



What are 'Capital Gains'?

By [Dr. Mason Gaffney]

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What are "capital gains"?

The 1986 tax reform was a massive shift of income tax liabilities off land (by lowering the top rates), and onto new investment (by decelerating write-off). Its only saving grace, from the viewpoint of Physiocratic incentive and redistributive taxation, was eliminating the preferential lower tax rate on capital gains. (Technically, it eliminates the exclusion of part of long-term gains from the base). The "saving grace" was a political bargain, to maintain some of the social compact while lowering the top rates from 70% to 28% in history's most massive shift toward a flat rate income tax. Now one side of the bargain is being reneged, "driving a stake in the heart" of the 1986 compact¹. The Administration knowingly lost much goodwill with Congress on this single issue, even risking its ability to govern in 1989. What are capital gains to warrant such hazards?

The term "capital gains" is a disguise, artfully contrived, growing more obfuscatory with long usage and growing complexity. It is the nature of most actual capital to depreciate, usually fast. There are few true resale gains to capital as such. It is rather land, irreproducible and limited, whose nature is to appreciate and yield unearned increments. There are exceptions, which the champions of downtaxing gains may use in debate; but exceptions are no basis for framing generalities or public policy. As a broad rule we are on the mark to read "land gains" where the world writes "capital gains."

As Lester Thurow wrote, "If lower capital gains taxes were limited to plant and equipment investment in new, high-risk venture capital situations, one could understand the proposal ... But the lower ... rates will also apply to antiques, ... land, ... assets that have nothing to do with reindustrialization. For every dollar's worth of reindustrialization incentives offered, several dollars worth of incentives will be provided for nonproductive investments."² James Poterba, as we have seen, estimates a very small share of capital gains derive from "venture capital"³

¹Tom Redburn, loc. cit.

²Lester Thurow, "Getting Serious about Tax Reform". Atlantic M? date? Thurow's later endorsement of VAT does not seem very consistent with this passage.

³James Poterba, loc cit.

Corporate shares also yield "capital" gains. What makes these shares rise is the rise in value of corporate assets. The writer has shown elsewhere⁴ that a large share of corporate assets consist of land (in the generic sense of natural resources).

The strongest reason for favoring capital gains is this. Another source of the rise in stock prices is the plowback of undistributed profits. Some of this actually does go to create real capital. (The rest goes to acquire old capital and land.) By this indirect route, a portion of any cut in capital gains taxes does actually foster real investment, as claimed. But the portion is too small, and the productivity of the investment often low, because this captive internalized undistributed profit comes to management free of any competitive market cost or test.

When the purpose of Congress is really to encourage new investment, fast write-off of new capital is the obvious tool. The tool was highly developed and applied during the 1960s, as noted above. It would also help to allow full deduction of capital losses, a provision conspicuously missing from current proposals, and indeed all reform proposals since 1932 or so.

The main effect of untaxing land gains, on the other hand, is simply to redistribute wealth and overprice land. When tax benefits go to land, the word "incentive" takes on a new and lesser meaning. Land, by definition, is not created by capital formation. Incentives to buy and hold land will raise the demand, not the supply. The incentives created are not the kind that produce anything or employ anyone. They simply raise asking price and exclude marginal buyers from the market.

ADDENDUM

Another major source of capital gains is in the resale of real estate with buildings that the owners have overdepreciated (using short factitious "tax lives," accelerated depreciation, etc.). The owners generally manage to depreciate their buildings fast enough (on the books) to offset all the

⁴Mason Gaffney, "Adequacy of Land as a Tax Base". In Daniel Holland (ed.) The Assessment of Land Value (1969). Madison: University of Wisconsin Press.

cash flow that would otherwise be taxable income, resulting in zero tax liability, for a while. However, they must subtract this *faux* (French for phony) depreciation from the original cost or "basis"; after a while they run out of basis. Then they usually decide to sell. Upon resale, the seller deducts the remaining (or "undepreciated") basis from the price he gets, and reports the excess as taxable income, which it is. At this point the I.R.S. gets its money back - although after a long time lag, and fall in the value of the \$. Overdepreciation has lowered the remaining or "undepreciated" basis, towards zero.

However, Congress has defined this kind of income as a form of "capital gain." That means it is taxed at a lower rate (now down to 15%); and it benefits by dozens of escape routes and loopholes not available for ordinary income.⁵

Congress has incrementally expanded the definition of "capital" assets over time. These now include:

- timber, except virgin timber
- breeding stock (cattle, sheep, other livestock)
- oil and gas, and other minerals in the ground
- owner-occupied homes
- "collectibles" (e.g. works of art)
- most kinds of land (including summer homes, hunting preserves, ski chalets, and other kinds of land used for recreation)
- miscellany

⁵ The one exception was 1989, just after Congress made all rates uniform. That didn't last long. Candidate Bush immediately made lowering the rate on capital gains his highest priority, and sacrificed many other goals to it.