Why the Capital Gains Tax Rate Should Be Zero

by

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Executive Summary

Proponents of cutting the capital gains tax rate cite economic studies showing increases in economic growth and realizations of gains, and even higher revenue for government. Opponents argue that a capital gains tax cut is unfair because it only benefits the rich. But neither side argues from a position of principle. The real question is: Are gains in the value of assets income like any other form of income — such as wages, dividends, rent and interest? Or are they not income?

For most of American history, the question was moot, because the definition of income is important only if income is taxed. However, during the Civil War, Congress instituted an income tax and the question of taxing capital gains arose. In the case of *Gray v. Darlington,* the U.S. Supreme Court ruled that capital gains are not income:

> The advance in the value of property during a series of years can, in no sense, be considered the gains, profits, or income of any particular year of the series, although the entire amount of the advance be at one time turned into money by sale of the property.... It constitutes and can be treated merely as increase of capital.

Even after the 16th Amendment authorized an income tax, several Supreme Court decisions indicated that capital gains are not income.

- In *Lynch vs. Turrish*, 1918, the Court ruled that realizing a capital gain did not constitute income. "Indeed," the Court said, "the case decides that such advance in value is not income at all, but merely increase of capital and not subject to tax."
- And in *Eisner vs. Macomber*, it ruled stock dividends were not taxable income, holding that "Enrichment through increase in value of capital investment is not income in any proper meaning of the term."

But then, in a series of decisions beginning in 1921, the Court stated definitively that capital gains are taxable as income. Since capital losses were fully deductible against gains, taxation of capital gains netted little revenue for the federal government, and may even have lost it money. Because income tax rates were so high, up to 73 percent in 1921, there was a lock-in effect as investors held on to appreciating assets until they had losses to offset the income tax. So in 1921 Congress created a preferential tax rate on capital gains of 12.5 percent.

Since then, the debate has centered mainly on whether or not capital gains should be taxed as ordinary income. Proponents of this approach depend primarily on the definition of income developed by economists Robert M. Haig and Henry Simons, which defines income as all consumption during the course of a year plus the change in net worth.

The Haig-Simons definition of income implicitly supports the double taxation of capital. Capital gains only arise in the case of an income-producing asset (with the exception of collectibles). Thus an asset's value is simply the discounted present value of the future flow of income (rent, interest or dividends) associated with it. Taxing both the income stream from a capital asset, and the value of the underlying asset, is taxing the same income twice.

The Haig-Simons definition of income is an ideological opinion supporting a more egalitarian society. It ignores the crucial distinction between capital and the income produced by it. Furthermore, it suggests gains should be taxed as they accrue, whether or not the asset is actually sold! However, Haig-Simons supports the full deductibility of losses in capital value, and the adjustment of capital gains for inflation. If these two adjustments were allowed, most capital gains would disappear.

- Indeed, from 1917 to 1921, when capital losses were fully deductible from ordinary income, the federal government had negative revenue from the capital gains tax.
- Economist Robert Eisner found there were no real capital gains whatsoever from 1946 to 1977.
- After adjusting for inflation, households suffered a real loss of $321 billion on nominal capital gains of $3 trillion during this period.

Insofar as a reduction in the capital gains tax is a move toward ultimate exclusion of capital gains from taxable income, it is welcome. But supporters of a lower rate would greatly strengthen their case if they argued that capital gains should not be taxed at all as a matter of principle.

Introduction

Later this year, there is likely to be a renewed effort in Congress to cut the capital gains tax rate — something conspicuously absent from the recently-passed tax bill. Proponents of this change will cite economic studies showing increases in economic growth, realizations of gains and even higher revenue for the government.[1] Opponents will dispute these points, but mainly argue that a capital gains tax cut is unfair because it only benefits the rich.[2] If history is any guide, neither of these arguments will be decisive. In the end, whether the capital gains tax rate is cut or not will be solely a function of politics.

Thus whether the capital gains tax is cut or not, it will remain a political football, as it has been almost continuously since 1921 when the first capital gains preference was enacted. It would be far better for Congress to resolve once and for all whether capital gains are income like any other form of income — such as wages, dividends, rent and interest — or are not income at all. If it accepts the former, it should move not only to tax capital gains as ordinary income, as was the case from 1914 to 1921 and from 1987 to 1990, but also to tax accrued capital gains on an ongoing basis, regardless of whether such gains are realized. If it accepts the latter, then capital gains should be completely removed from the tax base and not taxed at all. The alternative is to keep raising and lowering the capital gains tax rate depending simply on which way the political winds are blowing.

"It would be better for Congress to resolve once and for all the issue of whether capital gains are income."

Are Capital Gains Income?

The issue of capital gains taxation was of no importance during most of our nation's history because there was no income tax and therefore no effort to tax capital gains by the federal government. It became a problem when an income tax was imposed for the first time during the Civil War.[3] During the time this legislation was in effect, the government taxed capital gains as ordinary income.

Supreme Court Decision in *Darlington*. After the war, a case came before the Supreme Court in which it was argued that capital gains did not constitute income within the meaning of the law because, unlike wages or other forms of income, capital gains often accrued over many years. It was incorrect, therefore, to tax such gains as if they arose entirely within the course of a single year. The Court agreed with this argument, concluding that capital gains are not, in fact, income. In the case of *Gray v. Darlington* the Court ruled as follows:

> The question presented is whether the advance in the value of the bonds, during this period of four years, over their cost, realized by their sale, was subject to taxation as gains, profits, or income of the plaintiff for the year in which the bonds were sold. The answer which should

> be given to this question does not, in our judgment, admit of any doubt. The advance in the value of property during a series of years can, in no sense, be considered the gains, profits, or income of any particular year of the series, although the entire amount of the advance be at one time turned into money by sale of the property....
>
> The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income by the statute. It constitutes and can be treated merely as increase of capital.[4]

The case had no practical effect, however, because the same year the decision was handed down Congress refused to reauthorize the income tax and it ceased to exist. Nevertheless, an important precedent was established.

In 1894, another income tax became law, but before any capital gains cases could be heard, it was declared unconstitutional in the case of *Pollock v. Farmers' Loan and Trust Co.*[5] This case concluded that an income tax was a direct tax and thus must be apportioned among the states according to Article I of the Constitution.

"The issue of capital gains taxation was of no importance during most of the nation's history because there was no income tax."

Supreme Court Decisions under the 16th Amendment. Passage of the 16th Amendment to the Constitution in 1913 opened the way for enactment of the present income tax.[6] It was not long before a capital gains case was brought to the Supreme Court. In 1918, the Court heard a case identical to *Darlington*, *Hays v. Gauley Mountain Coal Co.* It concluded that capital gains by a corporation were taxable under the corporate income tax, but only by making a very fine distinction between the precise wording of the current law and the previous law.

> "Gains, profits, and income *for* the year ending the thirty-first day of December next preceding" (Act of 1867) conveys a different meaning from "the entire net income...*received by it*...*during* such year" (Act of 1909). The former expression, as this court held (15 Wall. 65), denoted "such gains or profits as may be realized from a business transaction begun and completed during the preceding year" with the exceptions already mentioned. The expression "income *received during* such year," employed in the Act of 1909, looks to the time of realization rather than the period of accruement, except as the taking effect of the act on a specified date (January 1, 1909), excludes income that accrued before that date.[7]

A commentator at the time said that the Court had dealt with *Darlington* in a "high-handed manner," and "redefined income" in *Gauley Mountain*.[8] A more recent commentator has noted, "The distinction between income 'for' a year ending on a certain date and income received 'during' the year seems extremely technical as there is no income at all 'for' a year unless some conversion of increased value to cash, or its equivalent, has occurred."[9]

Adding to the confusion, just a few days after the *Gauley Mountain* decision, the Supreme Court handed down another decision going in almost the opposite direction. In *Lynch v. Turrish*, the Court decided that realizing a capital gain did not constitute income because it was merely an asset conversion from one form to another, from unrealized gain to cash. "Indeed," the Court said, "the case decides that such advance in value is not income at all, but merely increase of capital and not subject to tax."[10]

This ruling seems to uphold the earlier decision in *Darlington* that capital gains are not income. In the words of a recent commentator, "*Turrish* thus provided strong support for the belief that *Darlington* was valid precedent and that capital gains occurring outside the business context were not income."[11]

The following year, 1919, the Supreme Court again revisited the capital gains question. In *Eisner v. Macomber*, the Court was asked to decide whether a stock dividend constituted taxable income. It concluded that such dividends are not income. "Enrichment through increase in value of capital investment is not income in any proper meaning of the term," the Court held.[12]

"In a series of flip-flops, the Supreme Court held that capital gains are income, then that they are not, and then again that they are."

Despite these rulings, the federal government continued to collect income taxes on capital gains. This gave rise to a Federal District Court case in 1920, *Brewster v. Walsh*. Following the logic of the earlier Supreme Court cases, the District Court held that capital gains are not income. As Judge Thomas wrote:

> The sale of capital results only in changing its form and, like the mere issue of a stock dividend, makes the recipient no richer than before....Therefore, under the authority of *Gray v. Darlington*, which is approved in *Lynch v. Turrish*, I feel constrained to hold that the appreciation in value of the plaintiff's bonds, even though realized by sale, is not income taxable as such.[13]

Commenting on this case, the *New York Times* agreed wholeheartedly with the philosophy. Capital gains, it stated firmly, are not income.

> Income is an addition to capital value, something which may be severed from it and still leave the capital undiminished, like a crop from land. Income is a flow. Capital is a fountain. Profit from a sale is not a flow. It cannot be repeated, the transaction being final. An income tax is a recurring tax, and ought to be confined to the tax period....The economic distinctions between capital and income is one of natural law, independent of either statutes or Constitutions. The Constitution controls the procedure of Congress, but the Constitution and Congress together would find difficulty in defeating natural law.[14]

Supreme Court Decides Gains Are Taxable. Finally, the Supreme Court moved to resolve the question of whether capital gains were taxable once and for all.[15] In a series of cases, the leading one being *Merchants Loan* *and Trust Co. v. Smietanka*, the Court stated definitively that capital gains are taxable under the income tax.[16] At this point, in 1921, the capital gains question ceased to be one for the courts and entered the realm of politics and economic analysis, which have governed the debate ever since.

This is not to say that the Court decided the case correctly. At the time, the Court was criticized for not taking economic analysis into account when defining the term "income." Said one commentator, "The Supreme Court has evinced slight regard for the science of economics when solving purely constitutional problems. Just as they refused in differentiating direct and indirect taxes to apply the economic tests of shiftability, incidence, and consciousness of paying, so in determining meaning of income, they will have none of the economists' analogies to 'tree and fruit,' 'fund and flow.'"[17] Fred Rogers Fairchild of Yale probably spoke for most economists of the day when he said, "the weight of economic authority supports the theory that mere growth in value of capital is not income."[18]

"In 1921, the capital gains question ceased to be one for the courts and entered the realm of politics and economic analysis."

More recent commentators have been equally critical of the Court's reasoning. In the words of Van Mayhall:

> A clear case may be made for the proposition that in the early development of our capital gains tax structure, this country chose the wrong path, from which no return has been possible. In short, it may be argued that the country adopted an incorrect approach to the taxation of capital transactions, resulting in a needlessly complex taxation system.[19]

Marjorie Kornhauser believes that the Court's precedents would have supported a decision against taxing capital gains under the income tax. What tipped the balance was not logic or precedent, but the political, economic, administrative and constitutional concerns of 1921. The nation had just come out of World War I, the debt was large and the economy in a recession. Depriving the government of its ability to tax capital gains would have reduced federal revenue at a time when it was needed and put the Court at odds with the Congress on an issue — taxation — to which it has historically deferred.[20]

Deductibility of Capital Losses. In truth, eliminating capital gains from the tax base might not have deprived the government of any revenue at all. Indeed, during the period from 1917 to 1921, the federal government had negative revenue from the capital gains tax, since capital losses exceeded gains by $213 million.[21] It is important to remember that at this time capital losses were fully deductible from ordinary income. Thus it is not surprising that investors simply held onto their gains free of tax, while realizing all of their losses for tax purposes, resulting in a net revenue loss for the government.

"During the period from 1917 to 1921, the federal government had negative revenue from the capital gains tax, since capital losses were fully deductible from ordinary income."

Full taxation of gains as ordinary income — at rates that went as high as 73 percent in 1921 — combined with full deductibility of losses also created

Capital Gains and Losses

(millions of dollars)

Year	Net Gain	Net Loss	Total
1917	318.2	70.0	248.2
1918	291.2	359.3	-68.1
1919	999.4	736.6	262.8
1920	1,020.5	1,037.0	-16.5
1921	462.9	1,102.0	-639.1
1922	991.4	759.6	231.8
1923	1,168.5	976.8	191.7
1924	1,513.7	476.8	1,036.9
1925	2,932.2	359.7	2,572.5
1926	2,378.5	212.8	2,165.8
1927	2,894.6	276.1	2,618.5
1928	4,861.8	357.4	4,504.4
1929	4,769.3	1,876.7	2,892.6

Source: Lawrence Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (New York: National Bureau of Economic Research, 1951), p. 367.

"After 1924, there was a preferential rate for gains, and a limit on deductibility of losses."

a massive lock-in effect.[22] Investors were stuck in their investments, unable to trade or reinvest their gains because of the punitive tax situation. This is what led Congress to establish a preference for capital gains for the first time. In the 1921 tax act, Congress provided that net gains over losses on assets held at least two years could be taxed at a flat rate of 12.5 percent. This led to a very sharp increase in capital gains realizations, with the government unquestionably taking in more revenue at the new, low rate than at the old, high rates. The data are presented above.

The 1921 legislation was unsatisfactory, however, owing to the asymmetrical treatment of capital gains and losses. Losses could still be deducted against ordinary income at rates that went as high as 58 percent in 1922 and 1923, while gains were taxed at a maximum of 12.5 percent. Treasury Secretary Andrew Mellon, therefore, asked Congress to resolve this asymmetry and either treat gains and losses alike or stop taxing capital gains altogether. Mellon made it clear that the latter was his preference:

> It is believed that it would be sounder taxation policy generally not to recognize either capital gain or capital loss for purposes of income tax. This is the policy adopted in practically all other countries having income tax laws, but it has not been the policy in the United States. In all probability, more revenue has been lost to the government by permitting the deduction of capital losses than has been realized by including capital gains as income.[23]

In the 1924 tax act, Congress moved to fix the problem by allowing only 12.5 percent of net capital losses against ordinary income. Unfortunately, no serious consideration was given to removing capital gains from the tax base — then or since.[24] Indeed, even many of those favoring preferential treatment for capital gains refuse to take seriously the argument that they should not be taxed at all.[25]

The British View of Capital Gains. Mellon alludes to the fact that capital gains historically were not taxed in other countries and this is true, especially in Britain and many former British colonies such as Canada, Australia and New Zealand.[26] The reason for not taxing capital gains in Britain mainly derived from a different concept of income. In Britain, income for tax purposes emphasized its regular or annual nature. Consequently, occasional, extraordinary, or temporary sources of income were not considered income for tax purposes. Thus such things as lottery winnings, one-time payments for a book or article, or occasional capital gains on the sale of stocks or land were not considered taxable income and were not taxed.

"In Britain, most capital gains originally were not considered income and not taxed."

It is hard to say how this concept arose. It may have arisen from the fact that for many years the income tax in Britain was considered a temporary measure. It was first imposed in 1799, but expired in 1802. It was reintroduced in 1803 and repealed in 1816. In 1842 another income tax was imposed. Like earlier income taxes, it was widely viewed as a temporary measure. In fact, Prime Minister Robert Peel suggested at the time the tax was introduced that it would be needed for just three to five years.[27]

Although the 1842 income tax proved, ultimately, to be a permanent feature of British law, many of its features, as they developed, were based on the assumption that it was temporary. Consequently, there was a concern for people who realized temporary income during the time the income tax was in effect, such as the sale of an asset which had appreciated for many years before the tax existed. It was felt that it would be unfair to tax such one-time income sources the same way that regular incomes, such as wages, rent or interest, were taxed.

The British tax system had separate tax schedules for different types of income. Capital gains fell under Schedule D. However, for income to be taxable under this schedule it needed to arise on an annual basis. A 1920 Royal Commission report explains why this requirement excluded capital gains from taxation:

> It will be noticed that the word annual is prominent, and although "annual" sometimes means no more than "calculated by reference to a year," yet in fact this use of the term "annual profits" in the charging words of Schedule D has had in general the effect of excluding from Income Tax liability all profits that are not annual profits in the sense of being likely to recur annually. Casual, non-recurring or occasional profits arising from transactions that do not form part of the ordinary business of the person who makes them are accordingly held not to be within the scope of the Income Tax, and consequently escape taxation.[28]

Of course, the distinction between casual and annual profits would extend to other forms of income in addition to occasional capital gains. It also means that individuals who made their income primarily from capital gains on a regular basis would pay tax on such gains, since for them such income would be considered regular in nature. The result was great confusion and controversy about what was taxable income and what was not. U.S. tax reformers frequently called attention to these problems in the British practice to argue against special treatment for capital gains in the U.S.[29]

Nevertheless, the British practice of not taxing occasional capital gains survived for 120 years. As recently as 1955, another Royal Commission recommended retention of the system, despite heavy criticism from tax reformers.[30] In the 1960s, however, the Labor Party finally abolished the tax-free status of capital gains and introduced a U.S.-style tax system.[31] Canada soon followed.[32]

Still, the point raised by the historical British practice is a valid one: Do occasional, unexpected gains constitute "income" in a meaningful sense? Does not the concept of "income" imply regularity and consistency? This was certainly the view of many economists at the time the Supreme Court decided that capital gains were "income." For example, in his presidential address to the American Economic Association in 1923, Carl Plehn of the University of California stated that, "Income is essentially wealth available for recurrent consumption, recurrently (or periodically) received. Its three essential characteristics are: receipt, recurrence and expendability."[33]

"Before 1921, lower U.S. courts also ruled that regularity was an essential quality of 'income,' a quality that capital gains necessarily do not have."

Before 1921, lower courts also ruled that regularity was an essential quality of "income" that capital gains necessarily do not have. For example, in a 1918 case, Judge Learned Hand ruled that the discharge of a debt did not constitute taxable income because it lacked regularity. The term "income," he wrote, "unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed."[34]

Is a Tax on Capital Gains a Double Taxation of Capital?

Since the 1920s, theoretical arguments about capital gains taxation have principally revolved around efforts by self-styled tax reformers to get rid of the capital gains preference. In general, the reformers have relied on a definition of income developed by Robert M. Haig and Henry Simons to press for full taxation of capital gains as ordinary income. Known as the Haig-Simons definition of income, it consists of all consumption during the course of a year plus the change in net worth.[35] Thus, under Haig-Simons, even unrealized capital gains would be subject to taxation (and theoretically, unrealized losses would be deductible).[36]

It is hard to say why the Haig-Simons definition of income achieved its status as the "official" definition universally used by economists and tax lawyers. Part of it has to do with its simplicity and part to the vigor with which some of its adherents have promoted it as the only theoretically pure definition of income. The latter would include especially economists associated with the Brookings Institution, such as Joseph A. Pechman and Richard Goode.[37]

"Under the Haig-Simons definition of income, an increase in the value of an asset would be subject to taxation even if it's not sold."

The Distinction between Income and Capital. The central problem with the Haig-Simons definition of income as it relates to capital gains is that it implicitly endorses the double taxation of capital. The fact is that capital gains only arise in the case of an income-producing asset (except, obviously, in the case of collectibles). The value of the asset is simply the discounted present value of the future flow of income associated with that asset (e.g., rent in the case of real estate, interest in the case of bonds and corporate profits in the case of stocks). Thus, if the income stream (rent, interest profits/dividends) is taxed, then any additional tax on the underlying asset (real estate, bonds, stocks) must necessarily constitute a double tax on the same income.

Of course, asset values rise and fall all the time with no change in income. But permanent changes only come about because of a permanent increase in income flows. As the great economist E.R.A. Seligman put it, "Capital is a capitalization not simply of present or actual income but of the present worth of all future anticipated incomes. There can be no permanent change in the value of the capital unless there is at least an anticipated change in future income."[38] More recent analyses confirm Seligman's characterization. As Richard Kopcke of the Federal Reserve Bank of Boston recently wrote in the bank's economic journal:

"Decreases in the value of an unsold asset would be deductible."

> According to common financial theories, an asset's price depends on its prospective income. In applying this description of asset prices, this article concludes that capital gains are not necessarily a proper element

> of taxable income separate from ordinary income, because these gains (or losses) reflect changes in the prospective income offered by assets. When this income is itself taxed fully, the asset's price, and any changes in its price, tend to reflect the tax burden on this income. In these circumstances, a capital gains tax imposes an additional levy beyond that on ordinary income, which effectively imposes a relatively high tax rate on any changes in an asset's earnings. Consequently, a levy on capital gains is a poor substitute for an income tax. Only changes in an asset's earnings generate taxable capital gains; the initial earnings would remain untaxed.[39]

Double Taxation of Bonds. Perhaps the clearest case of the capital gains tax being a double tax relates to bonds. Bonds are issued at par with a fixed income flow that is determined by the market rate of interest at the time of issue. However, the price of the bond may rise and fall as market interest rates change over the life of the bond. Since the nominal income flow is by definition unchanged, it is hard to see how selling a bond at a profit ever creates income in the aggregate — any gain to the seller in terms of command over resources is exactly offset by a loss to the buyer. As Martin J. Bailey explains:

"If the income stream of an asset is taxed, any additional tax on the asset is a double tax."

> Additions to wealth that result from a fall in the real interest rate are not income. Permanent income does include accruals to wealth due to all other causes, because such accruals could be consumed without impairing the ability to go on consuming at the same level forever. In contrast, consuming additions to wealth that result from a fall in the interest rate *would* impair the ability to go on consuming at the same level. A change in wealth due to changes in the interest rate reflects a price change, not a tangible change in goods available.[40]

Effect of Capital Gains on National Income. Confirming the broad acceptance of the principle that capital gains do not constitute income is the fact that the National Income and Product Accounts of the United States, from which the gross domestic product is calculated, have never included capital gains as part of the nation's economic income. Nobel Prize-winning economist Simon Kuznets, father of the national income accounts, explains, "Capital gains and losses are not increments to or drafts upon the heap of goods produced by the economic system for consumption or for stock destined for future use, and hence they should be excluded."[41] In 1998, $414.2 billion of capital gains included in adjusted gross income for tax purposes were excluded from personal income in the national income accounts.[42]

"Capital gains and losses are not counted in the calculation of GDP."

Neither Haig nor Simons ever addressed this argument. In truth, their rationalization for taxation of capital gains rested more on ideological grounds than scientific analysis. As Haig once put it, "an income tax which would allow capital gains to escape unscathed would, in this country at least, be an ethical monstrosity."[43] Simons took the same basic view. "The main and decisive case for inclusion of capital gains rests on the fact that equity among individuals is impossible under an income tax which disregards such items of gain and loss," he wrote.[44]

Thus, for all its presumed scientific precision, it turns out that the Haig-Simons definition of income is nothing more than an opinion based on ideological preferences for a more egalitarian society. In any event, the U.S. tax system does not remotely correspond to a pure Haig-Simons tax base. If it did, there would, for example, be no corporate income tax, which even Simons and other Haig-Simons adherents concede is a pure double tax when dividends are also taxed.[45]

Thus, one can argue that while a pure Haig-Simons approach might be an improvement — it would at least eliminate the lock-in effect, since the tax would no longer depend on whether an asset was held or sold — it makes no sense to argue that Haig-Simons demands full taxation of capital gains while ignoring all the other exceptions to a comprehensive tax base in our current tax system.[46] If supporters of eliminating the preference for capital gains wish to cite Haig-Simons in support of their position, they must also be willing to accept all the rest of the definition as well, which would, among other things, require taxation of unrealized gains, taxation of imputed income (such as the rent one receives for living in one's own home) and abolition of the corporate income tax. One cannot pick and choose.

Adjusting Capital Gains for Inflation. Finally, regarding capital gains, it is important to know that Haig and Simons both accepted the principle that all gains should be adjusted for inflation before being taxed. As Haig wrote in 1921:

> If income is defined as the total accretion in one's economic strength between two points of time, as valued in terms of money, it is clear that his income will reflect every change in the value of money between those two points of time in so far as the items entered on the balance sheets at those times affect the computation. If the level of prices goes up 10 per cent the money value of my assets will ordinarily follow at a like rate. That particular increase in value does not really indicate an increase in my economic strength. My power to command economic goods and services has not increased, for the money-value of these goods and services has likewise increased.... If it were possible to modify the concept of taxable income so as to eliminate this variation it would certainly be desirable to do so.[47]

"Both Haig and Simons agreed all gains should be adjusted for inflation before being taxed...[and] Simons conceded that most capital gains are 'largely fictitious.'"

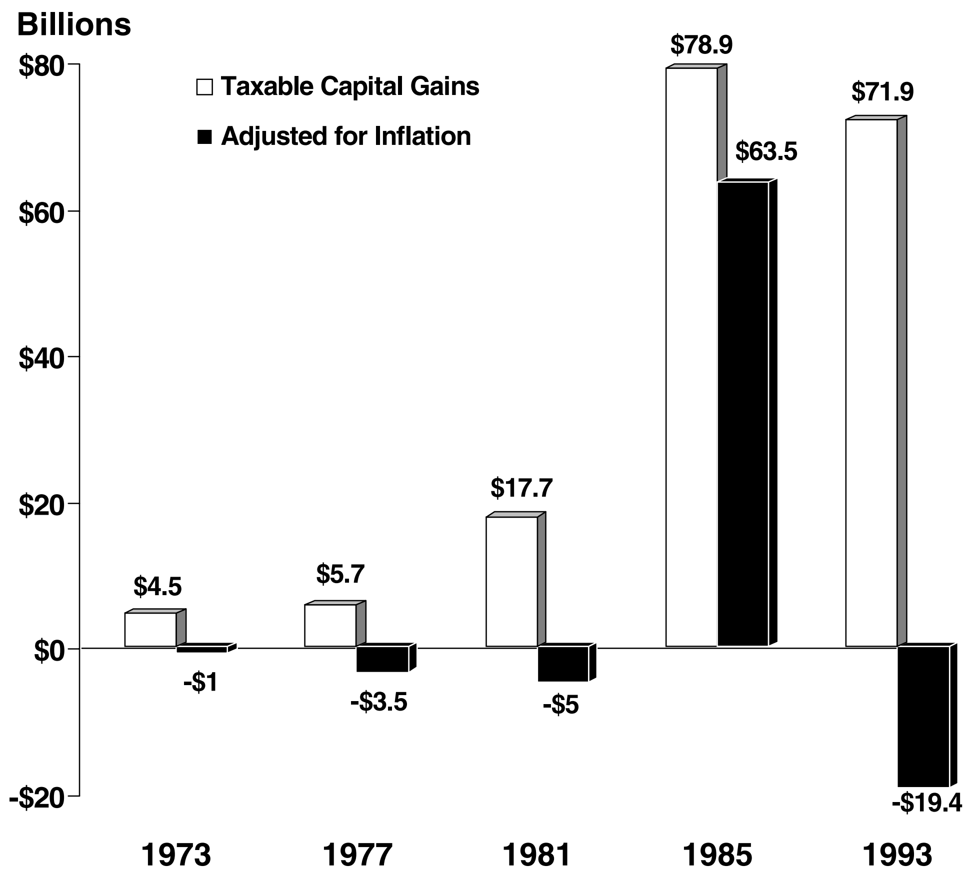
Simons conceded that most capital gains are "largely fictitious" once inflation is taken into account. In principle, he said, tax law should adjust gains and losses for changes in the price level. “Considerations of justice demand that changes in monetary conditions be taken into account in the measurement of gain and loss,” Simons wrote in 1938.[48] Numerous studies have documented that failure to index capital gains for inflation has subjected taxpayers to significantly higher taxes. [See Figure I.]

“Failure to index capital gains for inflation has subjected taxpayers to significantly higher taxes.”

- In 1973, taxpayers realized nominal gains of $4.5 billion, but a real loss of $1 billion.[49]
- In 1977, taxpayers paid taxes on $5.7 billion of nominal gains that actually represented a real loss of $3.5 billion.[50]
- In 1981, taxpayers paid taxes on $17.7 billion of nominal gains that represented a real loss of $5 billion.[51]
- In 1985, nominal gains amounted to $78.8 billion, but real gains came to just $63.5 billion.[52]

FIGURE I

Taxable Capital Gains versus Real Gains for Selected Years



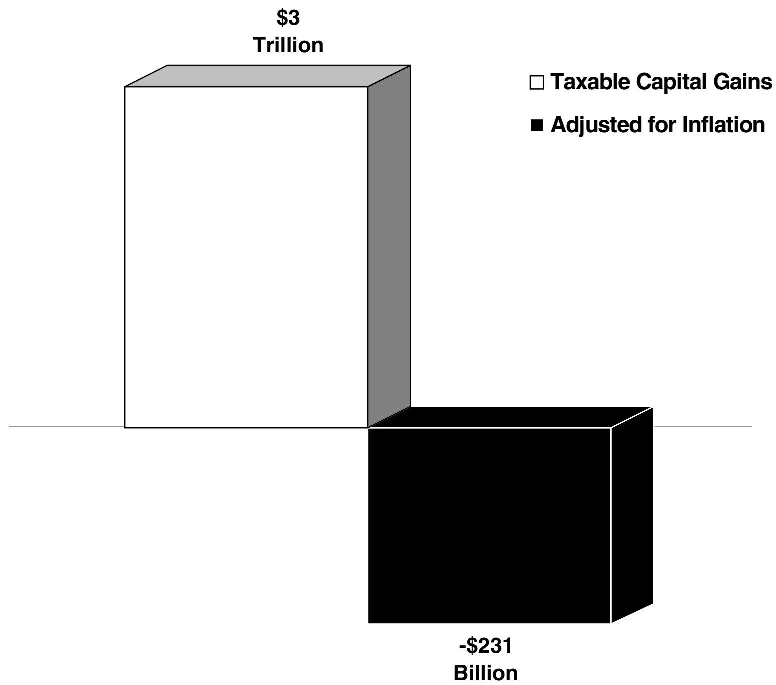
Source: U.S. Treasury Department, Congressional Budget Office and others.

"When inflation is factored in, from 1946 to 1977 households suffered a real loss of $231 billion on nominal capital gains of almost $3 trillion."

FIGURE II

Taxable Capital Gains versus Real Gains

(1946-1977)



Source: Robert Eisner, "Capital Gains and Income: Real Changes in the Value of Capital in the United States, 1946-77," in Dan Usher, ed., *Measurement of Capital* (Chicago: University of Chicago Press, 1980), p. 343.

- In 1993, nominal gains of $81.4 billion fell to $39.5 billion when adjusted for inflation. (Disregarding current limits on the deductibility of losses would produce a nominal gain of $71.9 billion and a real loss of $19.4 billion.)[53]
- Over the entire period from 1946 to 1977, economist Robert Eisner found that there were no real capital gains whatsoever. On balance, he found that households suffered a real loss of $231 billion on nominal gains of almost $3 trillion.[54] [See Figure II.]

Conclusion

In conclusion, there is a long line of analysis and court cases to the effect that capital gains are not income. And the main argument for taxing gains from a theoretical point of view, Haig-Simons, is deeply flawed. Yet accepting Haig-Simons would at least require full adjustment of gains for inflation, which would virtually wipe out all taxable gains in the aggregate.

"Capital gains are not income, but accepting the main argument for taxing them would require fully adjusting for inflation, which would wipe them out."

While there are many people who argue for a capital gains preference, and even support lowering the tax rate to zero, few have grounded their case on the fundamental principle that capital gains are not income.[55] They should make this argument consistently because it raises the case from the realm of political expediency or even economic efficiency, to the level of principle. Doing so at least gives advocates of lower capital gains a firmer foundation when confronted by those making a principled argument for not doing do, on the grounds that capital gains should really be taxed like ordinary income.

Notes

[1] See, for example, "Capital Gains Taxes and the Economy: A Retrospective Look," a study prepared by Standard & Poor's DRI for the American Council for Capital Formation (June 25, 1999), available at http://www.accf.org//capgainsDRI799.htm, which shows that higher growth and asset prices offset 100 percent of the static revenue loss from the 1997 capital gains tax cut, which lowered the top rate from 28 percent to 20 percent.

[2] Indeed, within hours of the announcement of a proposal to cut the capital gains tax two years ago, Citizens for Tax Justice, a union-backed group, issued a study stating that 67.9 percent of the benefits would go to the top 1 percent of taxpayers and 84.5 percent to the top 5 percent. "Proposed GOP Capital Gains Tax Cut Means More Money for the Rich, Crumbs for the Rest," (July 7, 1999), available at http://www.ctj.org/html/cgcut99.htm.

[3] See Harry Edwin Smith, *The United States Federal Internal Tax History from 1861 to 1871* (Boston: Houghton Mifflin, 1914).

[4] 82 U.S. (15 Wall.) 63, 65-66 (1872).

[5] 157 U.S. 429 (1895), 158 U.S. 601 (1895).

[6] The 16th Amendment states merely that income taxes may be imposed without being apportioned among the states. It did not in any other respect expand the Federal government's taxing power. See *Evans v. Gore*, 253 U.S. 245 (1920).

[7] 247 U.S. 189, 192 (1918). Emphasis in original.

[8] "Profits from Sale of Capital Assets as Income: Taxable under Sixteenth Amendment," *Michigan Law Review*, Vol. 19, No. 8, June 1921, pp. 857-58.

[9] Van Mayhall, "Capital Gains Taxation — The First One Hundred Years," *Louisiana Law Review*, Vol. 41, No. 1, Fall 1980, pp. 84-85.

[10] 247 U.S. 221, 231 (1918). One explanation for the seemingly contradictory rulings has to do with the fact that the first was decided under the corporate income tax statute, which had been found to be constitutional even before the 16th amendment because the Court ruled it to be an excise tax that was not, therefore, a direct tax that would be disallowed under the *Pollock* decision. The latter decision related to capital gains by an individual not regularly engaged in the trading of securities as a business.

[11] Marjorie Kornhauser, "The Origins of Capital Gains Taxation: What's Law Got to Do with It?" *Southwestern Law Journal*, Vol. 39, No. 4, November 1985, p. 900.

[12] 252 U.S. 189 214-215 (1919).

[13] 268 Fed. Rep. 207, 216 (1920).

[14] Editorial, "Taxation of Capital Gains," *New York Times,* February 15, 1921, p. 8.

[15] It should be noted that there was never any question that Congress could have passed a bill specifically taxing capital gains. The question was whether gains constituted "income" under the existing income tax law. Although the outcome may have been the same, had Congress passed the requisite legislation, it would have established the precedent that capital gains are by their nature different from other forms of taxable income. Furthermore, if capital gains were not taxable as income, any tax on them may have been considered a direct tax, and thus would have to be apportioned among the states. Although this constitutional provision has been considered a dead letter since the *Pollock* decision in 1895, some commentators still consider it to be a valid constitutional question. See Erik M. Jensen, "The Apportionment of 'Direct Taxes': Are Consumption Taxes Constitutional?" *Columbia Law Review*, Vol. 97, No. 8, December 1997; Calvin H. Johnson, "Apportionment of Direct Taxes: The Foul-Up in the Core of the Constitution," *William & Mary Bill of Rights Journal*, Vol. 7, No. 1, December 1998, pp. 1-103; Bruce Ackerman, "Taxation and the Constitution," *Columbia Law Review*, Vol. 99, No. 1, January 1999, pp. 1-58.

[16] 255 U.S. 509 (1921).

[17] "Constitutionality of Taxation of Realized Capital Increase under Federal Income Tax Acts," *University of Pennsylvania Law Review*, Vol. 69, No. 3, March 1921, p. 257.

[18] Fred Rogers Fairchild, "Federal Taxation of Income and Profits," *American Economic Review*, Vol. 11, No. 1, March 1921, p. 150.

[19] Mayhall, "Capital Gains Taxation — The First One Hundred Years," pp. 86-87.

[20] Kornhauser, "The Origins of Capital Gains Taxation," pp. 904-28.

[21] Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (New York: National Bureau of Economic Research, 1951), p. 367.

[22] See Charles C. Holt and John P. Shelton, "The Lock-In Effect of the Capital Gains Tax," *National Tax Journal*, Vol. 15, No. 4, December 1962, pp. 337-52.

[23] *Annual Report of the Secretary of the Treasury, 1923* (Washington: Government Printing Office, 1924), p. 9. See also *Annual Report of the Secretary of the Treasury, 1922* (Washington: Government Printing Office, 1923), p. 14. Some commentators agreed that eliminating capital gains from the tax base would probably not cost the Treasury any revenue, because although gains would not be taxed, losses would not be deductible. See "Profit on Investment as Taxable Income," *Yale Law Journal*, Vol. 30, No. 4, February 1921, p. 400.

[24] See Anita Wells, "Legislative History of Treatment of Capital Gains under the Federal Income Tax, 1913-1948," *National Tax Journal*, Vol. 2, No. 1, March 1949, pp. 12-32.

[25] See Walter J. Blum, "A Handy Summary of the Capital Gains Arguments," *Taxes — The Tax Magazine*, Vol. 35, No. 4, April 1957, p. 248; Noël B. Cunningham and Deborah H. Schenk, "The Case for a Capital Gains Preference," *Tax Law Review*, Vol. 48, No. 3, Spring 1993, pp. 325-26.

[26] Brian J. Arnold and Tim Edgar, "Selected Aspects of Capital Gains Taxation in Australia, New Zealand, the United Kingdom and the United States," *Canadian Public Policy*, Vol. 21, supplement, November 1995, pp. 58-61; Stephen R. Richardson and Kathryn E. Moore, "Canadian Experience with the Taxation of Capital Gains," *Canadian Public Policy*, Vol. 21, supplement, November 1995, pp. 77-99.

[27] B.E.V. Sabine, *A History of Income Tax* (London: George Allen & Unwin, 1966), pp. 60-61; F. Shehab, *Progressive Taxation: A Study in the Development of the Progressive Principle in the British Income Tax* (New York: Oxford University Press, 1953), pp. 97-98.

[28] Royal Commission on the Income Tax, *Report* (London: His Majesty's Stationery Office, 1920), p. 19.

[29] Robert M. Haig, "Capital Gains and How They Should Be Taxed," *Proceedings of the Academy of Political Science*, Vol. 11, No. 1, May 1924, pp. 131-142; *idem*, "Taxation of Capital Gains," *Wall Street Journal* (March 25 and 29, 1937).

[30] Royal Commission on the Taxation of Profits and Income, *Final Report* (London: Her Majesty's Stationery Office, 1955), pp. 25-37; G.D.N. Worswick, "Official Papers: The Royal Commission on the Taxation of Profits and Income," *The Economic Journal*, Vol. 66, June 1956, pp. 370-377.

[31] Interestingly, subsequent discussions of Britain's economic decline pinpointed the mid-1960s as a turning point. See, for example, Robert Bacon and Walter Eltis, *Britain's Economic Problem: Too Few Producers*, 2nd ed. (London: Macmillan, 1978); and Samuel Brittan, "How British Is the British Sickness?" *Journal of Law and Economics*, Vol. 21, No. 2, October 1978, pp. 245-68.

[32] Richardson and Moore, "Canadian Experience with the Taxation of Capital Gains."

[33] Carl Plehn, "The Concept of Income, as Recurrent, Consumable Receipts," *American Economic Review*, Vol. 14, No. 1, March 1924, p. 5.

[34] *United States v. Oregon-Washington R. & Nav. Co.*, 251 Fed. Rep. 211, 213 (1918).

[35] See Robert M. Haig, "The Concept of Income — Economic and Legal Aspects," in Robert M. Haig, ed., *The Federal Income Tax* (New York: Columbia University Press, 1921), reprinted in Richard M. Musgrave and Carl S. Shoup, eds., *Readings in the Economics of Taxation* (New York: Richard D. Irwin, 1959), pp. 54-76; Henry C. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938).

[36] Although no serious effort has ever been made to tax unrealized capital gains, proposals for doing so have periodically been put forward by tax theorists. See Joseph M. Dodge, "Restoring Preferential Capital Gains Treatment under a Flat Rate Income Tax: Panacea or Placebo?" *Tax Notes*, Vol. 44, No. 10, September 4, 1989, pp. 1133-43; David Shakow, "Taxation without Realization: A Proposal for Accrual Taxation," *University of Pennsylvania Law Review*, Vol. 134, June 1986, pp. 1111-1205; David Slawson, "Taxing as Ordinary Income the Appreciation of Publicly Held Stock," *Yale Law Journal*, Vol. 76, No. 4, March 1967, pp. 623-676.

[37] Richard Goode, "The Economic Definition of Income," in Joseph A. Pechman, ed., *Comprehensive Income Taxation* (Washington: Brookings Institution, 1977), pp. 1-30; Joseph A. Pechman, *Federal Tax Policy*, 5th ed. (Washington: Brookings Institution,

1987), p. 80. The latest Brookings publication on capital gains continues to maintain that Haig-Simons requires full taxation of unrealized capital gains. See Leonard Burman, *The Labyrinth of Capital Gains Tax Policy* (Washington: Brookings Institution, 1999). It should be noted that the Haig-Simons definition of income underlies the whole concept of "tax expenditures." For a critique of this concept, see Bruce Bartlett, "The End of Tax Expenditures As We Know Them?" *IRET Policy Bulletin*, No. 84, June 13, 2001.

[38] E.R.A. Seligman, "Are Stock Dividends Income?" *American Economic Review*, Vol. 9, No. 3, September 1919, p. 526.

[39] Richard W. Kopcke, "No Gain, No Pain: Some Consequences of Taxing Capital Gains," *New England Economic Review,* March/April 1989, p. 39. For a similar analysis, see Neil A. Stevens, "Taxation of Capital Gains: Principle versus Practice," *Federal Reserve Bank of St. Louis Review*, Vol. 60, No. 10, October 1978, pp. 2-8.

[40] Martin J. Bailey, "Comment," in Dan Usher, ed., *The Measurement of Capital* (Chicago: University of Chicago Press, 1980), p. 343.

[41] Simon Kuznets, *National Income and Its Composition, 1919-1938* (New York: National Bureau of Economic Research, 1941), p. 12. See also M.A. Copeland, "Concept of National Income," *Studies in Income and Wealth*, Vol. 1 (New York: National Bureau of Economic Research, 1937), pp. 3-34; Roy Blough and W.W. Hewett, "Capital Gains in Income Theory and Taxation Policy," *Studies in Income and Wealth*, Vol. 2 (New York: National Bureau of Economic Research, 1938), pp. 191-239.

[42] *Survey of Current Business*, Vol. 80, No. 9, September 2000, p. 16.

[43] "Simplification of the Federal Income Tax — Discussion," *American Economic Review*, Vol. 18, No. 1, March 1928, p. 120.

[44] Simons, *Personal Income Taxation,* p. 157.

[45] Henry C. Simons, *Federal Tax Reform* (Chicago: University of Chicago Press, 1950), pp. 20-21; Richard A. Musgrave, "In Defense of an Income Concept," *Harvard Law Review*, Vol. 81, November 1967, p. 61; Charles E. McLure, Jr., "Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals," *Harvard Law Review*, Vol. 88, January 1975, pp. 532-582.

[46] For practical problems with the Haig-Simons definition, see Victor Thuronyi, "The Concept of Income," *Tax Law Review*, Vol. 46, No. 1, Fall 1990, pp. 45-105.

[47] Haig, "The Concept of Income," p. 67.

[48] Simons*, Personal Income Taxation*, p. 155. See also Bruce Bartlett, "Inflation and Capital Gains," *Tax Notes*, Vol. 75, No. 9, June 2, 1997, pp. 1263-66.

[49] Martin Feldstein and Joel Slemrod, "Inflation and the Excess Taxation of Capital Gains on Corporate Stock," *National Tax Journal*, Vol. 31, No. 2, June 1978, pp. 107-118.

[50] U.S. Treasury Department, *Report to Congress on the Capital Gains Tax Reductions of 1978* (Washington: U.S. Government Printing Office, 1985), p. 11.

[51] Congressional Budget Office, *Indexing Capital Gains* (Washington: U.S. Government Printing Office, 1990), p. 24.

[52] Leonard Burman and Eric Toder, "Indexing v. Exclusion of Capital Gains: Effects on Income Distribution and Economic Efficiency," *1992 Proceedings of the 85th Annual Conference on Taxation* (Columbus, OH: National Tax Association, 1993), pp. 14-15.

[53] Congressional Budget Office, "Perspectives on the Ownership of Capital Assets and the Realization of Capital Gains," *CBO Papers* (May 1997), p. 29.

[54] Robert Eisner, "Capital Gains and Income: Real Changes in the Value of Capital in the United States, 1946-77," in Usher, *Measurement of Capital*, pp. 202-203.

[55]One who always did was Irving Fisher, who, although best known for his work on statistics and monetary theory, wrote extensively on why capital gains and saving in general should not be taxed in principle. Recent calls for a consumption-based tax system are really just echoes of Fisher's pioneering work. See Irving Fisher and Herbert W. Fisher, *Constructive Income Taxation* (New York: Harper & Brothers, 1942).

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About the NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute founded in 1983 and funded exclusively by private contributions. The mission of the NCPA is to seek innovative private-sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs). The *Wall Street Journal* called NCPA President John C. Goodman "the father of Medical Savings Accounts." Sen. Phil Gramm said MSAs are "the only original idea in health policy in more than a decade." Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs.

Congress also relied on input from the NCPA in cutting the capital gains tax rate and in creating the Roth IRA. Both proposals were part of the pro-growth tax cuts agenda contained in the Contract with America and first proposed by the NCPA and the U.S. Chamber of Commerce in 1991. Two other recent tax changes — an increase in the estate tax exemption and abolition of the 15 percent tax penalty on excess withdrawals from pension accounts — also reflect NCPA proposals.

Another NCPA innovation is the concept of taxpayer choice — letting taxpayers rather than government decide where their welfare dollars go. Sen. Dan Coats and Rep. John Kasich have introduced a welfare reform bill incorporating the idea. It is also included in separate legislation sponsored by Rep. Jim Talent and Rep. J. C. Watts.

Entitlement reform is another important area. NCPA research shows that elderly entitlements will require taxes that take between one-half and two-thirds of workers' incomes by the time today's college students retire. A middle-income worker entering the labor market today can expect to pay almost $750,000 in taxes by the time he or she is 65 years of age, but will receive only $140,000 in benefits — assuming benefits are paid. At virtually every income level, Social Security makes people worse off — paying a lower rate of return than they could have earned in private capital markets. To solve this problem, the NCPA has developed a 12-step plan for Social Security privatization.

The NCPA has also developed ways of giving parents the opportunity to choose the best school for their children, whether public or private. For example, one NCPA study recommends a dollar-for-dollar tax credit up to $1,000 per child for money spent on tuition expenses at any qualified nongovernment school — a form of taxpayer choice for education.

The NCPA's Environmental Center works closely with other think tanks to provide common sense alternatives to extreme positions that frequently dominate environmental policy debates. In 1991 the NCPA organized a 76-member task force, representing 64 think tanks and research institutes, to produce *Progressive Environmentalism*, a pro-free enterprise, pro-science, pro-human report on environmental issues. The task force concluded that empowering individuals rather than government bureaucracies offers the greatest promise for a cleaner environment. More recently, the NCPA produced *New Environmentalism*, written by Reason Foundation scholar Lynn Scarlett. The study proposes a framework for making the nation's environmental efforts more effective while reducing regulatory burdens.

In 1990 the NCPA's Center for Health Policy Studies created a health care task force with representatives from 40 think tanks and research institutes. The pro-free enterprise policy proposals developed by the task force became the basis for a 1992 book, *Patient Power*, by John Goodman and Gerald Musgrave. More than 300,000 copies of the book were printed and distributed by the Cato Institute, and many credit it as the focal point of opposition to Hillary Clinton's health care reform plan.

A number of bills before Congress promise to protect patients from abuses by HMOs and other managed care plans. Although these bills are portrayed as consumer protection measures, NCPA studies show they would make insurance more costly and increase the number of uninsured Americans. An NCPA proposal to solve the problem of the growing number of Americans without health insurance would provide refundable tax credits for those who purchase their own health insurance.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA experts appear regularly in national publications such as the *Wall Street Journal, Washington Times* and *Investor's Business Daily*. NCPA Policy Chairman Pete du Pont's radio commentaries are carried on 359 radio stations across America. The NCPA regularly sponsors and participates in *Firing Line Debate*, which is aired on 302 public broadcasting stations. The NCPA each year sponsors 22 one-hour televised debates on the PBS program *DebatesDebates,* seen in more than 170 markets.

According to Burrelle's, the NCPA reached the average household 10 times in 1998. More than 36,000 column inches devoted to NCPA ideas appeared in newspapers and magazines in 1997. The advertising value of this print and broadcast coverage was more than $56 million, even though the NCPA budget for 1998 was only $4 million.

The NCPA has one of the most extensive Internet sites for pro-free enterprise approaches to public policy issues, www.ncpa.org, receiving about one million hits (page views) per month. All NCPA publications are available online, and the website provides numerous links to other sites containing related information. The NCPA also produces an online journal, *Daily Policy Digest,* which summarizes public policy research findings each business day and is available by e-mail to anyone who requests it.

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