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Capital Gains Tax: Significance of Changes in Holding Period and Long Term Rate

Harold M. Somers*

The author studies the economic implications of changes in the structure of the capital gains tax. He shows how this tax creates a "lock-in" effect, which reduces the liquidity of the market and impairs economic growth, and he concludes that the proposed reduction of the long-term rate and lengthening of the holding period will only have further detrimental effect on the market.

The capital gains tax in this country has been subject to a number of changes in holding period and long-term rate. Once again, revisions are under consideration. The Administration's tax proposals of 1963 contemplate a change in the holding period from six months to one year and a change in the long-term rate from 50 per cent of the ordinary income bracket, with a maximum tax rate of 25 per cent, to a simple inclusion of 30 per cent of long-term gains. With the proposed reduction in ordinary income brackets from a range of 20-91 per cent to a range of 14-65 per cent, the long-term rate would change effectively from the current range of 10-25 per cent to a range of 4.2-19.5 per cent.¹

The present article is concerned with the economic significance of changes in holding period and long-term rate. The President's proposals are used for illustrative purposes only. The same basic analysis may be used in evaluating other specific proposals, such as the use of lower rates for holdings between six months and three years.

I. IMPACT ON AVAILABILITY OF CAPITAL

In order to understand the current provisions and the proposed changes, we must consider the philosophy behind the differential treatment of longer-term gains. It is recognized that there is a significant distinction between current income and capital gains and that true capital gains, if they can be distinguished clearly, should be

* Chairman, Department of Economics, University of California, Los Angeles. The author received valuable suggestions from Alice John Vandermeulen and J. Fred Weston who should not be held responsible for the defects of this paper.

1. H.R. Doc. No. 43, 88th Cong., 1st Sess. (1963); President's 1963 Tax Message, *Hearings Before the House Comm. on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 23-24 (1963).

subjected to a lower rate than current income. In some countries, the capital gains, once they are segregated, are left tax-free. In others, some tax is imposed, partly out of a concern for the difficulty of segregating true capital gains and partly out of a recognition of the fact that the gains do provide spendable income and should be subject to taxation. One rationalization of the differential treatment of longer-term gains is the assumption that longer-term holdings are somehow desirable for the economy, hence that the government should encourage longer-term holdings through lower rates. Is this a valid assumption? In particular, is it a valid assumption in the case of securities?

Here we must distinguish between the physical investment—the purchase of plant, equipment and inventories—and the financial instruments that facilitate such physical investment. The physical investment itself may involve a commitment of many months or years. Does this mean that the purchaser of the financial instruments should be encouraged by the government to hold on to the securities for months or years? In other words, should the government intervene in the securities market to encourage holders of securities to hold on to their securities longer than they might otherwise? There may be reasons why the government wishes to use tax policy (*e.g.*, through depreciation rates and investment credit) to encourage long-term physical investment; it does not automatically follow from this that the government should use tax policy to encourage longer-term holding of the underlying securities.

Pursuing this point further, let us distinguish between the “physical-investor” who actually purchases the plant, equipment or inventories and the “financial-investor” who provides the funds. We must also distinguish between the “initial” financial-investor, who provides funds to the physical-investor (hence, buys the new securities) and the “subsequent” financial-investor, who buys second-hand securities. The initial financial-investor may purchase stocks, bonds, notes, “open account” or, if he is also the physical-investor, may simply finance himself.

Depreciation preferences and investment credits are directed toward the physical-investor and are designed to induce him to make more physical investments of a particular duration or character. If, for the moment, we identify physical investment with economic growth, we might say that such tax concessions tend to promote economic growth.

What if the government decides that such inducements operating on the physical investor are not enough? It may decide to induce the financial-investor to make funds more readily or more cheaply available to the physical-investor. The obvious way would be to

reduce or remove any tax penalty associated with making funds available to the physical-investor. The taxation of capital gains is such a penalty and a reduced rate or shorter holding period tends to reduce the penalty. As a general proposition we may say that the lower the rate or the shorter the holding period the less the penalty, hence the greater the inducement to provide funds to the physical-investor, hence promote economic growth.

It is in this way that a lower tax rate on capital gains—whether on all gains or only long-term gains—tends to promote economic growth. In case the tax structure distinguishes between short-term and long-term gains and taxes the latter at a lower rate, a reduction in holding period will likewise tend to promote economic growth. Since we rely primarily on the free market to provide the funds to finance economic growth, it behooves us to increase the effectiveness of that market in providing those funds. Tax inducements to provide funds for investment through lower rates and shorter holding periods cannot be overlooked in that context.

A. AT POINT OF INITIAL INVESTMENT

The fact that financial and physical investment must be distinguished should not blind us to the fact that the one can have a profound impact on the other. It is true that, "The purchase of a security and the purchase of a capital good should be distinguished. In the former case, the investment decision from the social point of view has already been made and financial resources committed."² This fact does not make it a matter of indifference to us that tax policy tends to lock in the initial financial investment and slow down subsequent exchanges of second-hand securities. The prospective lock-in discourages new investors from entering the field and retards the transfer of financial resources among investors. The mobility of capital is impaired, the freedom to move in response to incentive (other than tax) is hampered and the liquidity of the market is reduced.

Assume that the old physical investment is now less desirable socially than some prospective new investment. It would be good policy to permit the cost of replacement—and expansion—financing in the less desirable physical area to rise relative to the cost of new financing in the more desirable area. The sale of existing securities in the old investment and the supplying of funds for the new investment tends to accomplish this. Anything that prevents this "transfer" continues to keep prices of the old securities uneconomically high and

2. Richman, *Reconsideration of the Capital Gains Tax—A Comment*, 14 NAT'L TAX J. 402, 403 (1961).

the prices of the new securities uneconomically low (with reverse effects on the costs of financing, respectively), thus encouraging the continued pouring of replacement and additional funds into the uneconomic activity and discouraging the financing of the socially more desirable investment.

The tax effect on security prices depends on the relative impact of the tax provisions on demand and supply, a point which has been developed elsewhere.³ The assumption is that, at times when paper gains predominate, supply is restricted more than demand, hence the prices of old securities are higher than they would otherwise be. Since the suppliers of new securities have no paper gains they are not affected directly by the tax. Prospective demanders of new securities are, however, repressed in two ways: (1) by the prospect of a capital gains tax (in roughly the same way as demanders of the old securities); (2) by the fact that some of the prospective demanders may have their money tied up in the old securities. The result is that the prices of the new securities are lower than they would be in the absence of the tax. This means that the cost of new financing is made greater by the tax.

The fact that the initial physical investment decision has been made and funds committed is thus not the end of the story. Improvements in the allocation of resources are made by failure to add to or replace the less desirable investment. This is accomplished partly by the financial markets insofar as they make financing more and more costly to the less socially desirable areas. Any interference with the mobility of capital interferes with this allocative effect of the financial markets.⁴

What would be the effect of lengthening the holding period? The longer holding period (rates constant) would make the securities less attractive to the initial financial-investor, hence hurt the physical-investor by making financing more expensive. Thus lengthening the holding period in and of itself would discourage physical investment and retard economic growth. On the other hand, a lowering of the long-term tax rates would tend to make the securities more attractive, hence make funds more readily and more cheaply available to the physical-investor.

The above discussion is in terms of the impact on the physical-investor by way of the direct and immediate impact on the initial financial investor. The direct and immediate impact is in the form of a penalty tax on sale, which makes the securities less attractive than they would otherwise be. This is separate from the subsequent "lock-in effect," which says that in order to avoid, postpone, or reduce

3. Somers, *Reconsideration of the Capital Gains Tax*, 13 NAT'L TAX J. 289 (1960).

4. For further discussion of the relation between the two see *id.* at 300.

the penalty, the holder of securities will postpone the sale. We are here at the point of initial sale of the securities. The prospect of any tax, and a fortiori a penalty tax on early sale, raises the cost of capital to the physical-investor, hence tends to discourage physical investment and retard economic growth.

B. THROUGH SUBSEQUENT LOCK-IN

Any subsequent lock-in that occurs will have an indirect effect on the physical-investor, also of a detrimental sort. The previous discussion was in terms of prices of old securities relative to the prices of new securities at any time. The lock-in effect makes prices of the old higher when they are already high and lower when they are already low.⁵ Since new and old securities are constantly in competition with each other for funds, prices of new securities will tend to go with old (subject to the tax-induced differential indicated above). Thus the physical-investor will tend to gain from the price consequences of the lock-in effect when prices are already high and he will tend to lose from the lock-in effect when prices are already low. In other words, the lock-in effect will tend to encourage physical investment in stock-market boom periods and discourage it in stock-market depression periods. Since there is known to be a high positive correlation, with appropriate lead-lag adjustments, between stock-market prices and business activity, the lock-in effect tends to aggravate over-investment and under-investment, hence is destabilizing in a physical-investment sense as well as in a financial-investment sense.

The key to this part of the analysis, of course, lies in the question whether there really is a lock-in effect and whether its potency would be affected by a lengthening of the holding period and reduction in long-term rate. These matters are discussed in the following parts of this paper.

It is important to emphasize that the lock-in effect is not a function merely of the holding period and differential rate. There would be a lock-in effect and a barrier to the free flow of capital even if the tax on capital gains were uniform regardless of the length of time the asset was held. The reason is that there is an advantage in postponing the tax as long as possible to avoid the capital-reduction involved in paying the tax. A reduction in rates after a certain period (such as six months, at present) merely increases, does not create, the incentive to be locked-in. Whether or not a particular individual will

5. *Ibid.* There is strong statistical evidence that realized capital gains tax revenues are destabilizing cyclically. See LEWIS, FEDERAL FISCAL POLICY IN THE POSTWAR RECESSIONS 49-50 (1962).

stay locked-in with a particular security will, of course, depend on the strength of the factors inducing him to sell. No one has ever claimed that everyone with a paper gain will refuse to sell. It is all a matter of the strength of the conflicting influences. Some will find it expedient to hurdle the capital gains tax barrier while others will find it expedient to huddle behind it.

C. INTERRELATION OF LIQUIDITY, MOBILITY AND VOLUME OF TRANSACTIONS

A strong economic argument can be made in favor of a large volume of transactions. The greater the volume of transactions, the less the relative impact of any particular sale or purchase. In a seldom-traded security—one in which the volume of transactions is low—there is a great risk of a wide gap between two successive prices. A prospective seller may suffer a considerable price risk if he places his stock on the market “at the market.” A prospective purchaser of such a seldom-traded security will likewise be discouraged from buying that security. Thus economically worthwhile ventures may have a hard time finding financing—*i.e.*, may find financing extraordinarily costly—if a thin market exists or is in prospect. Anything that increases the volume of transactions in a security (other than panic) improves the prospects or lowers the cost of the new financing; anything that decreases the volume of transactions discourages the new financing.

The “liquidity of the market” may be considered either synonymous with, or a unique function of, the volume of transactions. Anything that increases the liquidity of the market encourages the mobility of capital. The liquidity ensures a ready market when a sale is to be made, and a price that will generally be determinable within narrow limits at that time. A new issue has a better chance of a favorable reception if the prospect is that there will be a liquid market for that issue—a large volume of transactions—which will establish a prevailing price at any time and ensure a smooth price flow, not wide gaps from one transaction to another. The free flow of capital from one security to another, from one industry to another, is facilitated by the ease of purchase and sale, hence by the liquidity of the market (the volume of transactions). The basic premise is that mobility of capital is to be encouraged as a means of ensuring the best allocation of economic resources. By the same token, the liquidity of the market is to be encouraged. In this way a large volume of transactions tends to encourage the optimum allocation of resources.

II. COMMENTS ON ECONOMIC ANALYSIS OF EXISTING PROVISIONS

The possible consequences of the proposed changes may be evaluated against a background of the effects of the existing provisions. A theoretical analysis by the present writer, mentioned above, has suggested that the prevailing tax reduces liquidity of the capital markets, promotes cyclical instability by accentuating fluctuations in security prices, and retards economic growth.⁶ Theoretical analysis will have to be relied on until we have adequate statistical investigations, such as the comprehensive simulation study proposed by Steger.⁷

The existing provisions are, in summary: ordinary income tax rates on gains on holdings of six months or less; tax at one-half regular rates but not more than 25 per cent on holdings longer than six months; loss offsets against gains; for individuals, loss offsets against income up to \$1000 per year; a five-year carryover of unused losses.

Earlier disagreements on the effects of the tax, including the defense of the tax by Walter Heller and others, are considered in the above articles and the references cited therein. Recent criticism of the theoretical analysis is considered below. It is noteworthy that the President in his tax message says:

The present tax treatment of capital gains and losses is both inequitable and a barrier to economic growth . . . The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth of the economy. The provisions for taxation of capital gains are in need of essential changes designed to facilitate the attainment of our economic objectives.⁸

A. MEANING OF THE TERM "CAPITAL GAINS TAX"

A terminological confusion occasionally arises in using the expression, "capital gains tax." The term is used by the present writer to refer to any taxation of gains, whether those gains are short-term or long-term. In other words, we are referring to those items included in Schedule D, the form provided especially for reporting capital gains, both short-term and long-term. It happens that we have two sets of capital gains taxes, those on short-term gains, at ordinary income tax rates, and those on long-term gains, at lower rates. The

6. See note 3 *supra*.

7. Steger, *Simulation and Tax Analysis: A Research Proposal*, 14 NAT'L TAX J. 286 (1961).

8. H.R. Doc. No. 43, 88th Cong., 1st Sess. (1963); President's 1963 Tax Message, *Hearings Before the House Comm. on Ways and Means*, 88th Cong., 1st Sess., pt. 1, at 23 (1963).

separation is not actually so distinct because short-term gains and losses are netted out and then added to net long-term gains or losses. One does not literally apply one rate to the short-term gains and another to the long-term gains.

The confusion in terminology arises from the fact that "capital gains tax" is used by some to refer solely to the lower rate applicable to long-term gains. Since it would be confusing to use the term "capital gains tax" in both senses we adopt the Schedule D definition and use it to cover both short-term and long-term gains. The higher rates on short-term gains and the differential or lower rates applicable on long-term gains will be distinguished when appropriate.

A failure to recognize this terminological distinction is at the basis of some of the comments made by Richman.⁹

Richman compares a situation in which there is a low tax on gains with a situation in which all gains are taxed at ordinary income rates. As between the two, the low rate would encourage more realization than the high rate. The important question, however, is whether the present tax on capital gains, with all its provisions, discourages realization as compared with a lower or zero tax on capital gains. Richman's answers are consistent with, and tend to confirm, the answers obtained by the present writer. Richman, too, shows that a lower tax tends to encourage realization. Richman errs only in thinking that his analysis weakens or destroys the argument to which he addresses himself.

Three possibilities would be: (1) a high rate throughout (like the current income tax rate); (2) a low rate (like the present rates applicable to long-term gains only); and (3) a zero rate. Richman argues that realization is encouraged by (2) as compared with (1). Our analysis shows that realization is discouraged by going from (3) to a combination of (1) and (2). The two conclusions are consistent with each other and tend to reinforce each other.

The prevailing situation is that we have (1) and (2) simultaneously, separated by a holding period. An investor can move from (1) to (2) of his own volition, provided that he waits long enough. Thus (2) as compared with hypothetical (1) encourages not merely realization, as Richman argues, but also waiting in order to realize. The investor is locked-in, thereby reducing supply and raising prices when prices are already high. Richman's argument thus strengthens the conclusion that the existing capital gains tax (which includes (1) and (2) separated by a holding period) produces a lock-in effect.

9. Richman, *Incentive Effects of Alternative Tax Treatments of Capital Gains*, in NATIONAL TAX ASS'N, PROCEEDINGS OF THE FIFTY-THIRD ANNUAL CONFERENCE 597 (1960); Richman, *supra* note 2.

B. SLOPE OF THE DEMAND CURVE FOR SECURITIES

A question has been raised about the slope of the demand curves for capital assets. The curves are taken as downward sloping to the right. Richman claims that the demand curve for a given security is horizontal.¹⁰ Even in pure and perfect competition where the demand for a given firm's product is taken as horizontal, the demand for the product as a whole is generally taken as downward sloping to the right. A horizontal demand curve requires the assumption that the product involved represents only an *insignificant part* of the total demand and that the other products are *perfect* substitutes, not merely near perfect substitutes. A departure from these assumptions gives us a downward sloping demand curve for the capital asset involved. A horizontal demand curve means that an unlimited amount of the security in question will be taken off the market at the given price. This belies all experience in the stock market, where even a few hundred additional shares will generally result in some change in the price.

Even if the demand curve for individual securities were horizontal, the total demand and supply of securities would have the assumed characteristics. The vertical axis would represent a price-index of securities (like Dow Jones, Standard & Poor's, etc.) and the horizontal axis would represent the aggregate of securities. The result would be as indicated in previous articles, *i.e.*, higher prices when prices are already high and lower prices when prices are already low. Whether or not the demand curve for a single security is horizontal or downward-sloping would not affect this result (although, as indicated above, a perfectly horizontal demand curve for individual securities violates theory and practice).

C. STRENGTH OF THE "CAPITAL EFFECT" IN LOCKING-IN INVESTORS

The strength of the "capital effect" in locking-in investors has recently been brought into question by Holt and Shelton who have computed the additional yield required to compensate for the loss of capital resulting from payment of the tax.¹¹ The "capital effect" of the tax has been stated succinctly by James Riley:

You told about this fellow selling. What did he do with the money?
If he invested it he would then have to reinvest at a rate high enough to

10. Richman, *supra* note 2, at 402.

11. Holt & Shelton, *The Implications of the Capital Gains Tax for Investment Decisions*, 16 J. FIN. 559 (1961); Holt & Shelton, *The Lock-in Effect of the Capital Gains Tax*, 15 NAT'L TAX J. 337 (1962). Cf. Sprinkel & West, *Effects of Capital Gains Taxes on Investment Decisions*, 35 J. BUS. U. CHI. 122 (1962).

make up for the capital gains tax to continue the same return, wouldn't he?¹²

Any sale reduces the amount of capital available by the amount of tax paid. Amount of capital at work is important for the dividends earned and any prospective capital gain to be obtained. An earlier sale reduces the amount available earlier; hence, there is less capital working for the investor. The longer the investor can hold on to the tax money, other things being equal, the better off he is. The government does not (as yet) charge him interest on the potential tax on the paper gain.

The yield differential that is required to unlock a holding and induce a switch from one security to another—for those investors who are yield conscious—is demonstrated by Holt and Shelton as follows:

A numerical example will illustrate the point. Assume that a share of stock was purchased for \$10.00 and its value has risen (more than 6 months later) to \$50.00. Further assume that, because of high income, the investor is in the maximum capital gains tax bracket of 25 per cent. Note that such a situation makes the penalty of incurring the capital gains tax especially severe; not only is the tax rate maximum, but the stock has shown an unusually large gain. Not many investments attain a capital appreciation of 400 per cent. Assume that the investor believes that in the future this stock will, on the average, yield (including both capital gains and dividend income) 4 per cent per annum after taxes. If any alternate security can be found that is expected to yield over 5 per cent on the average in the future, then the investor should not be deterred from switching because of the capital gains tax. On his present stock he expects to net annually 4 per cent X \$50.00 or \$2.00 per share. If he switches to another stock, he will incur a capital gains tax of \$10.00 (25 per cent X \$40.00 capital gain), which will leave him \$40.00 per share to invest in the alternative stock. If this yields over 5 per cent, it will give the investor more net income than the \$2.00 that he expects to receive annually from continuing to hold his original stock. Thus in this extreme case a yield differential in favor of the alternate stock of 1 per cent would be enough, as far as current income is concerned, to offset the capital gains tax.¹³

In this case, as the authors note, "a yield differential in favor of the alternate stock of 1 per cent would be enough."

The yield effect of the capital gains tax as worked out by Holt and Shelton is subject to one important limitation which they themselves recognize. The authors state, "To isolate the influence of the capital gains tax, it is assumed that shifts are considered between securities of comparable risk."¹⁴ They add in a footnote, "The suppression of risk considerations is a limitation of the following analysis. Much

12. Question by James Riley (New York) addressed to Richman during his presentation, *Incentive Effects of Alternative Tax Treatments of Capital Gain*, NATIONAL TAX ASS'N, PROCEEDINGS OF FIFTY-THIRD ANNUAL CONFERENCE 604 (1960).

13. Holt & Shelton, *supra* note 11, at 567.

14. *Id.* at 565-66.

more work on this problem is needed.”¹⁵ Since risk considerations are ignored, “comparable risk” is actually “equal risk.” This is of the greatest importance in assessing the significance of the “small” differences in yield that the authors find sufficient to unlock a holding. It must be remembered that the yield differential of 1 per cent found in the above example is between two securities of *equal* risk.

The comparison of yield differentials required to unlock a security requires a computation of the yield on the full value compared with the yield on the full value net of tax. In the numerical example above the full value is \$50 and the net value is \$40. The yield obtainable on these respective amounts in the presently held security and in the alternative security, respectively, is what is relevant. If, instead of making a yield comparison, we are trying to decide how much of a price risk we can afford to run by holding,¹⁶ the computation is as a percentage of the gain alone, since it is a percentage of the gain that we preserve by holding out (or holding on) for a lower tax rate.

As to the significance of the yield differentials required to induce switching, Holt and Shelton say:

Thus far in this paper it has been shown that, unless the investor contemplates avoiding the capital gains tax by dying or giving away the stock or incurring a capital loss, he only postpones the capital gains tax by choosing to remain “locked in” securities he holds. The advantage of postponing the tax can be calculated, and the investor can determine how much greater the yield must be from some alternative investment to justify switching. Although precise data are unavailable, it would appear that for most investors the yield differential that is necessary to justify switching is smaller than the uncertainty that attaches to forecasts of future yields of securities and often is smaller than the yield differentials that are forecast between alternate securities.¹⁷

In the latter part of this statement, the authors make a factual statement of actual yield differentials as they prevail in the market. The prevailing yield differentials, however, partly reflect differences in risk. These the authors have ruled out by assumption. Yet prevailing differences in risk must surely explain a large part of existing yield differentials that exist in the market. How often would we expect to find a yield differential of as much as 1 per cent between the two securities of *equal* risk?

D. SOCIAL CONSEQUENCES OF THE LOCK-IN EFFECT

It has been suggested that the lock-in does not mean that money is tied up in a particular stock. The argument is that the stock may

15. *Id.* at 566.

16. As is done in the next main part of this paper.

17. Holt & Shelton, *supra* note 11, at 570.

be used for collateral.¹⁸ Since it is not possible to borrow 100 per cent of the value of a stock there is some money tied up by virtue of the fact that the full value is not available. Moreover, the interest and arranging cost generally exceeds the return available. For instance, a broker may charge 6 per cent even though none of the securities involved might yield that rate. The net effect of all this is that a security unsold means that an investor's money is tied up at least in part; and to the extent that it is tied up he cannot use it for alternative investments. This encourages misallocation of resources.

E. EFFECT OF REALIZATION ON CONSUMPTION

The above analysis dealt with investors who wished to preserve either their capital or their returns from capital. It is true that either realized or unrealized capital gains may also encourage consumption.¹⁹ A related example would be the liquidation of savings bonds purchased under duress in war time.²⁰ It has been suggested that "the intended 'investment' of the purchaser of the security or asset may be diverted into consumption, converting savings into consumption, hardly desirable from the standpoint of economic growth."²¹ Whether or not consumption contributes to economic growth is by no means a closed subject for the American economy. Where growth is retarded by a shortage of demand, including consumer demand, an augmentation of consumer demand may well contribute to growth.²² Apart from this, welfare maximization may be interfered with by an arbitrary tax barrier (without other redeeming or welfare-maximizing features) which prevents free consumer choice as between saving and consumption. If the capital gains tax were designed to discourage realization in order to achieve some higher purpose the tax could be considered on its merits as a means to accomplish that end. The economic repercussions of the lock-in are, however, as far as the author knows, an unintended and accidental consequence. Hence the tax provides an unintended and arbitrary barrier to welfare maximization and optimum allocation of resources.

It is even questionable whether a rational consumer would give

18. Richman, *supra* note 2, at 403. With respect to the cost of borrowing, it may be noted that in the week ending June 1, 1963 the average dividend yield of 500 common stocks was 3.15%. Even prime commercial paper yielded more than this, 3.25%. (*Federal Reserve Bulletin*, June 1963, at 818.) Bank rates on short-term business loans for the quarter ending in March 1963 averaged 5.00% in nineteen large cities. *Id.* at 817).

19. *Ibid.*

20. Statement of Harold M. Somers, *Hearings Before the Subcomm. on Fiscal Policy of the Joint Economic Comm.*, 85th Cong., 1st Sess. 198 (1957).

21. Richman, *supra* note 2, at 403.

22. See Stigler, *Policies for Growth*, in a Symposium on Economic Growth in AM. BANKERS' ASS'N, PROC. 110 (1963).

up the advantage of waiting for the long-term rate. Surely ordinary time preference would urge a consumer-disinvestor to wait a few months in order to take advantage of the lower rate and have much more available for consumption. If consumption is the motive, there would have to be a very high rate of time preference to warrant sale now at ordinary rates rather than sale later at long-term rates. The actual rate of time preference required would vary with the tax bracket of the individual and the length of time that would have to elapse before he could enjoy the larger consumption. Suppose a basis of \$100, a sale price of \$200, and rates of 50 per cent and 25 per cent respectively, with three months to elapse until the lower rate sets in. The tax now would be \$50 and the tax in three months would be \$25. The consumption now could be \$150 and in three months \$175. Thus a decision to consume now would imply a rate of time preference of $16.6 +$ per cent ($25/150$) for three months or 66.67 per cent per annum even without compounding! It is evident that a consumer-disinvestor would especially lock himself in. Even in case of a consumption emergency it would generally pay him to borrow to the end of the holding period rather than liquidate. As mentioned previously, it would generally not be possible to obtain a loan for the full value of the securities if the latter were used as collateral. Consumers are not limited to collateral loans, however, if they are willing to pay high enough interest rates.

The fact that going rates of interest are not of this order of magnitude suggests that such high rates of time preference do not exist, or at any rate, could not persist for long. There is a tendency toward an equalization of the marginal rate of time preference (marginal rate of return on consumption) and the market rate of interest.²³ It is not likely that a marginal rate of time preference of 66 per cent per annum would exist for long beside a market rate of interest for secured loans of, say, 6 per cent. There would be a tremendous demand for consumer loans. The market rate of interest would be forced up and the marginal rate of time preference would be forced down until equality was achieved or approached. In short, even consumers would prefer remaining locked-in to suffering the high cost of consuming now rather than a few months hence.

III. SIGNIFICANCE OF A REDUCTION IN LONG-TERM RATE

The effects of the holding period and the long-term rate are closely bound together. We cannot estimate the incentive effects of a change in the holding period unless we know how strong is the inducement

23. As well as other marginal rates of return. See Somers, *Monetary Policy and the Theory of Interest*, 55 Q. J. Econ. 488 (1941).

to hold to the end of the period. We must therefore first consider the effects of the lower long-term rate and of changes in that rate.

A. PRICE RISKS INDUCED BY THE LONG-TERM RATE

Shelton has directed his attention to those purchasers of stocks who are interested in obtaining a capital gain rather than income and are considering the possibility of waiting for the long-term rate.²⁴ He has dealt with the situation where a sale is desirable even at full income tax rates. The question is then whether the investor should hold until the six-month period is past. This isolates the effect of the lower long-term rate; the sale would take place immediately if there were no differential rate after six months. The problem is to determine under what circumstances the tax saving would induce a holding past the six months.

The problem, as always, is one of expectations concerning the particular security held compared with expectations concerning alternatives. If expectation (at moment of contemplated sale) is that the market will drop, tax consequences cannot be ignored. A sale before the end of the holding period will result in a larger tax bite than a sale after the end of the holding period, with corresponding (opposite) effects on the net cash position. Thus the extent of the anticipated drop must be considered before a decision can be taken as to whether or not to sell and go into cash. Moreover, it must be remembered that any new securities purchased with the cash will be at a lower base (hence ultimately higher tax). In short, the decision becomes a complicated one and tax implications cannot be ignored where a drop in the stock market is anticipated. The differential tax may in some cases then make the difference between selling or not.

As Shelton points out, it is very easy to fall into several forms of specious reasoning in trying to decide whether to sell now or wait until the six-month holding period is past. One type of error is to assume that a price drop equivalent to the tax to be paid now may be risked by waiting. It would be a mistake to risk a drop equal to the full amount of tax. The reason is that some tax will still have to be paid after the six months even if the price drops that much. This error exaggerates somewhat the lock-in inducement of the tax. There is a strong lock-in inducement but not quite so strong as this.

The opposite error is committed by the investor who thinks he can risk a price drop equivalent only to one-half the short-term tax. He forgets that a lower price would result in a smaller amount of tax. An investor who makes this error would be tempted to sell pre-

24. Shelton, *Influence of the Six-Month Capital Gains Rule on Short Term Transactions*, *Fin. Analysts J.*, Sept.-Oct. 1962.

maturely. He should feel locked-in more than he does. He can afford a greater price risk than he thinks.

The investor can determine the correct amount of price risk by trial and error or by an algebraic solution which takes account of the fact that any drop in price reduces the tax liability (thus avoiding the mistake made by the second investor) but may still leave some liability (thus avoiding the mistake made by the first investor). In short, the investor should lock himself in by precisely the right amount, neither more nor less. The key is the expectation of the investor as to the price after the short-term period has passed. If he expects the price to be the same as now or higher, unquestionably he should wait. If he expects the price to be lower, the question whether or not he should wait hinges on how much lower he expects the price to be.

Shelton has worked out the maximum price drop for investors in various tax brackets as follows:

If the Investor's marginal tax rate (<i>i.e.</i> , the ratio of extra tax to extra income) is:	He can afford to <i>lose</i> the following percentage of his <i>current gain</i> and still be as well off if he sells after holding six months instead of sell- ing earlier:
20.0%	11.1%
22.2%	12.5%
25.0%	14.3%
28.5%	16.7%
30.0%	17.6%
33.3%	20.0%
35.0%	21.2%
37.5%	23.6%
40.0%	25.0%
42.0%	26.6%
44.0%	28.2%
46.0%	29.9%
48.0%	31.6%
50.0%	33.3%
55.0%	40.0%
60.0%	46.7%
62.5%	50.0%
65.0%	53.3%
70.0%	60.0%
75.0%	66.7%

Illustrative example, based on the text: Assume an investor in a 50% marginal tax bracket has \$12,000 short-term paper profit. How much of the profit can he afford to lose and still be as well off, after taxes,

if he holds till six months have elapsed? Answer from the table: 33.3% or \$4,000.²⁵

It should be noted that the price drop is (necessarily) expressed as a percentage of the paper gain rather than as a percentage of the full price.

Shelton has developed a formula to compute the price risk. The fraction of drop in gain that may be risked is

$$\frac{G_n - GL}{G_n} = 1 - \frac{GL}{G_n} = 1 - \frac{(1 - R_n)}{(1 - RL)}$$

where G_n is the paper gain now existing; GL is the estimated gain if the asset is held to the end of the holding period; R_n is the tax rate on existing gains; and RL is the rate on long-term gains (or any lower rate).²⁶

Shelton's conclusion as to the strength of the lock-in effect is as follows:

Consideration of the table suggests that there is strong reason to be locked-in to securities with a short term profit until the six months holding period has passed. Most investors cannot predict changes in stock prices over a short period of time; and so it would take a clear presumption of a price slump to justify the expectation of a 20% or 30% shrinkage in gain over a few months.²⁷

It should be noted that Shelton says there is "strong reason to be locked-in" under the circumstances given.

B. COMPARISON OF PRESENT AND PROPOSED LONG-TERM RATES

A reduction in the long-term rate will alter the computations as to the desirability of remaining locked-in during the holding period. The President's proposal is to remove the maximum rate but include only 30 per cent of long-term gains. Using the formula given above, we develop the following comparison:

²⁵ *Ibid.*

²⁶ Thus if a person is in the 40% bracket, hence 20% long-term, the percentage drop that he can afford to risk is $1 - \frac{(1 - .40)}{(1 - .20)} = .25$, or 25%. If he is in the 70% bracket (hence, 25% long-term under the existing limitation) the figure is $1 - \frac{(1 - .70)}{(1 - .25)} = .60$, or 60%.

²⁷ Shelton, *supra* note 24.

Investor's Marginal Income Tax Rate (Hypothetical Rates)	Percentage of Current Gain That May Be Risked by Holding for Long-Term Rate	
	Under Present Rules (50% includible and maximum tax rate of 25%)	Under Proposed Rules (30% includible and no maximum rate)
14%	7.5%	10.2%
20%	11.1%	14.9%
25%	14.3%	18.9%
30%	17.6%	23.1%
40%	25.0%	31.8%
50%	33.3%	41.2%
65%	53.3%	56.5%
75%	66.7%	67.8%
80%	73.3%	73.7%
83.3%	77.7%	77.7%
87%	82.7%	82.4%
91%	88.0%	87.6%

Various income tax rates are illustrated in the above schedule, some indicative of the existing schedule and some indicative of the proposed schedule. A rough estimate of the results for any rates not illustrated may be obtained by interpolation; an exact estimate may be obtained by use of the formula. The rate of 87 per cent (often overlooked) is included since it is the overall limitation under the existing schedule (hence might better be placed after the 91 per cent rate). A person whose income is subject to the overall limitation is for all practical purposes faced with an 87 per cent rate for any additional income.

It is evident that the capital effect would be increased by the proposed capital gains tax provision and the proposed income tax schedule ranging from 14 per cent to 65 per cent. Even under the old income tax schedule ranging from 20 per cent to 91 per cent, the proposed capital gains tax provision (*i.e.*, 30 per cent inclusion) would increase the capital effect for all taxpayers except those at approximately an 83.3 per cent bracket (if there were such) or higher. This point is determined by the application of the 30 per cent inclusion to the 83.3 per cent "bracket," giving us an effective tax of 25 per cent on the long-term gains. Investors currently below the hypothetical 83.3 per cent bracket would pay less under the proposed plan, hence would have a greater lock-in inducement. Those above the 83.3 per cent bracket would pay more than 25 per cent on long-term gains under the proposed capital gains tax provisions. It is virtually certain, however, that a limitation of 25 per cent or less would be adopted for these persons in the unlikely eventually that the old income tax rate schedule is allowed to stand but the proposed capital gains plan is adopted *in toto*.

We may now speculate on what would happen if the long-term rate were reduced (assuming no change in the holding period). Looking at the problem first only from the supply side, we may separate those who are in the short-term period and those who are in the long-term period. Those in the long-term period who currently remained locked-in by the capital effect of the tax would find an inducement to sell. A reduction in the long-term rate from 25 per cent to 19.5 per cent, for instance, would represent a significant reduction in the tax. This is likely to have an effect in the direction of unlocking some of those who had been locked-in even by the old long-term tax.

Those who are in the short-term period, however, would have a greater inducement than ever to wait until the end of the holding period in order to enjoy the lower long-term rate. They could afford to risk a greater price drop in order to enjoy the lower rate. They would have a tendency to feel a greater lock-in inducement than before the reduction in long-term rate. (If all tax rates are reduced, both short-term and long-term, as in the President's proposal, some short-term holders who were locked-in by the capital effect of the ordinary income tax might be induced to sell under the lower rates on ordinary income.)

The net effect of the two opposing forces on supply would depend on the relative importance of the respective groups of holders at any time. It should be pointed out that we are not here dealing only with those who now *sell* but also with those who *hold* and do not sell at present rates. Studies of transactions of professional floor traders active on the New York Stock Exchange show that 90 per cent of their sales (long as opposed to short sales) in a sample period consisted of stock which had been purchased within the preceding month.²⁸ The sales that actually occurred under the existing taxes do not give us all the data we need for the present purpose. We are interested in two figures: (1) the sales that did *not* occur under existing rates and would occur if the rates were reduced a specified amount; and (2) the sales that *did* occur under existing rates and would not have occurred if the lower rates had prevailed. These statistics would be highly useful to our study but are unfortunately not available. We are therefore not in a position to weigh statistically the relative importance of short-term holders who are newly locked-in by a lower long-term rate and long-term holders who are unlocked by the rate.

As the newly locked-in short-term holdings mature into long-term holdings they will come onto the market. Thus insofar as the lower

28. Statement of G. Keith Funston, *Hearings Before the House Ways and Means Comm.*, 88th Cong., 1st Sess., pt. 3, at 1411 (1963).

tax discourages short-term sales it will increase the volume of long-term sales after the initial period. For every short-term sale that does not take place there will be a long-term sale which represents waiting by a seller who has held into the long-term period in order to enjoy the lower rate. The volume of transactions and the liquidity of the market will be reduced, however, in that the holder might have been in and out of the market several times in the interval.

IV. SIGNIFICANCE OF CHANGES IN THE HOLDING PERIOD

We may now turn to the consequences of changes in the holding period. One possibility is a simple change in the length of the period, such as shortening to three months or a lengthening to one year. Another possibility is to have multiple holding periods with a corresponding structure of rates, such as existed from 1934 through 1941. Of course, another possibility is a complete elimination of the holding period, which would mean that the lower rates (whatever they may be) would apply on any capital gains regardless of the length of time involved. At the other extreme, low rates might set in after only three, five, or ten years, or more.

A. STATISTICS ON EXISTING HOLDING PERIODS

The Treasury Department has made a study of capital gains reported on income tax returns in 1959. It shows that the average short-term holding on returns reporting short-term sales was 3.2 *months* and the average long-term holding was slightly over 4 *years*.²⁹ The returns showing long-term sales indicated holdings spread fairly evenly from the seventh to twelfth months; there was no bunching in the seventh month.³⁰

One might be tempted to draw the inference that bunching of sales in the seventh month would be logical if the holding period were important. This inference is invalid. Even if the lower long-term rate were the *sole* reason for holding during the holding period, no bunching would be expected. The reason for this is that when the holding period is over and the investor has reached low-rate territory, he would and should make a decision *de novo* whether and when to sell, based on the prospects at that time. It would be the height of folly to stick slavishly to a forecast made as much as six months before. An investor should reassess his situation every time he has an opportunity to do so. Unless he makes a binding contract (and even

29. *Sales of Capital Assets Reported on Individual Income Tax Returns for 1959*, in INTERNAL REVENUE SERVICE, STATISTICS OF INCOME 1959 (Supp. Report, p. 1).

30. *Id.* at 12.

then there may be a legitimate escape clause with penalty attached) he would be foolish to impose any self-made restriction on his actions.

An investor who is locked-in on account of a tax is locked-in because it is in his interests to be locked-in, given the tax, *i.e.*, because he wants to be locked-in, considering all relevant facts and circumstances. Thus a bunching in the seventh month is exactly what one would *not* expect from an investor who allowed himself to be locked-in to the end of the six-month period by the lower long-term rate. He will enjoy the lower rate *anytime* after the six months, not in the seventh month alone. Having once arrived in long-term rate territory, any date of realization is as good as another tax-wise except for two things: (1) timing in relation to other gains and losses for offset purposes; and (2) the continuing prospect of exemption by gift or death. Both these tax factors react against a tax-induced bunching in the seventh month or any other particular point of time. In addition, of course, price expectations may have changed completely.

In short, a person who has held a stock for more than six months may have done so for a variety of reasons. One of these reasons is the lower long-term tax that prevails. Once he has held the stock long enough to enjoy the lower long-term rate, whatever may have been his original motivation, he will sell whenever it is in his best interests to sell. There is no reason whatever to assume that the seventh month is preferable to any other month from that point of view. The non-bunching of sales at the end of the six-month period is consistent with the hypothesis that tax considerations originally induced the holding during the period.

B. FACTORS RELEVANT TO THE LENGTH OF THE HOLDING PERIOD

An extension of the holding period to one year would not change the price-risk analysis [of Part III] in its simple form. The amount of price-risk that may be taken does not depend on the length of the holding period. Returning to the formula where GR is the percentage of paper gain that may be risked, we have

$$GR = \frac{G_n - GL}{G_n} = 1 - \frac{(1 - R_n)}{(1 - RL)}$$

The length of the holding period does not enter into this formula at all, and thus plays no part in the outcome, on this simple basis. The lower tax rate for long-term holdings provides an inducement to hold regardless of the length of the holding period.

In a more complete analysis the length of the holding period does

play a part. The following are relevant considerations peculiar to the length of the holding period itself.

1. *The Forecasting-Error Factor.*—The longer the holding period, the longer the time over which the chance must be taken on the price that will prevail when the holding period is ended. It is conceivable that it will be easier to forecast prices a year from now than a half-year from now. If such is the case, there is nothing to stop an investor under a six-month holding period from acting as if he were on a one-year holding period. In such a case the six-month period is advantageous since the plan can readily be revised, if necessary, after the six-month period has passed.

If it is more difficult to forecast for the longer period than for the shorter period, the longer period imposes a cost on the investor in the form of greater uncertainty with no greater expectation of reward. There is presumably some price-equivalent for the greater uncertainty for the particular investor. This price-equivalent will vary from investor to investor. An investor may expect a price of eighty at the end of both a six-month period and a one-year period. This may be his focus expectation or the mean expected value. (We need not here go into the various theories of expectations except to use only those that come up with a single operational figure.) Since greater uncertainty attaches to the longer-term expectation, he is not indifferent between them (leaving aside the interest factor for the moment). Some higher focus or mean expectation of price for the longer term would be required for the investor to be indifferent between the two. The greater the time lapse, the greater the uncertainty (we assume) and the greater the price-equivalent required. (We ignore those who love uncertainty for its own sake.)

We may refer to this as the “forecasting-error” involved in holding to the end of the holding period. We are assuming here that the forecasting-error is a direct function of time and that an increased forecasting risk discourages taking the risk; hence, a longer holding-period would, in itself, discourage the holding.

The conclusion from this part of the analysis is that one aspect of a longer holding period would be a tendency to reduce the lock-in effect. Investors would say, in effect, “There’s so much uncertainty involved in waiting the longer period that I may as well sell now and pay the full tax.” In other words, the forecasting-error factor works for a reduced lock-in effect.

2. *The Interest Factor.*—The longer the period of tax avoidance, the longer the time the investor has use of the tax money. This stems from the capital effect, which means that if the investor sells now and pays the tax now he no longer has the use of the tax money. If he holds, he has the full amount of capital working for him until he

does sell. This factor speaks for increasing the lock-in effect, since there is an interest benefit in holding. The investor can afford to risk a lower price in the future in view of the interest he earns by holding. If he holds for a year rather than a half-year he will have the use of the implicit tax money longer.

This effect is mitigated somewhat by the fact that the tax is not paid immediately at the moment of sale. With tax returns due on April 15 of the following year, the seller might have use of the tax money as much as fifteen and a half months after sale. The requirement of income estimation and quarterly payment tends to reduce the length of this period. The variety of procedures for income estimation and the leeway permitted, in turn, reduce the significance of the payment requirement. Whenever he does pay the tax, the investor loses the use of the money involved.

The interest factor may seem to be irrelevant: there is nothing to stop a person from holding for one year even under a six-month holding period. An investor who wants to benefit from the interest factor is at liberty to do so. No matter when an investor sells, he suffers some loss of capital from the tax. Even after he gets into long-term rate territory, the capital effect and resulting interest factor provide an inducement to hold on. The fact that one can voluntarily subject himself to a longer holding does not, however, negate the fact that in any contemplated holding the interest benefit must be offset against any costs or risks involved.

3. *The Conflict of These Factors.*—Thus we have two conflicting tendencies arising from the lengthening of the holding period (keeping tax rates constant). The longer time increases the forecasting-error involved, hence weakens the lock-in effect; the longer time also increases the interest gained by waiting, hence strengthens the lock-in effect. Whatever lock-in effect there was on account of the existing holding period would thus be subject to these conflicting forces in case of a lengthening of the holding period.

What is the relative strength of these two conflicting forces? The interest cost is determined by market forces outside the individual investor. Each investor could learn from his banker the rate he would have to pay to give him the capital he needed to substitute for the tax he would pay if he sold now. The forecasting-error factor is more subjective, and depends on his evaluation of the risks, basing his evaluation on such objective data as he can muster. An additional wait of six months might completely dissuade some investors who had been willing to wait until the end of a six-month holding period.

4. *Comparison With the Tax Rate Effect.*—In summary, there are three effects working on the investor as a result of the lower-tax rate prevalent after a given holding period: the *tax rate* effect, the *fore-*

casting-error effect and the *interest* effect. The tax-rate effect creates a clear and unquestionable lock-in effect which is independent of the length of the holding period. The forecasting-error and interest effects are opposite functions of the length of the holding period. The somewhat surprising conclusion from all this is that the tax rate differential is important but the length of the holding period is, on the balance, either conjectural, indeterminate or unimportant in determining the strength of the inducement to remain locked-in.

The above discussion indicates simply that the lengthening of the holding period may not affect the inducement to hold, *i.e.*, the inducement to remain locked-in. The actual lock-in effect during the holding period stems primarily from the tax rate differential, regardless of the length of the holding period (within the range under consideration).

This does not mean that a lengthening of the holding period would be without market significance. On the contrary, the effects would be profound. If the inducement to remain locked-in is unchanged, it follows that roughly the same number of investors who are now locked-in until the end of the six-month period are likely to remain locked-in until the end of the one-year period. The composition of the investors involved will undoubtedly change and the amounts involved may not be quite the same. The rough magnitudes are, however, likely to be about the same. Those who remain locked-in will be locked-in longer than before. Under the six-month holding period, the average length of tax-inspired lock-in may be taken as three months. Under a one-year holding period the average may be taken as six months. (Such holding as occurs after the holding period has passed is inspired by other than the differential long-term rate.) As indicated above, we are assuming that the conflicting forces that operate on the inducement to hold offset each other. The longer holding period thus increases the weighted effect of the lock-in inducement. The result must be an aggravation of the economic consequences previously indicated for the existing provisions, namely, promotion of cyclical instability and retardation of economic growth.

There is also a decrease in volume of transactions. This occurs in two ways: (1) while he is locked-in the investor does not sell; and (2) not having sold, he may also fail to buy once or several times within the period. This reduced volume of transactions means a reduction in the liquidity of the market. Markets become thinner and securities less attractive in their liquidity aspect, *i.e.*, the readiness and sureness with which they can be turned into cash. This has the effect of making new financing more difficult or more costly or both. This must retard economic growth.

V. SUMMARY AND CONCLUSIONS

This paper has been concerned with the significance of proposed changes in holding period and long-term rate under the capital gains tax. The two are closely intertwined; whether it pays to hold for a particular length of time depends partly on the rate that will apply at the end of the holding period. For this reason, a full discussion of the significance of long-term rates is a prerequisite to a consideration of the effects of changes in the holding period. Basic to all this is an understanding of the way in which the capital gains tax (whether the detailed rates and period are modified or not) creates a lock-in effect and contributes to price instability, reduces the liquidity of the market and impairs economic growth.

Since the purchase of physical assets, such as plant and equipment, generally involves the issuance of securities of one sort or another at some time, the impact of the tax on the purchaser of securities may directly affect the ease and cost of making the physical investment. The effect looks beyond the time when the securities are sold and the initial financing is completed. The ease with which a holder of a security can subsequently sell it is one of the considerations that is taken into account in the initial purchase. The prospect of a "thin" market in a security tends to have a discouraging effect whereas the prospect of a large volume of transactions in a security, hence a highly liquid market, tends to have an encouraging effect.

It can be demonstrated that the capital gains tax tends to curtail the volume of transactions and reduce the liquidity of the market through the lock-in that it induces. Doubts that have been raised as to the significance of the lock-in effect do not stand up to close scrutiny. In particular, the fact that securities are substitutes for one another does not reduce the impact of the tax on the securities market as a whole. The fact that an investor might borrow on a security he holds in order to invest in another is not significant since the borrowing is generally at less than full value and the rates are generally higher than the yield on the securities. The argument that someone has the money to invest, even if the locked-in investor does not, fails to take account of the fact that an investor who is locked-in by the tax is prevented or discouraged from switching to another investment; hence the mobility of capital is curtailed, the optimum allocation of resources is interfered with, and economic growth is dampened. The possibility that an investor might want to liquidate for purposes of consumption is of little consequence; he would have to be terribly hungry to lose the great benefit conferred on him by waiting a few months to the end of the holding period.

The benefit of waiting to the end of the holding period is large and measurable; the proposed changes in rates would increase the

benefit. When expressed in terms of yields, it might appear that only a small yield differential would induce an investor to switch immediately instead of waiting until the end of the holding period. By virtue of the same substitutability as was mentioned above, however, it is not likely that significant yield differentials exist at any time between securities of equal risk. Hence, even a yield-conscious investor would find the lower long-term rate a strong inducement to hold to the end of the holding period.

A lengthening of the holding period would set conflicting forces in motion. Some long-term investors might "give up" and decide not to wait for the end of the longer period—the greater price risk involved in waiting longer is too much for them. On the other hand, the longer the period involved the longer the period during which the investor keeps his full capital working for him, unimpaired by tax. We assume that the inducement to hold is not likely to be affected materially on balance. Any net effect either way is likely to be small compared with the fact that a substantial period is added onto the lock-in period of those who decide to wait for the long-term rate. The result of a lengthening of the holding period would thus be an increase in the lock-in effect on the market and a reduction in the volume of transactions and in the liquidity of the market. The increased lock-in itself would tend to accentuate price instability and retard economic growth; and the reduced liquidity would reduce the attractiveness of securities, hence increasing the difficulty and raising the cost of financing, with further detrimental effects on economic growth.³¹

31. On May 28, 1963, the Committee on Ways and Means of the U.S. House of Representatives released a statement which included the following paragraph:

Under the tentative decision of the Committee, a taxpayer would include 30 percent (instead of 50 percent as under present law) of net long-term gains in excess of net short-term losses in his ordinary income tax base in the case of certain long-term capital gains where the asset has been held for three years or more. However, this 30-percent inclusion factor will only apply to gains which may be classified as "true" capital gains, the exact definition of which the Committee will subsequently decide upon. These capital gains will be subject to a maximum tax rate of 19.5 percent. The 50-percent inclusion factor and the 25 percent maximum tax rate of existing law will continue to apply in the case of assets held for more than six months and less than three years.

The proposed three-year rule would provide an *additional* tax benefit and would not supplant the existing six-month provision. The result would be to make securities, including new securities, more attractive to prospective buyers. The three-year period is long enough to make the "forecasting-error factor," discussed above, quite powerful. The likelihood that many investors will be newly locked-in by the three-year provision is not great. The reward for holding a full three years is a maximum rate of 19.5%, as opposed to a maximum rate of 25% for holding six months. Hence, prospective sellers of existing securities are not likely to be inhibited greatly, if at all, by the three-year provision. The net effect on demand and supply combined is thus likely to be favorable to liquidity and growth.

