dialogues

Capital-Gains Tax

By Michael Kinsley and John C. Goodman

Updated Sunday, April 20, 1997, at 3:30 AM ET

From: John C. Goodman
To: Michael Kinsley
Posted Tuesday, March 11, 1997, at 3:30 AM ET

Dear Michael,

You say your friends at Microsoft will pay too little in taxes when they cash in on all those stock options and pay capgains tax rates (28 percent) well below the top rate on ordinary income (40 percent). The injustice will be worse if Congress lowers the capgains rate.

But Microsoft employees should read this article before getting too depressed. Your message will be warmly received by the guilt-is-good crowd with mainly inherited wealth. But people who earn their own capgains should be able to enjoy their success guilt-free. So consider why your eight reasons for taxing capgains are wrong and why we should simply abolish this heinous tax.

Bad Argument No. 1: Capital-gains income is no different from any other kind of income. It isn't? The national income and product accounts for the United States do not include line items called "capital gains." And guess what? Capital gains is not part of our gross domestic product either. Nor is it part of the GDP of any other country. So apparently there is something different about capgains. And here's what it is:

Like every other country, the United States mainly taxes income as it is realized. Taxes are levied on a corporation's *actual* profit, not what its profit is likely to be in future years. Taxes apply to a building's actual rental income, not expected future rents. The same principle applies to human capital. Doctors' actual earnings are taxed. Medical students' *earning potential* at graduation is not.

Capital-gains taxation is an exception to this rule. Share prices rise and fall (generating gains and losses) based on changes in expected future profits. The sales price of a building rises and falls based on changes in expected future rents. Should these changes in expectations be taxed when they are consummated in a transaction? What happens if they aren't? See the next argument.

Bad Argument No. 2: If capital gains were untaxed, people could easily exploit this "loophole" and pay no taxes. Really? You wrote, "simple accounting alchemy can turn almost any form of income into a capital gain and will do so if the tax rate is different enough." If true, the folks who park their yachts at Boca Raton and Laguna Beach must have awfully bad accountants.

Back when the top tax rate on ordinary income was 70 percent and the capital-gains tax rate was 28 percent, capgains were equal to less than 3 percent of GDP. They were almost as puny when the rates were 50 percent and 20 percent respectively. Obviously, the opportunities to convert ordinary income into capgains are quite limited. And the IRS has made it increasingly difficult to convert solely for tax avoidance.

Further, it is a mistake to assume that people with capital gains escape the burden of the ordinary income tax. They don't. If the federal government imposes a 40 percent income tax, all assets (including all shares of stock) will be worth 40 percent less than they otherwise would be. That's because the after-tax future income from those assets will be 40 percent lower than otherwise. In this sense, owners of assets "pay" ordinary income tax rates, even if they don't write the checks to the IRS.

Bad Argument No. 3: So what if the government taxes purely inflationary capital gains? Other parts of the tax code are not indexed for inflation either. Actually, the tax code *is* indexed for wage earners. No one can be pushed into a higher tax bracket by the effects of wage inflation alone. The problem is the taxation of capital. And the effects are far from neutral.

The failure to index both depreciation schedules and capital gains penalizes investments in long-term assets (e.g., used in manufacturing) relative to short-term assets (e.g., used in the service sector). In this way, the tax code encourages hamburger flipping at the expense of steel production! I know it's more fun to blame foreigners for our problems, but to a large extent the structure of American industry is shaped by the IRS, rather than by competition in the international marketplace.

Bad Argument No. 4: Capital-gains taxes impose no special burden on the economy. All taxes burden the economy, but the capgains tax is in a class of its own. It dispenses harm that is totally disproportionate to the revenue it collects. Although capgains tax revenue is tiny compared with the size of the economy as a whole, the tax affects the entire capital stock, which is many times the size of GDP. The reason is that the capgains tax is really a transactions tax. It applies only when the holder of an asset sells it. The tax, therefore, discourages the sale of every capital asset. What difference does that make? See the next argument.

Bad Argument No. 5: Capital-gains taxes do not lock money into "old" investments. True, but misleading. On the one hand, all money and assets are held by someone. An investor can get rid of an "old" asset only by transferring it to some other investor. On the other hand, *the tax does lock in investors*. Someone who is not very good at managing real estate may be discouraged from selling a building to someone who is good at it by the capgains tax. In this way, the tax makes the entire capital market less efficient than it otherwise would be.

Bad Argument No. 6: Capital-gains taxes are needed to raise revenue. The 1986 tax reforms raised the average tax on the average cap-gain by about 50 percent. As a result, fewer people are reporting gains. In fact, capgains in 1994 (latest year available) were lower than they were a decade earlier. Forget any large-scale econometric model. My back-of-the-envelope calculations show that had capgains maintained their (early 1980s) share of economic activity, the old tax rate would have raised just $6 billion less revenue than the new rate. And since $6 billion is a rounding error in this context, there's no reason to think that the 1986 hike raised any revenue. Conversely, there is no reason to think that cutting the capgains rate in half would significantly reduce revenue.

But even I have to admit that completely abolishing the capgains tax would reduce revenue. So why do it? In addition to considerations above, see the next argument.

Bad Argument No. 7: Please don't make me be consistent in discussing capital losses. If sound economics or Aristotelian logic or common sense is employed, any discussion of capital losses should mirror that of capgains. But as all investors know, the government's position is: Heads they win, tails you lose. The sky is the limit when taxing gains, but deductions for losses (net of gains) are limited to $3,000.

Forget all the indefensible excuses for this policy and jump to the bottom line. What would happen if capital losses were fully deductible? The capgains tax would continue to wreak about as much havoc in capital markets as it does today, but economists have concluded that the government would collect very little net revenue! When all's said and done, a consistent advocate of capital-gains taxation must conclude that the tax is ultimately pointless.

Bad Argument No. 8: Capital-gains taxes are paid mainly by the rich, who can afford to pay more taxes. True enough, finding a rich person without a capital-gains problem is about as easy as passing a camel through the eye of a needle. But that's not the whole story. Middle-income and low-income taxpayers have capital gains as well. IRS data show that (when extraordinary capgains are separated from usual income) a fourth of all gains goes to those with below-average income and only a fourth goes to those earning more than $200,000. Barry Seldon and Roy Boyd, senior fellows of the National Center for Policy Analysis, have found that families in the lowest income group would have the highest percentage gains in after-tax income if the capital-gains tax were cut.

That's not all. The very rich can avoid capgains taxes altogether on shares of stock by employing a

complicated technique called "selling against the box." This tax dodge is impractical for average investors, but works well for those with considerable assets. So abolishing capgains taxes would not be a big boon to the super-rich who often can avoid the tax anyway. It would simply level the playing field for everyone else.

From: Michael Kinsley
To: John C. Goodman
Posted Friday, March 14, 1997, at 3:30 AM ET

Dear John,

First, as my "friends at Microsoft" were quick to note, the profit on exercised employee stock options is taxed as ordinary income, not capital gain. Therefore, the concern I expressed in my article that opposing a capital-gains tax cut might make me unwelcome in the company cafeteria was unwarranted.
Now to your arguments. Although we both refer to the "capital-gains tax," there is in fact no such tax. There is an income tax, and capital gains are a form of income. The issue is whether this particular form of income should be taxed at a lower rate than, say, wages or interest on a savings account.
Your first point is that capital gains represent increases in the present value of future income, not income itself, and therefore shouldn't be taxed. Your analogies: "[A] building's actual rental income" is taxed, but "not expected future rents"; ditto a doctor's "actual earnings," but not a medical student's "*earning potential*." The capital-gains tax, as it happens, works in precisely the same way! Increases in the value of a share of stock are not taxed until they are "realized" by a sale. If, as you say, a capital gain is just the present value of future income, the seller is, in effect, taking the income now--she certainly won't get it later! Your friends in the Dallas real-estate world will not be amused by your apparent belief that profits on the sale of a building aren't taxed. They are, of course (unless shelters or loopholes prevent it). A medical student cannot sell his earning potential, but an established doctor can sell her practice. The price partly reflects her future revenue potential, but it is still taxable income, and rightly so.
(You make a related point that taxes are capitalized into asset values, so that a share whose future income will be taxed at 40 percent is worth 40 percent less than otherwise. Therefore, you argue, the share's owner is in effect paying a 40 percent tax anyway. This is wrong, too. Obviously, if we accept your premise, the price she paid for the share also reflected the existence of the tax system. Her profits from the sale may reflect tax-rate changes--up and down--during her ownership, but not the basic fact of taxation.)
Any income can be turned into a capital gain. To take an extreme example, imagine a company whose only asset is $100 in a 5 percent savings account. If it pays no dividend, its value after one year is $105. If the owner sells the company for $105, has he really not enjoyed $5 of income--exactly as if the $100 savings account was in his name? Or consider a person earning, say, $100,000 a year, who creates a company with two assets: a contract to hire herself at a rate of, say, $40,000 a year, and another contract to provide her services to her old employer for $100,000. At the end of the year, the company would have $60,000 in the bank. If someone pays her $60,000 for the company, has that money been metaphysically transformed from "income" into something else?
The reason this isn't done routinely, of course, is that I've left out the corporate income tax. (And if you want to talk about the double taxation of corporate profits, we might even find some agreement.) But opportunities for other such shenanigans exist. Many aren't worthwhile at the current differential between the top tax rates on capgains and ordinary income (about 12 percent). But if the tax gap between capgains and other income is widened--let alone if capgains are made tax-free, as you advocate--opportunities for gaming the system will explode.
John, you state that the tax on capital gains should be cut because it is a greater burden on the economy

than the tax on other forms of income. As a believer in the free market, I think that the government should not try to outsmart individual investors about where their money goes, and therefore the tax system should aspire to neutrality among forms of income. You apparently do not believe in the free market. You think the government knows best and should rig the game. I'm shocked.

We're not arguing here about general tax levels. If you think that taxes in general are too high ... well, you're wrong about that, too, but that's not our topic. My argument is that for any given level of taxation, it makes no sense to single out one particular form of income for preferential treatment.

I conceded in my piece that, because one can avoid the capital-gains tax by not selling the asset, the tax does discourage economically efficient trading of assets. In your reply, you concede my point that this is quite different from the more common--and farcically incorrect--charge that the capgains tax starves new investment by "locking up" capital. (Every dollar "unlocked" by a seller is "locked" by the buyer.) Hats off to us both.

Regarding your back-of-the-envelope calculation: As I explained in my piece, tax revenues labeled "capital gains" are a meaningless measure of the effect of changes in the capital-gains tax rate. People arrange their affairs to have income with the favored label. A main purpose of the 1986--Ronald Reagan!--tax reform was to reduce the incentive and opportunity for wasteful tax shelters, most of which involved turning ordinary income into capital gains. So it is not surprising that capital-gains tax revenue didn't soar when reform (as you yourself note) drastically reduced the shelter industry.

Regarding capital losses: The obsession with the annual $3,000 limit on capital losses among capital-gains-tax obsessives is fascinating and revealing. Who, after all, is affected by this limit? Since losses over the limit can be "carried forward" to the next year, until they're used up, the only people the limit really bites are those who, year after year, have net capital losses of more than $3,000. Why the enormous concern for such losers? Answer: They (almost all of them) are not losers. They are people gaming the system: "realizing" losses and postponing gains. There is nothing wrong with gaming the system, within the rules, but there is also nothing wrong with rules that make it harder to do so.

You repeat Martin Feldstein's contention that if capital losses were fully deductible, they would equal capital gains and, therefore, the capgains tax would generate zero revenue. Your point: So what's the point? My point: This proves my point, not yours (and his). Do you think eliminating the capital-loss deduction would produce an economy with no net capital gains--in which, on balance, the value of capital assets (stocks, houses, etc.) did not grow at all? And if so, why on earth are you for it? In fact, you are in effect conceding here that the main effect of an unlimited capital-loss deduction would be to block taxation of capital gains.

Finally, regarding low- and middle-income taxpayers: I am suspicious of your statistics. What do you mean by "when extraordinary capgains are separated"? And I would like to know more about your man Boyd's study ostensibly showing that "the lowest income group" would do the best from a capgains tax cut. I have seen stats before suggesting that poor people enjoy huge amounts of capital gains, in jarring contrast to life as it seems to be taking place around us. ("Who are you going to believe, me or your own two eyes?") I suspect that many of these "low-income" taxpayers are actually comfortable or affluent people who have managed their affairs to minimize their taxes. That doesn't make them bad people, but it also doesn't make them poor.

Of course not all capital-gains taxes are paid by rich people. (And the middle class is frequently bribed with crumbs to protect much larger benefits for the upper brackets--so, politically, your strategy may work.) But no honest person--and you are an honest person, John--would deny that the benefit of an expanded capital-gains tax break would go disproportionately to the well-to-do. That's no reason not to do it, if it would benefit the economy. But I have been careful to frame my argument against a capgains cut in economic, not egalitarian, terms. And if, as you conclude, rich folks don't even need it, they and their tribunes are being amazingly selfless in pushing for it so energetically.

From: John C. Goodman
To: Michael Kinsley
Posted Thursday, March 20, 1997, at 3:30 AM ET

Dear Michael,

I see that my direct approach with you is not working, so let's approach this topic from a more lofty direction. How would an ideal tax system tax income? I propose that all income be taxed 1) only once; 2) at its source; 3) when it is realized; 4) at one low rate.

I know that you and I will disagree on point 4. You probably prefer one high rate. Or perhaps a series of rates that cascade upward as people experience modest success. Never mind. I'll forgive you that sin if you will accept points 1 though 3.

These are the principles (I'm sure you have already guessed) behind the flat tax--stripped of demagoguing by the *New York Times* and Republican primary opponents of Steve Forbes. Since you moderated our *Firing Line* debate on the flat tax, I'll count on you to remember why it's fair and efficient. Readers also can learn about its virtues at the National Center for Policy Analysis' Flat Tax Web site.

The last time I looked at Dick Armey's postcard tax return, guess what I didn't find? There is no line item for capital gains! And why not? Because a capgains tax violates principles 1 through 3 of a good tax system. Take your example of the woman earning $100,000 a year. She incorporates herself into a company that contracts to provide her services to her old employer for $100,000, paying her a salary of $40,000 and keeping the $60,000 profit as retained earnings. After one year, she sells her company for $60,000. If she doesn't pay a capgains tax on $60,000, won't she be getting tax-free income? Of course. But that's only because we're cheating by construction. In a flat-tax world, her company pays a business income tax on the $60,000 at the same rate as she pays on her $40,000 of wages. So all income is taxed. To add a capgains tax when she sells the company would be an unfair, indefensible, unjustified, inefficient, totally-without-merit act of double taxation!

Michael, if you agree there should be no capgains tax on the sale of the woman's business in an ideal world, you should have no trouble seeing why we should not tax the sale under our less-than-perfect tax system. As you acknowledge, we have a corporate income tax. Applying a corporate income tax to the $60,000 profit and a capgains tax on the $60,000 gain on the sale is taxing the same income twice!

Take your second example. A company has only one asset: $100 invested in a 5 percent savings account. At the end of the year, there is $5 of interest income. If the company is sold, we assume the owner would have a $5 capgain--reflecting its $5 increase in value. In a flat-tax world, this $5 would not be directly taxed. Since all income would be taxed only once at its source, the interest payers, not the receivers, would pay. That is, companies that earn profit to pay interest would pay taxes on that profit without any interest deduction. The sale of the company would not be taxed because no real income would be generated--selling the company consists of nothing more than trading one asset ($105 in cash) for another ($105 in cash).

In our imperfect world, entities that pay interest get a deduction, and interest recipients pay a tax (in this example, a corporate income tax). Surely you can see that to impose a capgains tax on the $5 "profit" from the sale of the company constitutes double taxation of the $5 of income. (Incidentally, entities that pay dividends don't get to deduct them, so if the $5 is dividend rather than interest income, it will be subject to triple taxation under our current system!)

Michael, I'm having so much fun using your examples to prove my points, I almost forget why you constructed them in the first place. You were trying to show how, in the absence of a capital-gains tax, people could "easily" convert taxable ordinary income into untaxed capgains income. Reread the last five paragraphs and verify for yourself. Even without a capgains tax, all income in your examples gets taxed. Q.E.D.

I suspect I'm way ahead on points right now. But at the risk of unseemly piling on, I would like to clear up a few more things.

Michael, you're missing the point about capital losses. You say that if people could fully deduct their losses, they would manipulate the timing of gains and losses to cancel each other out and avoid paying capgains taxes altogether. I agree! But this result does not arise from anything special about capital losses. It arises because the capgains tax is a tax on transactions. No one has to ever pay a capgains tax unless he (to balance your overuse of "she") decides to sell an asset. Impose a tax on asset sales, and people will naturally arrange their affairs to avoid tax-generating transactions.

Basically, there are two choices. On the one hand, we can treat gains and losses symmetrically, allowing full deductibility of losses and full taxation of gains. This would be consistent with your stated desire for a "neutral" tax system in which government doesn't "rig the game." Unfortunately, consistency on your part would yield no net revenue for government. On the other hand, we can arbitrarily limit deductions for losses as we do now, allowing government to become a full partner in all gains, but forcing taxpayers to bear almost all the losses themselves. This heads-the-IRS-wins, tails-the-taxpayer-loses policy is not neutral. It discourages risk taking and entrepreneurial capitalism. Plus it's unfair. Have you no sympathy for life's losers, Michael? Shame.

But wait! Isn't there a third alternative? Why tax transactions at all? Since all taxes must ultimately be paid out of income, why not tax income directly? (By this I mean real, gross-domestic-product-producing income, not the consequences of trading stocks and bonds and other pieces of paper.) A truly neutral system would tax income as it is realized, leaving people free to trade assets at will, unhampered by government intrusion.

On another matter, I am shocked by your suspicion about the studies I cited on who realizes capgains. (Barry J. Seldon and Roy G. Boyd, "A General Equilibrium Analysis of a Reduction in Capital Gains Taxes," *Public Finance Quarterly*, Vol. 23, No. 2, April 1995, pp. 193-216. Or, read my layperson's summary of that study.) The bottom line is: Many farming families are land poor. They have low incomes, but own valuable property. A capgains tax cut helps these families, as well as others of modest means. Overall capgains income is distributed much more evenly across income classes than you may think if you spend much time watching C-SPAN coverage of Dick Gephardt and Barney Frank railing away on the floor of the House of Representatives.

In my last memo, I pointed out that on stock transactions, rich investors can sell shares without paying the capgains tax through a complicated technique called "selling against the box." I notice you didn't respond to that point. If silence implies consent, you are defending a system that gets its pound of flesh from the middle class but lets wealthy investors off scot-free. Seems unfair to me. Even the Clinton administration, no friend of the poor these days, is bothered by this arrangement.

But enough of altruism. I prefer to appeal to self-interest. The revenue produced for government by the current capgains tax is relatively small. Its effect on the economy is large. Remember, the capital market is many times the size of the GDP. By discouraging the flow of assets to their highest-valued uses, the capgains tax renders the economy less efficient than it otherwise would be. That means fewer jobs, lower output, and less wealth. Both government and taxpayers would have more net income if we simply abolished the tax.

From: Michael Kinsley
To: John C. Goodman
Posted Wednesday, March 26, 1997, at 3:30 AM ET

Dear John,

You are not going to waylay me into a debate about the so-called flat tax. Anyone interested in why it's a fraud can click here for a short article I wrote on the subject in the May 1, 1995, *New Yorker*. It is clearly illogical, though, to say that because some rule would apply under your "flat tax," the same rule

should apply under the current system. For example, under a "flat tax," there would be no charitable deduction. I presume that even you do not favor eliminating that deduction without taking the other steps involved in the flat tax, such as lowering marginal rates.

Let's return to my two examples. I have conceded to you that our current system taxes corporate income twice: once at the corporate level and again when it is paid out to the shareholder. I favor "integrating" the individual and corporate taxes by counting retained earnings as income to the shareholder. Your corporate friends would hate that more than the current system, but it would be a powerful disincentive to the "lock-in" of capital you and they pretend to be so concerned about. But all this has nothing directly to do with the capital-gains issue.

What you must concede--or refute, which you don't even attempt so far--is my contention that there is no difference between the person whose remuneration for a year of work takes the form of $100,000 salary and the one whose remuneration takes the form of $40,000 salary and $60,000 capital gain. Ditto the person whose $5 return on investment takes the form of a dividend and the one whose $5 is a capital gain. Why should the amount labeled "capital gain" be taxed at a lower rate--or not at all, as you propose? As my examples demonstrate, a "capital gain" is not by its nature the result of greater risk or harder work or anything else more virtuous than the sources of ordinary income. The examples also demonstrate the emptiness of your argument that capital gains aren't income at all.

Capital losses. I don't believe for a minute--nor do you--that those pushing this idiosyncratic cause are moved by "sympathy for life's losers." Losers do not have the money or influence to have kept this issue on the political agenda. The people pushing unlimited deductibility of capital losses are winners who want to be taxed like losers. You concede as much by repeating that a system with unlimited loss deductibility "would yield no net revenue" from capital gains. I repeat the question you avoid: Do you imagine that under the arrangement you advocate there would be no net capital gains in our economy? Sounds grim! Or only no capital-gains *tax revenue*? Much nicer--for people with capital gains. A bit harder on other taxpayers who will have to make up the difference.

As for "consistency" in the treatment of gains and losses, the tax code is inconsistent in many ways. You want to make it even more inconsistent in its treatment of different forms of capital income. The proper goal is not consistency per se but the collection of adequate revenue as fairly and efficiently as possible. Unlimited deductibility of capital losses would clearly produce unfairness (allowing vast amounts of capital income to go untaxed) and inefficiency (an explosion of wasteful tax shelters). Therefore it's a bad idea.

Your studies showing that poor people have all these capital gains: I should have guessed that farmers were the explanation! Ideologues of all stripes seem to abandon their principles when it comes to farmers. "They have low incomes, but own valuable property," you say. But are we capitalists around here or are we not? If they own valuable property, it is apparently their own choice to settle for low incomes. They could sell the property and enjoy high incomes. Indeed if they are reporting capital gains, they apparently have sold at least some property and possibly aren't farmers anymore. A sensible thing to do, but no reason to give them special treatment.

As for "selling against the box," it is indeed a loophole that should be closed if possible. But I do not follow your logic that the existence of this loophole means that capital gains shouldn't be taxed at all. And I reject your totally unsubstantiated contention that "selling against the box" allows the rich to escape all capital-gains taxes, leaving the entire burden on the middle class. Statistics show otherwise. So does political common sense: If the rich didn't feel the burden of the capital-gains tax, we wouldn't even be having this discussion.

Yours,
Mike

From: John C. Goodman
To: Michael Kinsley
Posted Tuesday, April 1, 1997, at 3:30 AM ET

Dear Michael,

I'm glad you want to tax income only once. Abolishing the corporate income tax and making retained earnings taxable to shareholders is fine with me. But you don't seem to realize this concession obliterates your examples.
Scene 1: A woman earns $100,000 in wages and pays personal income taxes on the entire amount. Scene 2: She incorporates, pays herself $40,000 in wages, retains $60,000 in the corporation, but pays personal income taxes (per your direction) on the entire $100,000. Scene 3: She trades the corporation (whose only asset is $60,000 in cash) for $60,000 in cash from a buyer--and you want to assess a capital-gains tax? Surely not! This would give a whole new meaning to the idea of "soaking the rich" (to say nothing of penalizing women in business).
Ditto the interest example. Scene 1: I put $100 (my basis) into a corporation. Scene 2: The $100 earns $5 of interest and (per your direction) I pay a personal income tax on the $5. Scene 3: I sell my corporation for $105, trading $105 in cash for $105 in cash--and you want to impose another (capgains) tax on the $5? That's fair? That's efficient? I'll let readers decide.
In both these examples, the "capital gain" is not income. However, contrary to your last memo, I do not deny that capital-gains income exists. The question is, is this a form of income we want to tax? My answer is "no," for three reasons: 1) If all income is taxed when it is realized, a capgains tax is an unnecessary double tax (the flip side of that is: No income escapes taxation if we fail to tax capital gains). 2) If we treat gains and losses the same way, government will collect little, if any, revenue. 3) Since the only way to tax capgains is by taxing sales of assets, a capgains tax does great economic harm by making capital markets much less efficient than they otherwise would be.
Michael, I know that liberals tend to believe that success and failure are due more to luck than to merit. So I have constructed a hypothetical with that in mind. Consider a costless casino that miraculously provides gambling facilities but uses no real resources. Since the house has no costs, it takes no cut. Gamblers always play against each other. The winnings of some always equal the losses of others. People who enter this casino always play with after-tax dollars--money that was taxed when it was earned. Is there any reason why the IRS should get involved?
Let's apply each of my three points about capgains to the example. First, gamblers who win experience an increase in "income." But since this income is exactly offset by the losses of the losers, no net income--no addition to the gross domestic product--is produced in this casino. Any tax would be levied on dollars that had been taxed when the gamblers had earned them. Second, a tax on winnings would provide no net income to government, as long as losers could deduct their losses. Finally, if the government rigged the game and got net revenue, it would discourage gambling.
Of course, in the real world the government really socks it to gamblers by doing all three of the above (with liberals, I might add, protesting the results--at least for state lotteries). By taxing winnings, the IRS imposes a second tax on money that has already been taxed once, and it allows no deduction for net losers. Perhaps there is a social reason to discourage gambling. Or perhaps there is a public-policy rationale for making gamblers pay more than their fair share of taxes. I'll pass on those questions. Just note that this tax policy is intentionally unfair toward gambling.
Now consider that great casino we call the commodities market--the one in which Hillary Rodham Clinton did so well. In the commodities market, gains also equal losses. But unlike roulette wheels and slot machines, the commodities market performs important economic functions. A capgains tax on commodities transactions would raise no revenue if traders could fully deduct losses. By limiting their ability do so, the IRS imposes an unfair burden on this market. It also discourages a socially valuable activity.
The casino we call the stock market also performs socially valuable functions. It differs from the

previous examples in that there are positive net winnings over time, because as companies grow and prosper, their stocks become more valuable. So in theory, even with losses fully deductible, a capgains tax should bring in some revenue for government. But since the capgains tax is levied only when transactions occur, people can minimize taxes by carefully timing their transactions. For this reason, government would collect very little revenue in practice.
I hope this answers the question you claim I have avoided. You and I appear to generally agree on the revenue question. Our differences are only differences of degree. Where you go wrong is in concluding that "[u]nlimited deductibility of capital losses would ... [allow] vast amounts of capital income to go untaxed." Investors might escape a double tax or a triple tax, but no income would go untaxed. When corporations retain their earnings, they pay a corporate income tax. When they pay and deduct interest, bondholders pay an income tax. When they pay and do not deduct dividends, stockholders pay an income tax on income that has already been taxed as corporate profit. Even with no capgains tax, all income is taxed at least once!
Why are we having this discussion? You say it's only because the topic is of interest to rich people. I'm shocked! Is there no one left to defend the ordinary laborer who owns no capital? I'll fill the void. If the supply of capital to the United States from international capital markets is infinitely elastic, as I think it is, then taxes on capital are ultimately paid by labor. A tax on capital leads to a smaller capital stock, which leads to lower wages. A capgains tax is a tax on capital. Therefore it is bad for labor. Q.E.D. (Okay, it's an abbreviated Q.E.D.; for more on this topic, click here.)
Workers Unite!

Yours,
John

From: Michael Kinsley
To: John C. Goodman
Posted Thursday, April 3, 1997, at 3:30 AM ET

John,

In brief:
1) If retained corporate earnings were treated as taxable income to shareholders, yes, there should be a credit on the capital-gains tax, or a basis adjustment, to reflect that fact. In the first example, the woman's basis, which starts out at zero, should be increased to $60,000 (assuming she pays the tax on the $60,000 from noncorporate funds). Therefore, she would owe no capital-gains tax. But if she sells the stock for more than $60,000, she owes tax on the difference. Why not? It's income. Ditto the second example.
2) Even where losses and gains are exactly equal (e.g., your costless casino), there are individual winners and losers, so I do not follow your argument that if a situation produces no net tax revenue it should be exempt from taxation. Why shouldn't the lucky winners pay a bit more tax and the unlucky losers a bit less? The real-life asymmetrical tax treatment of gambling is a noneconomic policy decision I have mixed feelings about.
3) You concede that in the stock market, by contrast, real gains exceed real losses. Yet you also concede that if losses were deductible without limit (and the limits are much less onerous than on gambling losses), net revenue to the government would be zero. That, John, is precisely why it's reasonable to have limits! See my earlier detailed explanations of all this.
4) Without settling whether taxes on capital are "ultimately" paid by labor (if so, it's odd that holders of capital--such as the backers of your center--raise such a fuss about them), I merely note that the tax on

labor is *directly* paid by labor. For any given level of income-tax revenue, less raised from capital means more must be raised from labor. The point is not to punish or burden either capital or labor, but to raise the necessary revenue as fairly and efficiently as possible.

From: John C. Goodman
To: Michael Kinsley
Posted Tuesday, April 15, 1997, at 3:30 AM ET

Dear Michael,

This is Round 4 of our debate. Along the way, there have been so many detours that readers could easily have got lost. So let me recap where I think we've been.
You claimed that if the tax rate on capgains were lower than the rate on ordinary income, people could easily convert ordinary income into capgains and pay a lower tax. I rejoined that you must be wrong. Even though there have been large differences in the two rates historically, capgains income has remained modest relative to total national income. Prima facie, conversion must not be "easy." I challenged you to produce examples. Round 1 to me.
You produced two examples in which individuals channel income into a corporation (created for that purpose) to avoid paying a personal income tax. If they sell the corporation (whose value is equal to the amount of cash in the corporate bank account), won't they be getting tax-free income if capgains tax is applied to the sale? Ah, but there's a corporate income tax! So the corporate income already will have been taxed before the sale, I noted. Imposing a capgains tax would amount to double taxation, which is bad. Income should only be taxed once. Round 2 to me.
You then agreed that income should be taxed only once, although you demurred on the flat tax. In the Kinsley, perfect-tax world, corporate income would be taxed to shareholders. Fair enough. But you would tax capgains as well. My response: This stance obliterates the examples. If the individuals have already paid tax on all their income, how can you justify taxing the sale of the corporation, which, after all, consists of nothing more than trading cash for cash? That's 40-love.
You now concede there should be a basis adjustment for personal taxes paid on corporate income. So in the two examples, no capital-gains tax would be paid in the Kinsley, perfect-tax world! Debate over? Mainly. But then you assert that a capgains tax should be imposed if the sales price of the corporation rises for some reason. Why would the price rise? The only corporate asset is a bank account. The reason is: a buyer's suspicion that the corporation might mysteriously earn income next year. And the year after that. Expectations about the future income can cause share prices to fluctuate. But do we really want to tax phantom income? Isn't it better to wait until next year and tax income only if it materializes?
The best policy is to tax income only once, when it is realized. In the meantime, let capital markets freely trade pieces of paper assigning ownership, without interference from the IRS. Game, set, and match.

Regards,
John

From: Michael Kinsley
To: John C. Goodman
Posted Friday, April 18, 1997, at 3:30 AM ET

Dear John,

I won't abuse my position to usurp the last word, except to invite readers to review our whole dialogue and decide for themselves whether your point-by-point claims of victory are justified.

Yours,
Mike

John C. Goodman *is president of the National Center for Policy Analysis, a public-policy research institute.* ***Michael Kinsley*** *is editor of* ***Slate***.This dialogue grows out of Michael Kinsley's article "Eight Reasons Not to Cut the Capital-Gains Tax," which appeared recently in ***Slate***.

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