IRET Institute For Research On The Economics Of Taxation

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Letters to the Editor

Rich Man, Poor Man, Capital Gains

Herbert Stein's Aug. 23 editorial-page essay. "Common Sense on Capital Gains," perceptively observes that capital-gains tax reform should not be judged on the basis of whether rich people or poor people get more capital gains – that is, on vertical-equity grounds. Unhappily, he goes on to assert, much less perceptively, that horizontal equity is the appropriate standard; cutting the capital-gains tax rate, he claims, ".. , would leave some people paying less tax than other people with the same income." He concludes, incorrectly, I believe, that the only valid basis for capital gains tax reform is to offset the effect of inflation in raising the tax rate on gains above the statutory rate.

Mr. Stein's error lies in identifying capital gains as income with the same attributes, for tax purposes, as personal compensation (i.e., the earnings of a basketball player). A capital gain, however, is the increase in the market value of an asset; this increase is the capitalization of an anticipated increase in the income (or other rewards) that the asset will produce. In the general case, the asset was purchased with after-tax income, the income it produces is taxed as it materializes, and/or the increase in the income it is expected to produce – accounting for the increase in its market value – also will be taxed as it is realized. Taxing the capital gain that is realized when the asset is sold amounts to adding a layer of income tax on the same income. Nothing of the sort occurs in the case of the basketball player's salary.

The real reason to reduce, if not eliminate, the income tax on capital gains is to moderate this excessive, differentially heavy tax burden. This calls for reducing the statutory rate at which capital gains are taxed; to make sure this reduced rate is not subsequently hiked back up by inflation, indexing the bases of capital assets is also called for. Contrary to Mr. Stein's assertion, indexing is neither the sole nor primary reform called for; indexing is better seen as a complement to rate reduction, useful insofar as monetary policy fails its responsibility to prevent inflation.

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