panel (b) come from Smith et al. (2021). A color version of this figure is available online.

Considering this shift in composition is one reason why conventional elasticities may be overstated. The most recent data available from the IRS reveal that nearly half of capital gains accrue from pass-through and mutual fund distributions.<sup>16</sup> It is hard to know what share of non-personal capital gains are timeable around tax changes (e.g., corporate stock held by partnerships) and what share are inelastic (e.g., carried interest, which itself represents around 10% of annual capital gains in recent years; Smith et al. 2021). Although it is quite challenging to quantify this share empirically, suppose that half of capital gains are not easily timeable in response to tax changes. If, for the sake of argument, 50%



A. Around 70% of gains in partnerships come from funds with non-individual owners



B. Most gains in partnerships come from funds with many other partners

Fig. 10. A rising share of capital gains cannot be easily retimed. These figures plot statistics using data from the population of 1065-K1s that generate capital gains come from Smith et al. (2021). A color version of this figure is available online.

of gains are indeed untimeable, then for  $e = -0.7$  to be the right average elasticity across all gains, the remaining 50% of timeable capital gains that are elastic to the tax rate should have an elasticity of close to  $-1.4$ .

Said another way, if 50% of capital gains are not sensitive to the tax environment, then no matter how large the “timeable” elasticity is, doubling rates to top ordinary income levels will still raise substantial revenues. Even if the timeable realizations shrink to 0, there remains a large stock of gains that will be taxed regularly at new, higher rates. Moreover, the appropriate elasticity for bigger changes should put more

weight on the elasticity of the less timeable portion. The elasticities used by scorekeepers are averages across different asset types. But the weights are not static: when there is a substantial change in the tax environment, the weights of the different asset classes that comprise the capital gains tax base shift, and so too does the elasticity of the overall tax base.<sup>17</sup> When capital gains tax rates are low (or when taxpayers predict that rates may rise in the near future), a large share of realizations are in more easily timeable equities. This dynamism appears missing from existing revenue estimates.

Dowd et al. (2015) confirms that different types of assets exhibit different realization elasticities, finding, for example, that pass-through distributions exhibit a higher sensitivity to rate changes than other types of assets, whereas mutual fund distributions exhibit a much lower sensitivity. However, their data run from 1999 through 2008, so may not reflect the current composition of gains. In addition, they find that the elasticity of directly owned capital gains varies over different time periods and is lower in recent years. Further research incorporating the growth of carried interest and the quantitative importance of different types of gains and their varied elasticities would be useful for improving assessments of the revenue potential of capital gains tax reform.

#### **IV. Realization Responses Generate Fiscal Spillovers**

##### *A. Capital Gains Tax Changes Affect Tax Collections Beyond Realization Responses*

Elasticity estimates from the literature tend to focus on the narrow question of how the capital gains tax base evolves in response to rate changes, but this approach offers an incomplete answer to the question of total revenue effects. Although scorekeepers may already be modeling such spillovers, we are unaware of the approach, the assumed magnitudes, and the empirical basis for these assumptions.

Consider a few examples of how changes in the capital gains tax might affect other tax bases. First, incentives to mischaracterize labor income and profits as capital gains to take advantage of lower-tax rates can also affect revenues (Smith et al. 2019). The existence of preferential tax treatment encourages avoidance in the form of misclassification of wage income for fund managers through the carried interest loophole, discussed above. Similarly, the tax code favors employee stock options, which, when held for long enough, qualify for capital gains treatment.

Second, different treatment of capital gains and dividends affects the relative attractiveness of distributing corporate profits via share buy-backs versus dividends. Third, capital gains tax preferences can affect the allocation of capital across industries and locations, due to sheltering opportunities such as like-kind exchanges in real estate, oil, and gas, investments in opportunity zones, and incomplete recapture of depreciation deductions following asset sales. Reforming capital gains taxation will thus also reduce wasteful effort by taxpayers and their planners to devote resources to circumventing tax liabilities by exploiting preferential capital gains rates and sheltering opportunities.

### *B. Capital Gains Tax Changes and Investment Behavior*

One reason to be skeptical of the revenue potential of capital gains tax increases is that tax increases might impact economic growth. Many critics of capital income taxes argue that low rates induce business creation by allowing investors to reap a larger share of the gains they create (Feldstein 2006).

Indeed, in the Bush Administration, one rationale for cutting capital gains rates was incentivizing entrepreneurship. According to the 1990 Economic Report of the President, “[m]uch of the return to entrepreneurs . . . comes through increasing the value of the business. Reducing the tax rate on capital gains will provide a climate that encourages businesses to invest in new technologies and products” (President and CEA 1990). If large, such investment and entrepreneurship effects would amplify realization elasticities by shrinking the future corporate tax base in the case of a capital gains tax increase.<sup>18</sup>

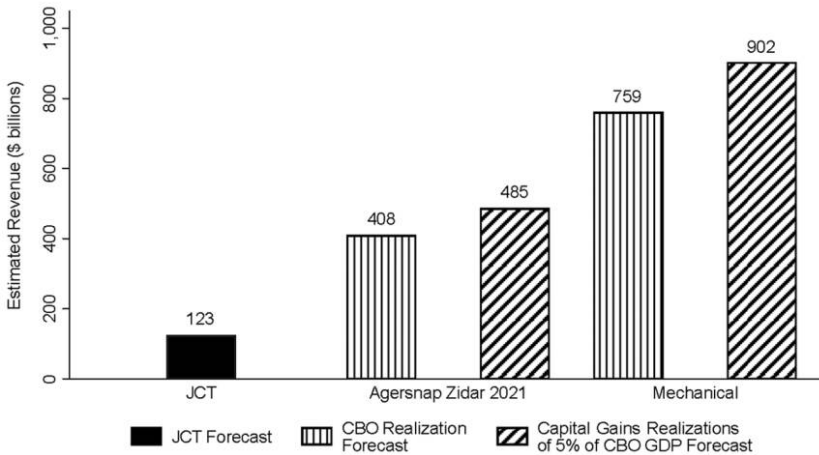
But the case for large-investment effects of lower capital gains rates appears overstated. First, preferential capital gains treatment incentivizes some income sheltering that may cause misallocation and prevent capital from being employed in its most productive use. Second, the majority of venture capital comes from large institutions like pension funds, endowments of universities, charitable foundations, and sovereign wealth funds, which are already tax-exempt.<sup>19</sup> Third, it is hard to imagine entrepreneurs making decisions about investment and risk on the basis of the capital gains tax regime: Mark Zuckerberg was not focusing on the capital gains tax when he was in his dorm room coding up Facebook. Bell et al. (2019) reach the same conclusion based on comprehensive data on US inventors, arguing that tax cuts do not produce more Einsteins. Finally, in a related context, empirical evidence suggests that dividend tax cuts that decrease

firms’ cost of capital in similar ways to the capital gains tax do not affect investment (Yagan 2015).<sup>20</sup>

## V. Implications for Scorekeeping and Revenue Estimates

### A. Comparing Recent JCT Estimates to Alternatives

In September 2021, the Joint Committee on Taxation estimated that increasing the top tax rate on long-term capital gains and qualified dividends to 25% would raise \$123 billion over 10 years. Figure 11 compares this estimate to the mechanical revenue from a 5 percentage point increase on long-term capital gains realizations as well as a crude estimate resulting from applying elasticities estimated in Agersnap and Zidar (2020).



**Fig. 11.** Estimated change in revenue from a 5% capital gains rate increase. This graph plots the estimated change in revenue during 2022–31 for an increase in the tax rate on long-term capital gains and qualified dividends from 20 to 25%. The first bar shows the estimated change in revenue as estimated by the Joint Committee on Taxation in September 2021 (<https://www.jct.gov/publications/2021/jcx-42-21/>). The two middle bars estimate revenue using the methods of Agersnap and Zidar (2020). Estimates use  $\epsilon_{NTR} = \{1.48\}$  from Agersnap and Zidar (2020)’s table 2. The final bars are a mechanical calculation of a 5% increase in the capital gains rate. Bars using “CBO Realization Forecast” data come from a forecast of annual capital gains realizations by the CBO released in July 2021 (<https://www.cbo.gov/publication/57218>). Bars using “Capital Gains Realizations of 5% of CBO GDP Forecast” estimate that capital gains realizations will remain at 5% of GDP as forecasted by the CBO. During the 2017–21 period, the average realizations to GDP ratio was 0.05 as reported by the CBO. A color version of this figure is available online.

The JCT estimate is only 16% of the mechanical revenue estimate, which takes the CBO's July 2021 forecast for long-term capital gains realizations and qualified dividends as given and multiplies that base by 5%. This stark gap between the JCT's estimate and the mechanical estimates reveals that the JCT's model assumes very large behavioral responses. It's striking that applying estimates from Agersnap and Zidar (2020) of an elasticity with respect to the net-of-tax rate of 1.48 from Agersnap and Zidar (2020)'s table 2 (which corresponds to an elasticity with respect to the tax rate of around  $-0.42$ ) delivers an estimate of \$408 billion, which is 3.3 times higher than the JCT estimate.

The gap is even larger when considering alternative forecasts of capital gains realizations, which are shown in the striped bars. CBO's baseline forecast has capital gains as a share of GDP falling slightly over the next decade. The the diagonally-striped bars plot revenue estimates based on realizations that would result from using the 2017–2021 realizations-to-GDP ratio of 5% times the CBO's GDP forecast for 2022–2031. This larger tax base would deliver a mechanical estimate of \$902 billion, or 7.3 times the JCT's revenue estimate. Agersnap and Zidar (2020)'s implied estimate would be nearly four times as large as the JCT's, using the 5% of GDP tax base.

### *B. Illustrative Revenue Estimates of Tax Increases under Different Assumptions*

Table 3 shows realization and revenue estimates for capital gains tax rate increases of 2% and 20%.<sup>21</sup> As noted above, CBO's baseline has capital gains as a share of GDP falling slightly over the next decade, which is why the table shows a relatively stable base of realizations despite the higher nominal GDP. If the capital gains share of GDP is stable or increasing (due to rising wealth-to-GDP and wealth concentration), then the revenue potential is even greater than the estimates we present.

The first column presents CBO's projections for realizations from 2022 to 2031. Although the amount of realizations itself is endogenous, the CBO projections of approximately \$1.25 trillion of realizations per year over the next decade provide a useful starting point. At a 20% tax rate, the table shows that the baseline capital tax revenues amount to around \$250 billion a year. To simplify the discussion, we apply different elasticities to this baseline level of realizations and revenues every year over a 10-year period.<sup>22</sup>

We consider two tax changes. The first is a 2 percentage point increase in the rate, which allows us to compare our approach to published

**Table 3**  
Realization and Revenue Estimates for 2 Percentage Point and 20 Percentage Point Tax Increases,  $e \in \{0, -0.3, -0.4, -0.7\}$

	$t = 22\%$												$t = 40\%$													
	Realizations						Revenue						Realizations						Revenue							
	CBO Projections		$e_{\text{tax}}$	$e_{\text{NTR}}$			Realizations		Revenue		$e_{\text{tax}}$		$e_{\text{NTR}}$			Realizations		Revenue								
Realiz.	Rev.		0	-3	-4	1.6	2.8	0	-3	-4	1.6	2.8	0	-3	-4	1.6	2.8	0	-3	-4	1.6	2.8				
2022	1,278	256	1,278	1,240	1,227	1,189	281	273	270	261	1,278	895	767	383	511	358	307	153	1,278	895	767	383	511	358	307	153
2023	1,275	255	1,275	1,237	1,224	1,186	280	272	269	261	1,275	892	765	382	510	357	306	153	1,275	892	765	382	510	357	306	153
2024	1,180	236	1,180	1,145	1,133	1,097	260	252	249	241	1,180	826	708	354	472	330	283	142	1,180	826	708	354	472	330	283	142
2025	1,130	226	1,130	1,096	1,085	1,051	249	241	239	231	1,130	791	678	339	452	316	271	136	1,130	791	678	339	452	316	271	136
2026	1,107	221	1,107	1,074	1,063	1,030	244	236	234	226	1,107	775	664	332	443	310	266	133	1,107	775	664	332	443	310	266	133
2027	1,108	222	1,108	1,075	1,064	1,030	244	236	234	227	1,108	776	665	332	443	310	266	133	1,108	776	665	332	443	310	266	133
2028	1,121	224	1,121	1,087	1,076	1,043	247	239	237	229	1,121	785	673	336	448	314	269	135	1,121	785	673	336	448	314	269	135
2029	1,144	229	1,144	1,110	1,098	1,064	252	244	242	234	1,144	801	686	343	458	320	275	137	1,144	801	686	343	458	320	275	137
2030	1,174	235	1,174	1,139	1,127	1,092	258	251	248	240	1,174	822	704	352	470	329	282	141	1,174	822	704	352	470	329	282	141
2031	1,210	242	1,210	1,174	1,162	1,125	266	258	256	248	1,210	847	726	363	484	339	290	145	1,210	847	726	363	484	339	290	145
SUM	11,727	2,345	11,727	11,375	11,258	10,906	2,580	2,503	2,477	2,399	11,727	8,209	7,036	3,518	4,691	3,284	2,814	1,407	11,727	8,209	7,036	3,518	4,691	3,284	2,814	1,407
$\Delta$ from baseline	0		0	-352	-469	-821	235	157	131	54	0	-3,518	-4,691	-8,209	2,345	938	469	-938	0	-3,518	-4,691	-8,209	2,345	938	469	-938

Note: All values are presented in billions of dollars. CG base taken from July 2021 CBO predictions for capital gains realizations over the next 10 years (accessible at <https://www.cbo.gov/data/budget-economic-data> under "Revenue projections, by category"). We assume a starting tax rate of 20% to compute baseline total revenues. We calculate that the percent change in realizations is equal to the product of the net-of-tax rate elasticity and the percent change in the net-of-tax rate (Change in rate divided by initial net-of-tax rate). An similar method using tax elasticities instead of net-of-tax rate elasticities yields identical results.

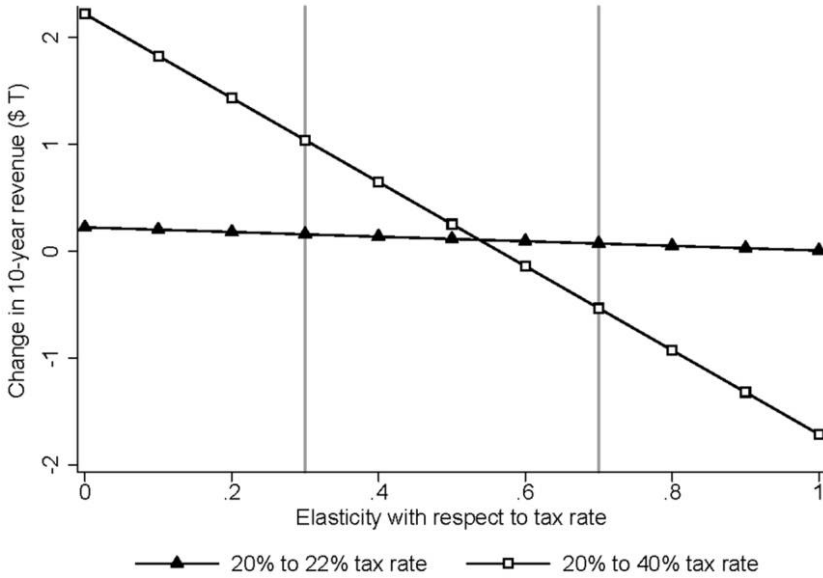
scores from JCT.<sup>23</sup> Table 3 shows how much realizations shrink under different elasticity assumptions. When  $e = 0$ , realizations remain at their baseline level. For  $e = -0.3$  and  $e = -0.7$ , values on the lower and upper end of the realization elasticities estimated by prior work, the baseline realizations shrink by 3% and 7% respectively.<sup>24</sup> Applying the new 22% tax rate to the smaller realization levels results in less revenue than the additional \$25 billion per year that would result if there were no behavioral response. With  $e = -0.3$  and  $e = -0.7$ , the annual gains are about \$15 billion and \$5 billion, respectively.

The JCT scores capital gains hikes of 2 percentage points as generating around \$70 billion over the 10-year budget window, which matches our 10-year estimate using the crude elasticity approach with  $e = -0.7$  of \$70 billion after accounting for the additional revenue gains of \$16 billion from qualified dividends.<sup>25</sup> We view it as validating that the crude approach matches the public JCT score.

The second tax change of interest is doubling the rate from 20% to 40%, which would raise the capital gains rate to top ordinary income levels. This change requires much more extrapolation from observed variation in the data. Especially given that the elasticity estimates we use are derived by observing responses to much smaller tax changes, a thorough exploration of such a large tax increase would involve more elaborate methods to model behavioral responses. Nonetheless, it is striking to see how much elasticity assumptions affect revenue estimates. Using an elasticity of  $e = -0.3$ , raising the tax rate to 40% would raise nearly \$950 billion over 10 years. Figure 12 shows the sensitivity of revenue estimates to a range of elasticities from 0 to 1. Adjusting our preferred elasticity toward 0 (e.g., if rate hikes are coupled with base-broadening reforms like the elimination of step-up in basis or death as a realization event) produces estimates approaching \$2 trillion.

Comparing this figure to the case of  $e = -0.7$  illustrates the striking behavioral responses implied by such an elasticity. Simply applying  $e = -0.7$  to the CBO's projections for realized gains implies a revenue loss of nearly \$950 billion over 10 years, compared with the gains of the same magnitude implied by our estimate using  $e > -0.4$ . Furthermore, in the Auerbach (1989) model, we can relate behavioral responses to changes in the frequency of realization and the extent of deferral until death or via charitable contribution. In the appendix, we find that with  $e = -0.7$ , if the effect on the capital gains tax base is driven solely by an increase in deferred realizations, the share of unrealized gains would have to rise from 50% to nearly 70%. If the effect is driven by an increase





**Fig. 12.** Illustrative revenue estimates for different elasticities. We base our estimates on CBO projections of capital gains realizations from 2022 to 2031 (accessible at <https://www.cbo.gov/data/budget-economic-data> under “Revenue projections, by category”). See table 3 for underlying CBO projections and realizations estimates corresponding to  $e = -0.3$ ,  $e = -0.4$ , and  $e = -0.7$ . We assume a starting tax rate of 20%. When multiplied by  $-([1 - 0.2]/0.2)$ , tax rate elasticities at a tax rate of 20% become net-of-tax rate elasticities. A color version of this figure is available online.

in turnover, then turnover would decrease from once every 3 years (CBO and JCT 2016) to once every 13 years, increasing by a factor of 4.

For the case of  $e = -0.3$ , the impact on unrealized gains would be half as large. The impact on turnover would also be about half as large, as turnover rises from once every 3 years to once every 7 years. Thus, the change in underlying investor behavior predicted by applying  $e = -0.7$  is significantly more dramatic than in the case of  $e = -0.3$ . More explicit modeling of turnover behavior and the distribution of unrealized gains would help provide discipline when modeling large tax changes.<sup>26</sup>

These calculations are far from a final word on the tax revenue at stake from these reforms. Moreover, we suspect that, for a large change in tax rates, scorekeepers have developed more elaborate revenue models than our stylized approach implies. Our objective is to illustrate that if, due to the many issues we raise above, the capital gains tax base overall is less elastic than previously understood, then the impact on official revenue estimates could be substantial.

## Revenue Estimates from Scorekeeping Community

To our knowledge, there are no recent official JCT estimates available for raising capital gains rates to ordinary income levels. The most recent estimates from JCT are those we discussed in section 5.1, which analyze a 5 percentage point increase in the long-term capital gains tax rate.

Estimates offered during this election cycle from unofficial scorekeepers (see table 4) suggest that large increases in capital gains rates can raise significant revenue. The general consensus appears to be that an increase in capital gains rates of the size we contemplate is likely to raise hundreds of billions of dollars in the coming decade.<sup>27</sup> Collectively, the US Treasury scored reforms to the taxation of capital income in the American Families Plan—taxing capital income for high-income earners

**Table 4**  
Unofficial Estimates of Revenue Potential from Taxing Capital Gains  
at Ordinary Income Levels

Source	Revenue Estimate (\$B)	Elasticities	Notes
Penn Wharton Budget Model	382	With step-up in basis: $-.66$ Eliminating step-up in basis: $-.53$	Reported estimate includes \$178 billion from taxing capital gains and dividends at ordinary rates, and \$204 billion from repealing step-up in basis
Tax foundation	469	Long-run: $-.79$ Transitory: $-1.2$ (year 1) and $-1.0$ (year 2)	Tax capital gains and dividends at the same rate as ordinary income for those with income \$1 million+ and repeal step-up in basis
Tax policy center	373	With step-up in basis: $-.7$ Eliminating step-up in basis: $-.4$	Tax capital gains and dividends at the same rate as ordinary income for those with income \$1 million+ and tax unrealized gains at death

Note: All rows present 10-year revenue estimates for raising the tax on capital gains and dividends to ordinary rates (39.6%) for income above \$1 million and eliminating the step-up in basis at death. Penn Wharton Budget Model revenue and elasticity estimates can be found at <https://budgetmodel.wharton.upenn.edu/issues/2020/3/10/the-biden-tax-plan-updated> and <https://budgetmodel.wharton.upenn.edu/issues/2019/12/4/the-revenue-maximizing-capital-gains-tax-rate-with-and-without-stepped-up-basis-at-death>. Tax Foundation revenue and elasticity estimates are available at <https://taxfoundation.org/joe-biden-tax-plan-2020/> and <https://taxfoundation.org/2020-capital-gains-tax-proposals/>. Estimates from the Tax Policy Center can be found at <https://www.taxpolicycenter.org/model-estimates/updated-analysis-former-vice-president-bidens-tax-plan-october-2020/t20-0246-former> and [https://www.taxpolicycenter.org/sites/default/files/publication/158624/An\\_Analysis\\_of\\_Former\\_Vice\\_President\\_Bidens\\_Tax\\_Proposals\\_1\\_2.pdf](https://www.taxpolicycenter.org/sites/default/files/publication/158624/An_Analysis_of_Former_Vice_President_Bidens_Tax_Proposals_1_2.pdf).

at ordinary rates and treating transfers of appreciated property by gift or on death as realization events—as raising \$322 billion from 2022 to 2031.<sup>28</sup> Because this estimate is also much smaller than the mechanical revenue effects, it is also worth revisiting in light of the considerations we offer.

### *C. Elasticity Depends on Broader Capital Gains Context*

Unique features of capital gains taxation make the tax base more sensitive to rate changes than other types of taxes (Dowd and Richards 2021). Most obviously, the existence of a step-up in basis upon the death of the taxpayer dissuades holders of unappreciated assets from realizing their gains in a high-rate environment, in the absence of consumption needs or a desire to diversify. Eliminating stepped-up basis would diminish incentives to lock-in gains, which would substantially increase the revenue potential of any hike in capital gains taxes.<sup>29</sup> Making death a realization event for capital gains tax collection would likely raise even more, because the value of deferral, especially in a low-rate environment, would be minimal if taxes were sure to be collected at death (abstracting away from policy risk that such a change would be rolled back by future policy makers).

In the current code, deferring gains until death is not the only capital gains avoidance tactic. When an individual donates an asset to charity (e.g., share of stock) that has appreciated in value, capital gains on that asset go untaxed, and the individual receives a credit equivalent to the full value of the gift, despite not paying any taxes on the gain. Further, investors can place existing assets with accumulated gains into opportunity zones (meant to spur investment in economically distressed communities) to defer payment of capital gains, or they can avoid taxation all together—for example, through the use of like-kind exchanges for real estate transactions. On top of this, investing in small businesses can mean up to \$10 million in gains is excluded from capital gains taxation. Broadening the capital gains tax base by limiting these preferences raises the revenue potential of capital gains reform efforts. Conversely, although significant sheltering opportunities exist, there is a legitimate concern that raising the capital gains rate will result in taxpayers relying more on existing tools to shield gains from taxation, thus limiting the potential of reform.

The elasticities that we use are based on the current capital taxation regime, including a step-up in basis at death, which amplifies the incentive to respond to capital gains tax changes. A broader overhaul of capital gains taxation—which raises rates while also eliminating sheltering

opportunities—could result in a lower realization elasticity, and thus even more revenue potential than our estimates suggest.<sup>30</sup>

#### *D. Role of Transparency and Dialogue*

Transparency on how dynamic adjustments are made in official scores would be valuable for several reasons. First, this transparency will facilitate discussion between professional scorekeepers and outside experts about the extent to which models can be improved and new data collected. Second, it will facilitate comparison of estimates across a broader set of proposals with confidence that consistent scorekeeping practices are applied. Ensuring comparability across scores produced for different proposals is essential to informing the policy process. And comparability depends on transparency of the assumptions that underlie these estimates.

A few examples are illustrative. Mark-to-market capital gains proposals have yet to be officially scored. But some available estimates of the likely revenue potential suggest that nearly \$200 billion annually could be raised (Batchelder and Kamin 2019; Gravelle 2019). By way of comparison, JCT estimates that taxing capital gains at death would yield about \$40 billion annually (absent any behavioral changes).<sup>31</sup> In a low-rate environment, the value of deferral is small, so one might expect closer revenue estimates from these policies. Clearly the methodologies underlying these estimates differ, but it is hard to understand why without more detail.

Another example concerns the score for eliminating the carried interest loophole. The JCT approach to scoring this provision seems to assume even larger shifting responses than in the case of capital gains tax increases, presumably because they model such a change in the absence of other changes to taxing gains. Essentially, the assumption is that fund managers will devise alternative contractual arrangements to reconstruct the status quo, so that revenues ultimately rise very little. It is unclear (to us) whether there is an empirical basis for this assumption.

Transparency is a double-edged sword. Given the importance of official scores to legislative decision-making, making the assumptions underlying scorekeepers' estimation publicly available will invite greater lobbying around those assumptions by supporters and critics of different reforms.

We do not propose opening the floodgates with respect to scorekeeping writ large. Scorekeepers already have many venues to get ideas from

academics, such as the NBER conferences, the Tax Economists Forum, the NTA meetings, and informal discussions. Nonetheless, a natural structure for more focused dialogue is in place: CBO already has a panel of advisers who provide input on economic issues and forecasting macroeconomic trends. This group—or a related subgroup of tax experts—can be convened to advise JCT, as well as CBO and the Treasury Office of Tax Analysis, to review and reconcile current capital gains scores and methods.<sup>32</sup> Continuing to promote informal conversations and collaborations between scorekeepers and academics would facilitate advancing the research frontier in the most useful directions.

## VI. Conclusion

The appropriate tax treatment of capital gains is a major issue. Historically, the consensus of scorekeepers has been that very sizable behavioral effects diminish the revenue-raising potential of rate hikes, because they encourage taxpayers to lock-in gains and avoid taxation, potentially indefinitely. We believe this conclusion is worth revisiting in light of recent research, an improved understanding of dynamic responses via medium-run investor behavior, and the recent evolution in the composition of capital gains.

Indeed, we argue the revenue potential from substantially increasing tax rates on capital gains may be greater than previously understood. Crude estimates suggest that raising capital gains rates could raise vastly more revenue than what is implied by applying conventional elasticities. The striking difference suggests there is much to be gained from refining the approach to scoring capital gains tax reforms.

Our call to action is borne from a position of enormous respect and admiration for the integrity and seriousness of the scorekeepers. The ultimate goal is to continue to advance our understanding of taxpayer behavior and the revenue potential of capital gains (and other) tax-reform efforts to inform the policy-making process. For example, it would be valuable for scorekeepers to explicitly model the consequences of capital gains tax changes on turnover, taking into account the large stock of yet-unrealized gains, how it varies across types of gains, and how it may evolve. We're optimistic that focusing on turnover is one avenue toward potentially improving revenue estimates and the analysis of capital gains taxation.

## Endnotes

Author email addresses: Sarin (natasha.sarin@gmail.com), Summers (julie@lawrence.summers.com), Zidar (ozidar@princeton.edu), Zwick (ezwick@chicagobooth.edu). This work does not necessarily reflect the views of the US Treasury. We thank Coly Elhai and Emily Bjorkman for outstanding research assistance. We also thank Tim Dowd, Howell Jackson, Robert McClelland, Rich Prisinzano, Jim Poterba, Joel Slemrod, and David Splinter for helpful comments. This work is supported by National Science Foundation under Grant Number 1752431. We declare that we have no relevant or material financial interests that relate to the research described in this paper other than owning some assets that have unrealized accrued capital gains. For acknowledgments, sources of research support, and disclosure of the authors' material financial relationships, if any, please see <https://www.nber.org/books-and-chapters/tax-policy-and-economy-volume-36/rethinking-how-we-score-capital-gains-tax-reform>.

1. Scorekeepers use a 10-year budget window. Although there are important budgetary effects outside this window, we follow convention in reporting revenue effects within this budget window.

2. For example, McClelland provides a short discussion of revenue-maximizing rates, noting that "the Tax Policy Center uses estimates that imply that the revenue from taxing long-term capital gains is maximized when the top rate is set to be about 28%" and the Treasury Department and JCT appear to use similar estimates. <https://www.taxpolicycenter.org/taxvox/new-study-suggests-congress-could-raise-money-increasing-capital-gains-tax-rates-47-percent>.

3. It is our understanding that realizations are modeled as falling by 70% over a 2-year period (based on the effects described in eq. [1]) and remain at depressed levels thereafter for years 3–10 of the budget window. In other words, the assumed effects for years 3–10 are 0 and therefore, the cumulative effective after 10 years is approximately a 70% decline in realizations over the collective 10-year period. We assume a starting tax rate of 20% and calculate percent change in realizations to be the product of the net-of-tax rate and percent change in the net-of-tax rate. To convert  $-0.7$  from a tax elasticity to a net-of-tax rate elasticity, we multiply by the ratio of the net-of-tax rate to the tax rate. Thus, postchange, we predict realizations will fall by  $0.7 \times ([1 - 0.2]/0.2) \times (0.2/[1 - 0.2]) = 0.7 = 70\%$ . This stylized example abstracts from the 3.8% net investment income tax and other tax considerations.

4. See Saez, Slemrod, and Giertz (2012), who use an elasticity of taxable income of  $-0.2$ . When comparing elasticity of taxable income estimates with estimates of the elasticity of capital gains, it is most appropriate to focus on the high-income elasticity of taxable income. Another caveat to this comparison is that elasticities of taxable income are typically estimated based on the net-of-tax rate, whereas capital gains elasticities are traditionally estimated using the tax rate.

5. In practice, we consider short-term effects to include the first 2 years and medium-term effects to cover years 3 through 7.

6. Auten and Cordes (1991) discuss the challenges identifying long- versus short-term gains in cross-section, panel, and time-series studies.

7. Auten, Burman, and Randolph (1989) critique earlier analyses of capital gains tax rates that rely on cross-sectional data and thus reveal only transitory tax effects.

8. Note that Dowd et al. (2015) use first-dollar marginal tax rate variables and the maximum combined state plus federal rate as instruments for the contemporaneous and lead tax rates (i.e.,  $\tau_{it}$  and  $\tau_{it+1}$ ).

9. Bakija and Gentry (2014) use a similar state-level identification strategy. Their approach controls for 1-year lag and lead changes in the tax rate, but does not consider changes outside this window and thus does not capture medium- or long-term effects.

10. This example builds on the logic of some examples of using savings elasticities with respect to after-tax rates of return in Ferey, Lockwood, and Taubinsky (2021).

11. There is also a 1985 SOCA study, but there are no study files for other years in the 1980s and early 1990s.

12. Indeed, the share of assets held for long periods is mechanically tied to recent market movements: when the stock of capital gains rises significantly in a year, the share of total gains that have been held for long periods drops.

13. See, for example, Odean (1998, 1999) and Barber and Odean (2000). In more recent work looking at bunching behavior around capital gains tax thresholds, Dowd and McClelland (2019) find that many taxpayers appear to pursue “distinctly inferior tax minimization [strategies]” when selling assets (p. 347).

14. See, for example, *Estate of Andrew J. McKelvey v. Commissioner*, No. 17-2554 (2d Cir. 2018).

15. Larrimore et al. (2021) is one recent example of work that does this.

16. Eichner and Sinai (2000) also point to the rise of equity held through mutual funds as one mechanism for lower elasticities. There may also be other risk-sharing or other nontax motivations for forming these legal forms that might limit the elasticity as well.

17. These effects may be nonlinear, so a large increase in the capital gains rate can increase absolute elasticity.

18. Another reason why considering dynamics and longer horizons would be valuable is that longer horizons are needed to detect and quantify these effects.

19. This was a point made by early work by Poterba (1989) and is even more true today.

20. In contrast, Moon (2020) presents evidence that a capital gains tax reform in South Korea had substantial effects on corporate investment.

21. We also provide revenue tables for a 10 percentage point rate increase from 20% to 30% in the appendix.

22. As we emphasize earlier in the paper, investors likely alter the timing of realizations within the budget window, but we abstract from this aspect of the discussion in this crude calculation here. Instead, we focus on the role of different elasticities and the implied reductions in the tax base and tax revenues over the 10-year budget window.

23. Note that the CBO cites the JCT as the source for the table of revenue effects. <https://www.cbo.gov/budget-options/2018/54788>.

24. Specifically, we take  $e = -0.3$  from Agersnap and Zidar (2020) discussed above (and pick the lower end of their range to reflect an elasticity that may be consistent with eliminating stepped-up basis and including other base broadeners) as well as  $e = -0.4$ , which is more of a midpoint estimate;  $e = -0.7$  is the midpoint of the current JCT and Treasury elasticity estimates of  $-0.68$  and  $-0.72$ , which we believe may be based in part on the headline estimate of  $-0.72$  in Dowd et al. (2015). We calculate change in realizations by multiplying the net-of-tax elasticity by percent change in the net-of-tax rate (calculated relative to the initial net-of-tax rate). We assume that tax elasticities apply at a tax rate of 20%, and so convert from tax elasticities to net-of-tax elasticities by multiplying by a factor of  $(1 - 0.2)/0.2$ . Thus, the change in realizations for  $e = -0.3$  is  $0.3 \times ([1 - 0.2]/0.2) \times (0.02/08) = 0.03$ .

25. The JCT’s estimate includes both long-term capital gains realizations and qualified dividends, which are about 23% ( $= \$3.5T/\$15.2T$ ) of total realizations plus qualified dividends in CBO’s July 2021 forecast for the next decade. Our \$54 billion estimate included only long-term realizations and needs to be scaled up to include revenues from qualified dividends to match JCT’s estimate. Incorporating qualified dividend revenue by scaling our realization estimate of \$54 billion by  $1/(1 - 0.23)$  delivers an estimate of \$70 billion that matches JCT’s score.

26. This calculation abstracts from reductions in the overall base due to real responses, which can also contribute to the change in gains and place less burden on turnover in accounting for the total response.

27. One difference between our back-of-the-envelope calculation and these scores is the size of the tax base. These scores focus on a proposal to raise rates only for those whose AGI exceeds 1 million, who collectively account for around 70% of all taxable realizations based on 2019 SCF data. Applying our approach to this group would result in 70% of the revenue in table 3 from raising rates across the board or \$620 billion at  $e = -0.3$  and \$310 billion at  $e = -0.4$ .

28. For plan details, see p. 61. For the revenue estimate, see the table of revenue estimates p. 105 of “General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals” <https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf>.

29. For context, the JCT estimates that stepped-up basis elimination at current rates would raise \$105 billion over a decade (CBO 2018). An alternative, crude approach from the Penn Wharton Budget Model scales the realization elasticity down by 20% from  $-0.65$  to  $-0.52$  (<https://budgetmodel.wharton.upenn.edu/issues/2020/9/14/biden-2020-analysis>).

30. Incorporating estate taxation and the taxation of inter vivos transfers in this broader overhaul would be worth considering.

31. From the JCT's 2019 tax expenditure estimates: <https://www.jct.gov/publications/2019/jcx-55-19/>.

32. It may also be useful to include a rotation policy for young scholars so their subsequent work can engage with the issues such as those outlined in this paper.

## References

- Agersnap, Ole, and Owen Zidar. 2020. "The Tax Elasticity of Capital Gains and Revenue-Maximizing Rates." Working paper no. 27705, NBER, Cambridge, MA.
- Auerbach, Alan J. 1989. "Capital Gains Taxation and Tax Reform." *National Tax Journal* 42 (3): 391–401.
- Auten, Gerald, and Charles Clotfelter. 1982. "Permanent versus Transitory Tax Effects and the Realization of Capital Gains." *Quarterly Journal of Economics* 97 (4): 613–32.
- Auten, Gerald E., Leonard Burman, and William Randolph. 1989. "Estimation and Interpretation of Capital Gains Realization Behavior: Evidence from Panel Data." *National Tax Journal* 42 (3): 353–74.
- Auten, Gerald E., and Joseph J. Cordes. 1991. "Policy Watch: Cutting Capital Gains Taxes." *Journal of Economic Perspectives* 5 (1): 181–92.
- Bakija, Jon M., and William M. Gentry. 2014. "Capital Gains Taxes and Realizations: Evidence from a Long Panel of State-Level Data." Unpublished Manuscript, Department of Economics, Williams College.
- Barber, Brad M., and Terrance Odean. 2000. "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors." *Journal of Finance* 55 (2): 773–806.
- Batchelder, Lily L., and David Kamin. 2019. "Taxing the Rich: Issues and Options." Available at SSRN. <https://ssrn.com/abstract=3452274>.
- Bell, Alex, Raj Chetty, Xavier Jaravel, Neviana Petkova, and John Van Reenen. 2019. "Who Becomes an Inventor in America? The Importance of Exposure to Innovation." *Quarterly Journal of Economics* 134 (2): 647–713.
- CBO. 2018. "Options for Reducing the Deficit: Change the Tax Treatment of Capital Gains From Sales of Inherited Assets." <https://www.cbo.gov/budget-options/54792>.
- CBO and JCT. 2016. "The Distribution of Asset Holdings and Capital Gains." <https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/51831-capitalgains.pdf>.
- Dowd, Tim, and Robert McClelland. 2019. "The Bunching of Capital Gains Realizations." *National Tax Journal* 72 (2): 323–58.
- Dowd, Tim, Robert McClelland, and Athiphat Muthitacharoen. 2015. "New Evidence on the Tax Elasticity of Capital Gains." *National Tax Journal* 68 (3): 511.
- Dowd, Tim, and Zach Richards. 2021. "Contextualizing Elasticities for Policy-making: Capital Gains and Revenue-Maximizing Tax Rates." Available on SSRN. [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3767121](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3767121).



- Eichner, Matthew, and Todd Sinai. 2000. "Capital Gains Tax Realizations and Tax Rates: New Evidence from Time Series." *National Tax Journal* 53 (3, part 2): 663–81.
- Feldstein, Martin. 2006. "The Effect of Taxes on Efficiency and Growth." Working paper no. 12201, NBER, Cambridge, MA.
- Ferey, Antoine, Benjamin Lockwood, and Dmitry Taubinsky. 2021. "Sufficient Statistics for Nonlinear Tax Systems with Preference Heterogeneity." Working paper no. 29582, NBER, Cambridge, MA.
- Gravelle, Jane. 2019. "Mark-to-Market Taxation of Capital Gains." [https://www.taxpolicycenter.org/sites/default/files/mark-to-market\\_taxation\\_of\\_capital\\_gains.pdf](https://www.taxpolicycenter.org/sites/default/files/mark-to-market_taxation_of_capital_gains.pdf).
- Jakobsen, Katrine, Kristian Jakobsen, Henrik Kleven, and Gabriel Zucman. 2020. "Wealth Taxation and Wealth Accumulation: Theory and Evidence from Denmark." *Quarterly Journal of Economics* 135 (1): 329–88.
- Joint Committee on Taxation, Staff. 1990. "Explanation of Methodology Used to Estimate Proposals Affecting the Taxation of Income from Capital Gains." Vol. JCS-12-90. <https://www.jct.gov/CMSPages/GetFile.aspx?guid=8c7d67bd-1e93-4dbd-885b-be35e7077b1d>.
- . 2021. "Estimated Budgetary Effects Of An Amendment in the Nature of a Substitute to the Revenue Provisions of Subtitles F, G, H, I, and J of the Budget Reconciliation Legislative Recommendations Relating to Infrastructure Financing and Community Development, Green Energy, Social Safety Net, Responsibly Funding Our Priorities, and Drug Pricing, Scheduled for Markup by the Committee on Ways and Means on September 14, 2021." Vol. JCX-42-21. <https://www.jct.gov/publications/2021/jcx-42-21/>.
- Larrimore, Jeff, Richard V. Burkhauser, Gerald Auten, and Philip Armour. 2021. "Recent Trends in US Top Income Shares in Tax Record Data Using More Comprehensive Measures of Income Including Accrued Capital Gains." *Journal of Political Economy* 129 (5). <https://doi.org/10.1086/713098>.
- Moon, Terry S. 2020. "Capital Gains Taxes and Real Corporate Investment." Working paper, Princeton University.
- Odean, Terrance. 1998. "Are Investors Reluctant to Realize Their Losses?" *Journal of Finance* 53 (5): 1775–98.
- . 1999. "Do Investors Trade Too Much?" *American Economic Review* 89 (5): 1279–98.
- Poterba, James M. 1989. "Venture Capital and Capital Gains Taxation." *Tax Policy and the Economy* 3:47–67.
- President and CEA. 1990. "Economic Report of the President." <https://fraser.stlouisfed.org/title/economic-report-president-45/1990-8161>.
- Saez, Emmanuel, Joel Slemrod, and Seth H. Giertz. 2012. "The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review." *Journal of Economic Literature* 50 (1): 3–50.
- Smith, Matthew, Danny Yagan, Owen M. Zidar, and Eric Zwick. 2019. "Capitalists in the Twenty-First Century." *Quarterly Journal of Economics* 134 (4): 1675–745.
- Smith, Matthew, Owen M. Zidar, and Eric Zwick. 2021. "Top Wealth in America: New Estimates and Implications." Working paper, Princeton University.
- Stiglitz, Joseph, E. 1983. "Some Aspects of the Taxation of Capital Gains." *Journal of Public Economics* 21 (2): 257–94.
- Yagan, Danny. 2015. "Capital Tax Reform and the Real Economy: The Effects of the 2003 Dividend Tax Cut." *American Economic Review* 105 (12): 3531–63.