The Partiality of Indexing Capital Gains

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In 1986 Congress made realized capital gains fully taxable, in the spirit of uniformity animating the 1986 reform. The effect on gains taxes was largely offset, to be sure, when Congress lowered the top rate from 50% to 28%, abandoning 70 years of rate progressivity. Congress also lowered the corporate tax rate. Nonetheless, the change did overturn a long tradition of excluding half or more of gains from taxable income. No special concern was shown for the phantom income element in nominal capital gains.

Now we are witnessing a major effort to revive the exclusion of part or all of capital gains from taxable income, partly on the grounds that much of the gains are "phantom" income, an illusion of inflation. President Bush is the most visible champion. In his 1988 campaign, relief for capital gains was nearly the only specific plank in the domestic platform. As President he has focused intensely on it for nearly two years, to the point of jeopardizing his relations with Congress. With troops in the Persian Gulf he still accepted a risk of having no budget, and shutting down domestic government to win the issue. Nearly two years of prior negotiations had stalled on this one matter.

The President is not doing this alone. In October 1990 he announced a willingness to bend on capital gains, only to be reversed by his supporters and forced into a politically dangerous acceptance of higher tax rates, to win a small concession for capital gains. He and his supporters carried it so far as to risk serious electoral losses in November, 1990. This is a concerted, sustained drive by intensely focused people willing to take heavy losses to win the one point. The token preference they finally won this year is of value mainly to differentiate gains from ordinary income, to prepare the way for later efforts. They have shown staying power; so has the other side. The contest is as old as income taxation, and is to be perennial.

The issues are distributive, allocative, and macroeconomic.

The distributive issue is clear, as issues go, and (for most people) argues against excluding gains from tax. There is little substantial dispute that the proximate benefits of lowering the rate on gains would be highly concentrated. The dispute focuses on subsequent macroeconomic effects: supply-side kick, and demand-side stimulus.

The allocative issue is not much stressed. A tax on realized gains has some "locked-in effect." If the issue were pushed, the answer would be that the locked-in effect results mainly from step-up at death, rather than from a high rate per se.

The macro issues are capital formation, and raising investment. The case for lowering gains taxes is made mainly in those terms, and we will treat it likewise. This case is a major expression of what its champions call "supply-side economics," coupled with traditional demand-side stimulus from investment.

Spokesman Paul Craig Roberts writes the tax on capital gains is simply "pandering to envy," and will abort capital formation at the expense of the general welfare. The Marxist historian Maurice

Dobb, with a different emphasis, has also attributed capital accumulation to fortunes made by holding land for the rise.[1]

We surely agree with Roberts *et al.* that domestic capital formation is a crying current need; and the means is to foster saving and investing (but properly defined, as below). We also agree there is a strong, bi-partisan case for raising investment flows of the income-creating, work-activating kind. Here, however, we meet the problem of distinguishing new capital from old assets, especially land.

Land is not formed, like capital, by saving and investment; land is not reproducible. For that very reason land tends to appreciate, and therefore has to be a major source of what are misleadingly called "capital" gains. Again for that very reason, there is no supply-side kick in untaxing gains. Most of them are *land* gains, and should be called that. To use land as a store of value is macro-economically unproductive at best, and on balance counterproductive and destabilizing (considering its effect on financial institutions like the S&Ls).

To handle this matter we need two semantic distinctions which often are lost in the word-fencing of debate. Walter Heller, whose policies still enjoy bi-partisan support, thought and spoke in a Keynesian framework where "investment" means "investing," an affirmative, job-making action. It is a process, not a store of value; an economic flow, not a fund. It is not the asset held: this "investment" is a noun, macro-economically static and sterile.[2] To signalize these differences I use the present participle "investing," rather than the ambiguous noun "investment."[3]

Every Keynesian also knew in 1961 that investment means *net*, positive-sum investing. It does not include buying and selling existing assets like land: these are zero-sum transactions, macro-economically non-functional and barren.[4] I use "investing" only in the sense of net, income-creating, job-making spending.[5] As to borrowing on land, that can be worse than barren when the financial system rises and falls on a land bubble, as it has and is.

1.. Maurice Dobb, 1947, *Studies in the Development of Capitalism*, New York: International Publishers, at pp. 179 ff.

2.. Land may appreciate, and one may call this "investment," but the appreciation employs no one and creates no new wealth (although it may reflect the externalities of wealth created by others).

3.. Webster's *9th New Collegiate* defines investment both ways: it is an action, (the Keynesian usage); it is also an asset being held, a store of value. Such a two-faced word is a natural medium for double-talk, and has been so exploited, to the detriment of general understanding.

4.. Keynes, although careless of consistency, generally took care to distinguish old and new assets. " ... the competition of a high interest-rate on mortgages may well have had the same effect in retarding the growth of wealth from current investment in newly produced capital-assets as high interest rates on long-term debts ... " [*General Theory*, 1936, p. 241.] The old macro-economists generally refer to investing in newly produced assets as "income-creating expenditure," which is clear and correct, but too much of a mouthful.

5.. Note the difference between real turnover and mere ownership turnover. Ownership turnover generates no income (except for brokers and M&A personnel) and creates no capital. Real turnover also creates no capital, but does forward supplies of goods to consume, and flows of investing to produce replacement goods. Most of gross investing is *re*investing funds received or anticipated from sales of old capital (including inventories, which turn fast, and "fixed" capital which turns slowly as it depreciates and the funds are reinvested).

Heller and his contemporaries also knew that the incentive driving job-making investing is MRORAT, the Marginal Rate of Return after Taxes.[6] The marginal idea is pivotal. The *Average* ROR includes rents; the *Marginal* ROR is the pure return to new investment, Keynes' "inducement to invest," which is activating and functional.

These Heller ideas were invoked again by supply-siders in early Reagan times. However, policy over the course of the 80s lost the substance of that policy, keeping only the guise. Domestic leaders forgot the usage of "investment" in macro-economics. They gradually slipped into an illusion that buying and holding and bidding up old assets like non-reproduceable lands and stocks would make jobs and produce goods. They forgot to distinguish old from new assets, and marginal from average returns on investment (average returns, recall, include rents). Both critics and supporters of "supply-side" policies now darken counsel by debating current policies in supply-side terms, when the terms no longer describe the policy at issue.

Along with normal confusion, there is intelligence behind such error. The case for downtaxing gains depends in part on exploiting confusion, in order to pass off rent-raising as an incentive for saving and investing, and so to disguise its non-functionality and eminent taxability. The policy is called "supply side," but isn't.

The litmus test of the sincerity of capital-formation champions is their treatment of irreproduceable land. Raising rents and land prices, and protecting the gains from taxation, is purely distributive, with no power to foster saving and investing. On the contrary, a higher share for rent and/or land purchase must mean a lower share for the investor in new capital.

Ignoring land and its distinctive attributes has the effect of treating land as though it were true, reproduceable capital, to be formed by saving and investing, to be routinely worn out and replaced in the normal course of life and business. It lets advocates of investing and capital formation abuse the legitimate case for macro incentives, exploiting the case to camouflage unearned, nonfunctional rents and increments to land value.[7]

Tantamount to ignoring land is minimizing its weight. Thus one may acknowledge it indulgently, while actually dismissing it. In fact, though, land comprises some half the assessed value of taxable real estate in California, and is not dismissable. Half the assessed value means *more* than half the *market* value because of assessment discrimination favoring land. A raft of studies of assessment discrimination, like the sales/assessment ratio studies of the U.S. Census, show consistent patterns of discrimination favoring land. In addition to ordinary assessment discrimination there is much legislated underassessment, for land in forest, farm, country club, and other favored uses.[8] If that data were not enough, most of us resident in California have been

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6.. Economists of the 1960s, following Keynes, called it the MEC, or "Marginal Efficiency of Capital," an awkward phrase now little used. Awkward or not, and intended or not, it had great historical consequence by putting the emphasis where it belongs, on *marginal* rates of return, excluding rents.

7.. Brookings' major contribution to our subject is Henry Aaron (ed), 1976, *Inflation and the Income Tax*, with chapters by 15 eminent economists. Land is treated by none and is not in the index. [It is mentioned in passing only by one, George Lent.]

8.. An interesting recent case involves Charles H. Keating, Jr. of Arizona. He and Kemper Marley posed as farmers to secure "millions of dollars in agricultural tax breaks on land they planned to develop." The breaks result from lower assessed land values for "farmers." [Steve Yozwiak, "Land-tax bill OK reached," *The Arizona Republic*, 13 April 89.] Most states legislate similar loopholes, widely used by suburban land speculators. More generally, the effect in California of Prop. 13 is to keep much land assessed not much above its 1978 valuation.

through one or more years since 1976 when the value of our homes alone rose by more than our annual salaries.[9]

Considering the true nature of most "capital" gains, it is not surprising that economists have not come forward with claims of large macro benefits from untaxing gains. The CBO, using a Washington University Model, recently estimated that excluding 30% of gains from the income tax base would raise GNP by only "0.1%" - a number well below the accuracy of any macro model, and effectively zero. James Poterba last year came up with another figure near zero.[10]

Poterba stresses the effect of portfolio substitution. So does John Muellbauer of Nuffield College, Oxford.[11] Land value, like slaves and government bonds, meets the security need of asset-holders without their having actually to create capital. High land values doubly check saving. First, by rising they look like individual income and encourage more drafts on the flow of consumer goods, without adding to supply. Second, once risen, they satisfy portfolio demands in lieu of real capital. British policy-makers take some heed of such wealth effects but, according to Muellbauer, look only at paper assets and err by overlooking land values.

Regardless of the several points above, many economists are bent on relieving capital gains from taxation. Faced with mighty political forces in collision, mainline economists have brought forth a compromise technical fix: indexing capital gains. Alan Blinder, a moderate and intelligent conservative, is a prominent spokesman. The late Joseph Pechman, a moderate and intelligent liberal who long championed taxing capital gains, wrote last year that "economists agree" that indexing is the way to go. When the dean of Haig-Simons boosters concedes so much, indexing would indeed seem to be the consensus position. At times Congress and the President have been close to seizing on indexing as a viable compromise, and may finally do so one day.

The idea is to step up the basis of capital assets by the same percentage as the price index rose over the period of ownership, before deducting the basis from sale price to determine taxable gain.[12] The purpose of this indexing is, of course, to remove "phantom income" from the tax base.

Why remove phantom income from capital gains, and not from other property income? William Vickrey often points out that all assets, not just capital assets, are "taxed" by inflation. Inflation with an income tax is in effect a *general* wealth tax. Monetary assets are surtaxed in the obvious way, and equity assets (both capital and ordinary) are surtaxed when they or their products are sold, because of the phantom income they generate. Thus, if one favors a general wealth tax (many people do) taxing phantom income is a way to achieve a desired goal.[13]

9.. As early as 1970 it was possible to document a high share of land value in national wealth: Mason Gaffney, 1970, "Adequacy of land as a Tax Base," in Daniel Holland (ed.), *The Assessment of Land Value*, Madison: University of Wisconsin Press, pp. 157-212. The theme is further developed in the writer's "Why Research Farmland Ownership and Values?", 1985, in T.A. Majchrowitz and R.R. Almy (eds.) *Property Tax Assessment*, Chicago: U.S.D.A., I.A.A.O, and The Farm Foundation, pp. 91-109.

10.. Reported in *Business Week*, 24 April 89, p.20. [My copy of Poterba's monograph has apparently self-destructed.]

11.. John Muellbauer, 1990, "The Great British Housing Disaster," ROOF, London: *Shelter*, May/June.

12..There has been little discussion of what index to use, and it is not our topic. It is a major problem for indexers.

13.. In today's atmosphere we forget how recently it was learned, respectable and progressive to favor taxing property, especially rents and unearned increments to land value.

We are not pushing for a general wealth tax, but for impartiality and accurate thinking about indexing capital gains, a policy that would protect some forms of wealth, but not others. This apparently temperate, common-sense proposal is in fact partial and discriminatory. Worse, it protects most where the macro social benefits are least.

Holders of monetary assets and recipients of fixed incomes are the primary victims of inflation. Holders of depreciable capital pay the inflation tax on phantom income that arises constantly in ordinary use because depreciation write-off is limited to historical cost.[14]

In contrast, *ordinary cash flow to landholders contains no phantom income* because there is no depreciation. Land is only taxed on phantom gains at the time of sale, if ever. Since taxable ownership turnover is very slow, about 2-3% per year, land is the asset whose gains are already most sheltered by step-up of tax basis at time of death and devise. Land is most sheltered by deferral of tax until realization.

Indexing would simply give more shelter where shelter already is. Land would be the asset most favored by the indexing of capital gains under tax law. Land's basis (the value to be augmented by indexing) is not depreciated away (except illegally); and it is the asset most likely to appreciate with and also without general inflation.

Equities gain when inflation lowers the real value of debt. Indexing would then additionally help the equity owners, who have already gained from inflation, not the creditors who have already lost. Most private debt today is secured by real estate, either directly or through the corporate

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After World War II a whole generation of development economists toured the Third World promoting forms of property taxation. One result was the Punta del Este Charter. Its ancillary Santiago Conference on Fiscal Policy of December, 1962, sponsored by OAS, IADB, and ECLA, pushed for no less than five kinds of high taxes on property: on gains, on net wealth, on urban and rural property, surtaxes on property income, and inheritance taxes. ["Tax Reform is Major Objective of Alliance in Latin America," *International Commerce*, 4 Nov 63, pp.14 ff.]

International agencies were pushing land reform and property taxation around the whole Third World. The east coast of Asia responded, especially the "four tigers" of Taiwan, Hong Kong, Singapore and Korea. If the policies have tended to suppress enterprise and capitalism one is hard put to explain the extraordinary capitalist development of the four tigers which tax property heavily, and the stagnation of Latin America which does not.

Lloyd George, when Chancellor of the Exchequer under Herbert Asquith in 1909, proposed a huge peacetime budget increase "to wage war against poverty." (He was also financing a naval race.) He included not just a small national land tax, but a tax on land gains, and a surtax on income from land.

William Howard Taft and Woodrow Wilson presided over the birth of the American income tax. Wilson's second Congress, elected in 1914, contained the craftsmen. The first substantial application of the 16th Amendment was in 1916, the law being designed by Congressman Warren Worth Bailey. Bailey shaped the law to meet the demands of the time for, and his personal belief in, special taxation of unearned incomes. He was a leading "single-taxer" as they were then miscalled, a champion of taxing unearned increments. The idea was merged into Progressivism.

The Wilson administration Treasury even moved to tax gains as they accrue, a principle later endorsed by most tax economists following Professors Haig and Simons and others. The USSC, however, ruled that Congress must authorize such taxation explicitly (Eisner v. Macomber, 1920). Congress, by that time heavily changed following the Palmer raids and deportations delirium of 1920, declined. With the end of the Cold War (which dates back to then, in its influence on domestic ideology and policy), may we not now expect a revival of Progressivism?

14.. It is useful to think of "fixed" depreciable capital like an onion with concentric layers. With time and/or use, layers are sequentially peeled off and sold to consumers, like parts of an inventory. With inflation, each peeling is sold for more than its original nominal cost, yielding phantom taxable income. Actual inventories may be sheltered by LIFO accounting; fixed capital is not.

veil. These landowner-debtors who gain from inflation are largely the same ones whom it is proposed to aid further by indexing their gains.

An invisible creditor that loses is the United States Treasury. Most land carries deferred tax liabilities to be recouped at time of sale. These liabilities include deductions taken by expensing carrying costs on appreciating land. [Such deductions are "ordinary," and do not lower the basis of property.] Much of the recoupment is illusory, when these invisible debts are paid in depreciated dollars. This is phantom recoupment: the standard literature neglects it completely. *Phantom recoupment for The Treasury is real untaxed income for landowners*. The literature is devoted to deploring taxes on phantom income. The results are unbalanced thinking and misleading conclusions.

There are more invisible debts to The Treasury. Under the Haig-Simons rationale these also include taxes that should have been collected in the past, annually, as land price rose. When unpaid taxes are accrued in good dollars, but paid later in bad, the recoupment of tax liabilities is only partial. Accrued unpaid tax liabilities are the Treasury's basis in appreciating lands: it has bought into them by deferring taxes. To index the owner's basis but not the Treasury's basis would cheat the Treasury, *i.e.* other taxpayers. They are cheated anyway, since The Treasury does not charge interest on the deferred taxes. They are cheated again because the top marginal tax rate of 28% is now far below the 50% rate at which most past deductions were taken.

Although most benefits of indexing go to land, the true capital in owner-occupied residences, and personal playgrounds, would also gain from indexing because the basis (the deductible value to be stepped up by indexing) is not tax-depreciable and so remains fully intact at time of sale. Thus, indexing would add to the heavy existing tax bias for true capital in this particular form. Interest and property taxes are fully expensible even though the counterpart "imputed income" (benefit of occupancy) is untaxed.

In summary, selective lightening of taxes on new investment can be justified on incentive grounds, but indexing "capital" gains would mainly favor old assets and assets already sheltered, notably land. The ordinary cash flow from depreciable capital, which needs better treatment, would not get it. The ordinary cash flow from land contains no phantom income; landowners already benefit from phantom recoupment of early deductions and deferrals; debtor-landowners gain peculiarly from drops in the real value of debt. Indexing would least relieve those most needing relief, and vice versa.

Ominously, selective indexing of gains would also create a powerful new pro-inflation lobby. It would further enrich lobby supporters with more discretionary funds, and give them an urgent interest adverse to the general welfare.