

The Capital Gains Preference: An Analysis of Economic Efficiency, Equity, and Reform Alternatives

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Abstract: *The preferential tax treatment of long-term capital gains is a cornerstone of many countries' tax systems, including that of the United States. This policy is primarily justified on the grounds of promoting economic efficiency by encouraging investment, mitigating the "lock-in" effect, and adjusting for inflation. On the other hand, it faces significant criticism for exacerbating income inequality and reducing the progressivity of the tax code. This paper combines a review of the economic literature, an analysis of historical tax data, and a comparative policy study in a mixed-methods approach to evaluate the trade-offs inherent in the capital gains preference. The findings indicate that the efficiency arguments are theoretically sound, but their empirical support is mixed and often outweighed by substantial equity concerns. The paper concludes that the current structure in the U.S. is suboptimal and proposes a set of reforms, including a tiered inclusion system based on asset holding periods and the harmonization of rates for very high-income earners, to better balance the goals of efficiency and equity.*

Keywords: Capital Gains, Taxation, Efficiency, Equity, Lock-in Effect, Income Inequality, Tax Reform

I. INTRODUCTION

Taxation of capital income is at the heart of two often conflicting goals of public policy: economic growth and distributional fairness. One particularly contentious and debated issue under this heading is the taxation of capital gains, or the profits derived from the sale of assets such as stocks, bonds, and real estate. In the United States and most other OECD nations, tax rates imposed on long-term capital gains are lower than those levied against ordinary income—wages and salaries. This preferential treatment is not an accidental feature of the tax code, but an explicit policy choice with far-reaching ramifications.

The debate over taxation of capital gains is at its core a debate over trade-offs. Proponents argue that lower taxes on the returns to investment are necessary to encourage savings, promote entrepreneurship, and spur long-term economic growth. They cite the "lock-in" effect, wherein high tax liabilities deter investors from selling assets and shifting capital to more productive uses. Critics counter that the benefits of this policy flow overwhelmingly to the wealthiest households, who derive a disproportionate share of their income from investments rather than labor. This, in turn, undermines the progressivity of the tax system and exacerbates wealth and income inequality, possibly without yielding the promised economic dividends.

This paper aims to go beyond the political rhetoric by providing a clear-eyed analysis of the capital gains preference. The central research question is: Does the preferential tax treatment of long-term capital gains in the United States effectively promote economic efficiency without unduly compromising tax equity, and if not, what are the viable reform alternatives? This paper's thesis is that, while much theoretical rationale exists for a capital gains preference, the policy structure in place within the U.S. today is a blunt instrument that generates significant inequity while providing uncertain and potentially inefficient economic incentives. In contrast, targeted reform might better achieve both objectives of investment promotion and fairness in taxation. The paper is organized as follows: Section 2 sets out the theoretical and empirical background to the debate; Section 3 describes the methodology; Section 4 presents the



analysis-under the headings of anatomy of capital gains, efficiency arguments, and equity concerns; Section 5 discusses the findings and their implications; Section 6 concludes with specific policy recommendations.

II. LITERATURE REVIEW

2.1 Theoretical Foundations

The theoretical case for a capital gains preference rests on three pillars:

Promotion of Savings and Investment: Classical and neoclassical economic models posit that lower taxes on capital income increase the after-tax return on investment. This encourages individuals to save and invest more of their income, rather than consume it. This increased pool of savings lowers the cost of capital for firms, leading to higher levels of investment in physical capital, research and development, and innovation, which are key drivers of long-term economic growth (Zodrow, 2010).

The "Lock-in" Effect: This is perhaps the most robust efficiency argument. A high tax rate on realized gains creates a disincentive to sell an asset. An investor may choose to "lock in" to a current, underperforming asset to avoid triggering a tax liability, rather than selling it and reinvesting the proceeds in a potentially higher-return opportunity. This leads to a misallocation of capital and reduces economic efficiency (Auerbach, 1992). A lower tax rate reduces this distortion.

Inflation Adjustment: Nominal capital gains are not adjusted for inflation. Thus, some of the gain appearing in any given year is not a "real" economic gain but rather a result of rising price levels. Taxing this inflationary gain increases the effective tax rate on real returns and can sometimes even represent a tax on a real economic loss (Auten & Cordes, 1991). A reduced statutory rate is sometimes viewed as a crude proxy for an appropriate inflation adjustment.

2.2 Empirical Evidence on Efficiency

The empirical record is less clear-cut than the theory.

Supportive Studies: Some studies find a positive correlation between lower capital gains taxes and increased entrepreneurial activity and venture capital funding. Other studies indicate high responsiveness of capital gains realizations to tax rates: when rates are cut, individuals are more likely to sell assets, leading to a short-term surge in tax revenue-the "realizations response".

Critical Studies: More recent evidence tends to weaken the impact of low capital gains tax rates on productive investment. Saez & Zucman (2019) argue that a large fraction of capital gains accrues to passive investors who are less sensitive to tax-induced incentives for productive investment. In addition, increased realizations after a tax cut often cause temporary revenue gains, whereas long-term revenue loss can be significant; see Congressional Budget Office [CBO] (2022).

2.3 Literature on Equity and Distribution

The equity argument against preference is strong and bolstered by data.

Concentration of Gains: The benefits of the capital gains preference are extremely concentrated. The Tax Policy Center estimates that in 2023, more than 75 percent of the benefits of the preferential rates will accrue to the top 1 percent of households by income. This is because ownership of taxable capital assets is heavily skewed towards the top of the wealth distribution.

Erosion of Progressivity: The ability of high-income individuals to generate income in the form of preferentially taxed capital gains, rather than ordinary income, undermines the progressivity of the federal income tax. This creates a disparity where a wealthy investor may pay a lower effective tax rate than a middle-class wage earner (Saez & Zucman, 2019).

The "Buffett Rule" is the popular name given to the fact that investor Warren Buffett once famously said he pays a lower tax rate than his secretary. According to Piketty, this shows the perceived unfairness of taxing income from wealth at a lower rate than income from work.

Research Gap

While the efficiency-equity trade-off is well-established, much of the existing literature tends to focus on one dimension at the expense of the other. The current paper aims to synthesize these perspectives and use the synthesis to



evaluate specific, under-discussed reform proposals that move beyond the binary choice of keeping or eliminating the preference.

III. METHODOLOGY

This research uses a qualitative mixed-method approach to give a holistic analysis.

- **Research Design:** The main design is a descriptive and analytical policy analysis, entailing the study of existing structures, weighing arguments, and compiling data in support of potential reforms.
- **Data Collection:** The study solely relies on secondary data from authentic public sources:
- **U.S. Government Agencies:** Data from Internal Revenue Service, Statistics of Income Division, Congressional Budget Office, and Joint Committee on Taxation on the distribution and magnitude of capital gains.
- **International Organizations:** Comparative data from the OECD on tax policies and economic outcomes for member countries.
- **Academic Research:** Peer-reviewed economic studies, many from journals including the American Economic Review and the National Tax Journal.
- **Policy Institute Reports:** The analyses by non-partisan think tanks such as the Tax Policy Center and the Tax Foundation.
- **Analytical Framework:** The analysis is organized around a Trade-off Evaluation Framework. Each major argument-e.g., lock-in, investment incentive, equity-is evaluated on two dimensions: the strength of theoretical and empirical support, and the magnitude of economic or social impact. This allows for a comparative assessment of competing claims.

IV. ANALYSIS / FINDINGS

4.1 The Anatomy of Capital Gains in the United States

Understanding who earns capital gains is critical to the debate. The distribution is profoundly skewed.

Distribution by Income Group: Figure 1 is a hypothetical graph used in this paper. The top 1% of taxpayers report over 50% of all long-term capital gains. The bottom 80% report less than 10%. The concentration has rapidly developed over the past several decades.

Composition by Asset Type: Capital gains are not homogeneous. Realizations arise from multiple sources:

Corporate Stock: the largest source for high-income earners.

Pass-Through Businesses: Sales of partnerships and S-corporation interests.

Real Estate: Both residential and commercial, though the primary residence often has significant exclusions.

This diversity is important for policy, given that the economic justification for a preference may be stronger for some asset types-e.g., startup equity-compared to others-e.g., passive stock trading.

4.2 The Efficiency Argument: A Closer Look

The Lock-in Effect is Real: There is strong evidence that supports the lock-in effect. It indicates that there is a clear inverse relation between tax rates and the volume of asset sales. For instance, when the Tax Cuts and Jobs Act of 2017 maintained preferential rates, it did not trigger a major sell-off, whereas discussion of future rate increases often does. This behavioral response confirms the distortionary power of the tax.

But the Investment Link is Weaker: The critical question, of course, is whether reduced lock-in translates into more productive investment. Here the evidence is much less convincing. A significant portion of realized gains from a one-time tax cut may be consumed or reinvested in existing assets, simply driving up stock prices without funding new capital formation. The link is strongest for venture capital and initial business formation, which represent a small fraction of total capital gains realizations.

Revenue Volatility: The realizations response makes capital gains tax revenue highly volatile and unpredictable. Revenue spikes during bull markets or in anticipation of tax rate increases, and plunges during downturns. This complicates federal budgeting and long-term fiscal planning.



4.3 The Equity Argument: An Overwhelming Case

Violation of Horizontal Equity: Horizontal equity requires that taxpayers with similar incomes pay a similar amount of taxes. The preference violates this principle. Consider two different people, each earning \$500,000—one from salary and another from the sale of stock. They will pay dramatically different taxes. A wage earner falls in the top bracket and pays 37%, while an investor faces up to 20%.

Erosion of Vertical Equity: What vertical equity demands is that those with a greater ability to pay contribute a higher proportion of their income. In fact, the capital gains preference actively works against this. As shown by Piketty, Saez, and Zucman, often the very highest earners in the United States have the lowest effective tax rates because of the composition of their income.

Wealth Inequality Feedback Loop: Preferential taxation of the main source of income for the rich allows for higher after-tax accumulation of wealth. That accumulated wealth in turn generates more capital gains in the future, creating a feedback loop that compounds wealth concentration across generations.

4.4 A Comparative Perspective: Lessons from the OECD

A comparison with other advanced economies puts the issue into some context. Capital gains taxation policy varies markedly:

No Separate Taxation, for instance, Belgium and Switzerland: Capital gains are largely not subject to tax, with capital mobility and investment taking precedence.

Income tax integration, such as in Denmark and Canada: The entire capital gain is included in taxable income; however, a partial inclusion rate may be allowed, such as 50 percent in Canada, for immediate recognition of inflation and the lock-in effect.

Complex Tiered Systems—for instance, the United States and France: Rates depend on holding period, asset type, and taxpayer income.

The comparison shows there is no single "correct" model. Countries with higher capital gains taxes, like Denmark, have not seen their investment rates collapse, suggesting other factors—like infrastructure, education, and macroeconomic stability—are also critical drivers of investment.

V. DISCUSSION

A stronger disconnect between theoretical justifications and real-world outcomes than the one revealed by this analysis would be difficult to imagine. While the efficiency arguments can be valid conceptually, they are empirically fraught with weak links to broad-based productive investment and are trumped by the policy's major contributions to revenue volatility—and most important, stark inequality.

But the fundamental problem with the current U.S. system is that it is a blunt instrument. It imposes the same preferential rate on the venture capitalist holding a startup for five years as it does on the day trader who sells tech stocks in a year and a day. It doesn't distinguish between truly entrepreneurial long-term investment and shorter-term, more passive financial activity.

Our findings in this paper indicate that the no-preference-versus-the-current-preference framing of the political debate involves a false dichotomy. The more fruitful direction for discussion would be to focus on how to design a smarter, more targeted preference that retains incentives for economically beneficial investment while reducing windfalls from passive wealth accumulation.

Limitations: First, this analysis is largely qualitative in nature and depends on aggregate data. The use of micro-data from the IRS would allow for a better, more specific tracking of individual investment behavior subsequent to tax changes. In addition, there are also major political constraints to any reform effort, which this economic analysis does not delve into.



VI. CONCLUSION AND POLICY IMPLICATIONS

Preferential tax treatment of capital gains is a policy at a crossroads. The evidence reviewed in this paper suggests that its current incarnation in the United States is hard to defend on either efficiency or equity grounds. It provides uncertain economic benefits at a very high cost to the progressivity and fairness of the tax system.

It is, therefore, not a very sound policy to keep things as they are. The following set of reforms is more balanced, nuanced:

A Tiered Inclusion System Based on Holding Period: Rather than having a binary (short-term/long-term) switch at one year, the percentage of a capital gain included in taxable income should decline over a longer period.

Example: 100% inclusion for assets held <3 years; 75% for 3-5 years; 50% for 5-8 years; 25% for 8+ years.

Rationale: This would aggressively target the incentive towards truly long-term investment, directly addressing the lock-in effect for assets which are most likely to be "stuck," while reducing the benefit for short-term trading.

Harmonization of Top Marginal Rates for High Incomes: Taxation of capital gains and dividend income for taxpayers with adjusted gross income above \$1 million should be aligned with the top marginal rate on ordinary income.

Rationale: This directly addresses the equity problem at the very top of the distribution, where the disparity is most egregious and the economic benefits of the preference are most questionable. It would implement the "Buffett Rule" in a straightforward manner.

Create a Targeted Exclusion for Entrepreneurial Investment: Provide a permanent, 100 percent exclusion for gains from original-issue shares in small, private businesses held for more than five years.

Rationale: This would surgically support the type of risk-taking and business formation that is the strongest justification for a preference, without providing a blanket subsidy to all capital gains.

Avenues for Future Research: Future work should be done which quantitatively models the revenue and distributional effects of the suggested multi-tiered system of inclusions. Furthermore, it would be useful to conduct studies on how various groups of investors-venture capitalists and retail investors, for example- react to targeted reforms. In all, reform of the tax on capital gains should aim not to penalize investment but to channel it more productively, and to make the tax system that finances the government seen as fair by all its citizens. The reforms outlined here offer a path toward a system that rewards the patience and risk-taking that drive growth, without unfairly privileging wealth over work.

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