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Cap-Gains Logic

By Donald L. Luskin

Here's some advice to the Democrats on how to raise the revenues they'll need to pay for all the spending they have in mind. Don't hike the capital gains tax rate. Don't lower it, either. Eliminate the capital gains tax entirely.

How can tax revenues be increased by eliminating a tax? It's simple, when the tax in question is on capital gains. Capital itself exerts a multiplier effect that benefits the entire economy. Investment in new plant, equipment, business processes and whole companies creates new and higher paying jobs, and higher levels of economic activity, all of which generate additional tax revenues far in excess of what government would lose by foregoing cap-gains taxes.

This idea has broad theoretical support. Former Clinton Treasury Secretary Lawrence H. Summers has written, "the elimination of capital income taxation would have very substantial economic effects" which "might raise steady-state output by as much as 18%." Economist Jack L. Treynor has shown that "the level of taxation on capital that is 'fairest' -- i.e., most beneficial -- to labor is zero." And Nobel Prize-winning economist Robert E. Lucas, Jr., has concluded, "neither capital gains nor any of the income from capital should be taxed at all." These economists think in terms of very complex models. But the real-world intuition here is quite straightforward.

The cap-gains tax is a barrier to the investment of capital. Without it, capital will flow to investments that otherwise wouldn't have been made. The cost of eliminating the barrier is foregone revenues from that particular tax. But those revenues are small, usually deferred and non-recurring. In their place, government receives large and recurring revenues from corporate taxes, sales taxes, wage taxes and dividend taxes -- all generated by new economic activity.

The cap-gains tax is a poor revenue raiser, because any given capital gain is a one-time event that can only be taxed once, and in many cases, ends up not being taxed at all. Consider Microsoft. Since the company went public 20 years ago, its market value has increased by about $275 billion. A generous estimate of the cap-gains tax revenues we could expect from this increase is about $40 billion.

Actual collections will surely be less. Many shares will never be sold -- held by founders who wish to retain control, or by people who wish to avoid paying taxes. Many shares will be gifted to charitable foundations, as Bill Gates has done for the Bill and Melinda Gates Foundation, out of the tax collector's reach. Even for those shares that will eventually be sold, from today's perspective the resulting tax revenues have to be discounted, as they won't be collected for years.

At the same time, Microsoft has been a fountain of other tax revenues. Since the company went public, I estimate that, in cumulative present-value terms, corporate taxes already paid total roughly $60 billion; sales taxes paid by Microsoft's customers total roughly $11 billion; income

taxes paid by Microsoft's employees total roughly $12 billion, and dividend taxes paid by Microsoft's shareholders total about $3 billion. These four sources of tax revenues over the last 20 years total $86 billion -- more than twice our generous estimate of the notional cap-gains tax revenues ($40 billion) for the same period.

Moreover, unless Microsoft's stock price increases -- which it's had a hard time doing the last couple years -- the estimated $40 billion in cap-gains tax revenues will never grow to a larger number. But corporate taxes, sales taxes, income taxes and dividend taxes will continue to be generated year after year. Even if assuming Microsoft's business stops growing (it has been reliably growing at better than 10% per year), the present value of the tax revenues from these other sources is roughly $182 billion. Added to the revenues already collected, the total is $268 billion.

There is also all the new taxable economic activity enabled by Microsoft's products. It's impossible to estimate a dollar value for it, but we can be sure it is a multiple of the value created within Microsoft. In this context, there is nothing unique about Microsoft. Anytime capital is invested, the small, deferred and non-recurring revenues that can be expected from the cap-gains tax are a tiny fraction of the perpetual revenues from other economic activities, generated directly and indirectly.

While eliminating the cap-gains tax may well induce companies like Microsoft to generate additional taxable activity, there's a more important opportunity here. Eliminating the cap-gains tax will cause the economy to generate more innovators like Microsoft.

For each new Microsoft, the cost to government would mean $40 billion in foregone revenues. But for those new Microsofts that wouldn't have existed otherwise, the payoff would mean raking in $268 billion.

That's a smart trade-off. If the Democrats were really interested in raising revenues -- and not just making life harder for a handful of wealthy private equity players -- it's a trade-off they should eagerly make.

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