

The NBER Digest

NATIONAL BUREAU OF
ECONOMIC RESEARCH, INC.

April 1987

Capital Gains Taxes and Revenues under the 1986 Law

The increase in tax rates on capital gains written into the Tax Reform Act of 1986 is unlikely to produce increased revenues, according to a new study by NBER researcher **Lawrence Lindsey**. In **Capital Gains Taxes under the Tax Reform Act of 1986: Revenue Estimates under Various Assumptions** (forthcoming as an NBER Working Paper), Lindsey estimates that taxpayers will respond to the higher tax rates by postponing—in some cases indefinitely—their sales of appreciated assets. As a result, capital gains tax revenues will be lower or flat under the new law.

For the first time since 1922, long-term capital gains under the new tax law are treated as ordinary income (except in 1987, when the tax rate on capital gains is limited to 28 percent). The end of special treatment means that the typical tax rate for capital gains recipients will more than double, from about 9 percent to about 21 percent, Lindsey estimates. Taxpayers with incomes under \$30,000 will generally see their rates on capital gains triple; taxpayers with incomes of \$30,000 to \$200,000 will have their rates double; and at incomes over \$200,000, rates will increase by about 75 percent.

Lindsey estimates how these changes in the tax law will affect the behavior of taxpayers who have net long-term gains and, consequently, will affect revenues raised by the capital gains tax. He uses five different sets of behavioral assumptions that have

emerged from previous studies of capital gains tax rates and realizations. In each of those studies, the authors estimated the extent to which reported realizations varied with marginal tax rates or with the share of capital gain the taxpayer would keep after taxes.

Lindsey then considers four possibilities: (1) taxpayers expect the new rates to be permanent; (2) they take account of past rates; (3) they take account of future rates; or (4) they take account of both past and future rates. In the first two cases, realizations and revenues will fall substantially. In the last two cases, realizations will rise in 1986 and will fall in future years.

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Further, when Lindsey contrasts the revenue that would have been raised by the old law with his two highest projections of revenue under the new law, he concludes that, “the effect of the new law is to increase the share, and in some cases the level, of taxes paid by lower-income groups while cutting

both the share and the level of capital gains tax revenue paid by upper-income groups.”

Only one of the five sets of behavioral assumptions predicts an increase of \$0.7 billion in capital gains tax revenues over a five-year period: fiscal year 1987 through fiscal year 1991. In general, the simulations predict five-year revenue losses of \$20 billion or more. Only if realizations increased significantly in late 1986 in anticipation of future rate hikes would the five-year revenue losses be under \$10 billion.

In contrast to Lindsey's findings, both the Department of the Treasury and the Joint Committee on Taxation project a large increase in revenue over the next five fiscal years. But their analyses assume some prospective behavior on the part of taxpayers. In addition, they both assume that any tax rate effect on realizations and revenues is purely transitory. None of the academic models makes this assumption.

Training Programs and the Unemployed

After a lapse of several years, training programs once again are being proposed as a way to help unemployed and disadvantaged workers to better themselves. This idea is not new. In fact, during the late 1970s, thousands of people participated in training programs subsidized by the federal government under the Comprehensive Employment and Training Act (CETA). These CETA programs were drastically cut back by the Reagan administration, largely because of claims that they were ineffective in helping to lower unemployment and raise earnings.

Now a study by NBER Research Associate **David Card** and Faculty Research Fellow **Daniel Sullivan** finds that some CETA programs were effective. In **Measuring the Effect of Subsidized Training Programs on Movements In and Out of Employment** (*NBER Working Paper No. 2173*), Card and Sullivan report that a sample of men enrolled in these programs during 1976 increased their chances of employment by two to five percentage points during the following three years. Classroom trainees experienced the most improvement, while participants who received on-the-job training saw less change in their status.

Card and Sullivan find that the effect of CETA training did not diminish over time. The improvement in the employment level of the trainees was as great in 1979 as in 1977, the first year after training.

Card and Sullivan estimate that classroom training raised the annual earnings of the average participant by \$300, compared with a cost to the federal government of under \$900 per participant. They also estimate that other CETA programs, including on-the-job training and work experience, raised the annual earnings of participants by \$100, compared with government costs of \$1500 to \$3000.

“Some CETA programs were effective.”

Total enrollment in all CETA programs was over 800,000 in June 1976. At that time, roughly 20 percent of the participants were enrolled in classroom training, 25 percent were in work-experience programs, and 35 percent were in public sector employment programs. In the sample of men studied by Card and Sullivan, the average age was 31. The men had an average of 11.5 years of education, and half of them were married.

Unions and Job Security

Union members have more job security in government than in the private sector, according to NBER Research Associate **Steven Allen**. He finds that, “unions reduce by a substantial amount the already low lay-off and unemployment probabilities in the public sector. . . .” On the other hand, union members in the private sector are more likely to become unemployed than nonunion workers are.

In **Unions and Job Security in the Public Sector** (*NBER Working Paper No. 2108*), Allen compares the unemployment rates for private versus government workers over 1948–85. Although rates for private workers were higher throughout the period, the gap between those rates (for private versus government workers) has narrowed substantially. When Allen controls for differences in the characteristics of workers and jobs, he finds that the odds of being unemployed have been identical for nonunion workers in both sectors since the mid-1970s.

In contrast, union members are much less likely to become unemployed if they work in government than if they work in the private sector. For household heads who are union members, the odds of being

unemployed during the course of a year are five percentage points lower for government workers than for private sector workers.

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Why is this so? Allen suggests two explanations. First, public sector unions may be able to resist reductions in their employers' labor costs more effectively than private sector unions can. “The political power of public employee unions can be used in many cases to prevent budget cuts,” he writes.

Second, when unions in the public sector cannot prevent budget cuts, they may prefer wage cuts to employment cuts. Although most union members in the private sector are covered by fairly generous unemployment insurance, Allen shows that such coverage is less extensive and less generous for unionized government workers.

The Bolivian Hyperinflation and Stabilization

Increased financial problems with developing country debtors have heightened concerns about inflation both in the United States and abroad. Brazil and Argentina recently experienced annual inflation rates of 100 to 600 percent, and Bolivia had inflation that reached an annual rate of 60,000 percent during the summer of 1985. Bolivia's experience in particular shows what can happen in very extreme situations when governments print money to finance budget deficits.

Bolivia is the only country in the twentieth century to have had a hyperinflation that did not come in the aftermath of a war or revolution. In **The Bolivian Hyperinflation and Stabilization** (*NBER Working Paper No. 2073*), Research Associate **Jeffrey Sachs** analyzes the causes of that hyperinflation and the changes in government policies that ended it in the fall of 1985.

Sachs explains that the process leading up to the hyperinflation began around 1981 when new foreign lending to Bolivia ceased, partly because of

extreme political instability there and partly because of the tightening of international credit markets and the rise in world interest rates. New lending, net of interest payments, fell from 4.2 percent of GNP in 1980 to 2.2 percent of GNP in 1981. In 1982 and 1983, when new lending had stopped but interest payments were still being made, Bolivia paid 2.4 percent and 5.6 percent of its GNP, respectively, to foreign creditors.

No longer able to finance budget deficits by borrowing abroad, the Bolivian government stepped up its printing of money. At first, inflation increased only slowly, but as the growth in the money supply rose, Bolivians cut back on the real value of the cash they used. The faster they spent money, the higher the rate of inflation was, rising from 32 percent in 1981 to 124 percent in 1982, 276 percent in 1983, and 1282 percent in 1984, before reaching true hyperinflation levels during the summer of 1985.

As inflation rose, the government failed to adjust certain controlled prices quickly enough to keep up with the general price level. As a result, the controlled price of oil fell to less than one-sixth of the world price, and government revenues from domestic sales of Bolivian oil virtually disappeared. Further, most tariffs and domestic excise taxes were levied at fixed amounts rather than as a percentage of value, and property taxes were based on assessed values that were fast becoming only a negligible fraction of market value.

The government also failed to adjust the official exchange rate to keep up with inflation, and the Bolivian peso became extremely overvalued. As the gap between the official rate and the black market rate widened, exporters could earn far more by smuggling their goods out of the country and receiving the black market rate than by exporting through legal channels.

“These shocks have not led to a resurgence of inflation because the government has maintained tight fiscal policies.”

As government foreign exchange receipts fell, importers were increasingly forced to obtain foreign currency in the black market. Once in the black market, they too smuggled their goods. As smuggling increased during the hyperinflation, government revenues from tariffs fell further. Near the end of the hyperinflation, the black market exchange rate for the peso was 14 times the official exchange rate, and a large share of Bolivia's trade was smuggled.

The result of this process was a fall in government revenues from about 9.5 percent of GNP in 1979-81 to 1.3 percent in 1985. As revenues declined, so did

government spending other than on interest payments. Public sector investment and central government spending on personnel and materials fell sharply. However, because interest payments continued, the government budget deficit did not fall, and throughout 1982–85, most government spending was financed by the printing of money.

The end of the hyperinflation came in August 1985. A new government announced that it would no longer attempt to control the exchange rate. Public sector prices, especially oil prices, would be raised to world levels and public sector wages would be cut and employment reduced. Also, private sector prices would be decontrolled. The new government also promised tax reform and new negotiations with foreign lenders.

These policies had their effect within ten days.

The official exchange rate weakened from 67,000 pesos to 1.1 million pesos per dollar, but then stabilized. The domestic price of oil rose from 3 cents to 28 cents per liter. During the week that followed these dramatic changes, prices rose by 37 percent. But in the weeks that followed, prices were stable or even declined. And, except for a brief period around Christmas 1985, prices have continued to stabilize despite further sharp declines in export earnings. Sachs estimates that another collapse in world tin prices, the fall in oil prices, and the Bolivian government's crack-down on the domestic cocaine industry have reduced real income in Bolivia by up to 10 percent, but so far these shocks have not led to a resurgence of inflation because the government has maintained tight fiscal policies.

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