STI COMMENTS ON PUBLIC AFFAIRS

CAPITAL GAINS TAXES AND MARKET EFFICIENCY

By

Clinton H. Whitehurst, Jr.
Senior Fellow

The Strom Thurmond Institute of Government and Public Affairs
Clemson University, Clemson, South Carolina

May 2010

CAPITAL GAINS TAXES AND MARKET EFFICIENCY

Under current law the long term, individual capital gains tax for assets held one year or longer will increase from its present 15 percent to 20 percent in 2001 and 23.8 percent in 2011. It is uncertain as to whether, and to what extent, the Obama administration may modify the above rates. One option favored by Vice President Joe Biden is to eliminate the capital gains tax on small business investments as a way to encourage job creation. Republicans, in general, favor low or no capital gains tax.

Argued here is that any capital gains tax inhibits free market efficiency, such being defined as the ability to buy and sell any legally owned asset without financial penalty or other government imposed encumbrance. An exception would be sales that compromise national security Some examples:

An individual in the ordinary income tax bracket of 28 percent in planning for retirement buys an equity with the stated goal of long term appreciation. Assume his initial investment is $10,000 and 30 years later is valued at $75,000. Let's say that as the investor approaches retirement he or she would like to change to an investment paying dividends rather than equity appreciation. Omitting the transaction costs, the original investment must be sold realizing a capital gain of $65,000. However, instead of having approximately $75,000 to invest the investor must pay (in 2010) a federal capital gains tax of 20 percent and possibly a state capital gains tax. The investor now has $62,000 to invest, not $75,000. Does the lesser amount realized influence the investor's decision to change his investment?

Now, instead of an equity investment assume our investor bought real property, say a rental house, a lot, or unimproved land for $75,000. While the asset has changed, his or her capital gains tax remains the same. No matter how stated, a capital gains tax violates the definition of a free market as outlined above. And while the above were individual examples, businesses and just about any other "for profit" entity are also subject to a capital gains tax. One negative example is where a capital gains tax delays or forestalls a decision by management to move firm resources from a less productive to a more productive use. This inhibition is the antithesis of decision making in a market driven, capitalist economy where individuals and entities make decisions with respect to the use of resources owned or under their control.

Another deterrent of exercising the right to sell or modify a capital investment is that a capital gain could put the investor into a higher income tax bracket in the year the gain was realized. Still another is that a capital gain tax on business impacts negatively on whether or how much a shareholder receives on his investment. Also noted is that there is no offset for capital gains due to inflation. And finally, for the individual, the capital gains tax also applies to profits made on investments outside the country.

Is there any restraint on the federal or state governments increasing the capital gains tax to, for example, 50 percent and rationalizing the decision as a need for revenue? Or to balance a budget? Or to retire government debt? Or raise revenue for an infinite number of public programs? In this respect, the 1977 top individual capital gains rate was 49.88 percent.

While there are several ways to avoid a capital gains tax, notably by donating the asset to charity, offsetting the gain by a capital loss, incorporating as a non-profit entity, or postponing a

capital gains tax with a "like kind exchange," non the less a capital gains tax tends to freeze assets in present uses without regard as to whether the current use maximizes resource use.

In conclusion, a capital gains tax is nothing more or less than a tax on an individual or individual's ability to profit from their labor and ingenuity.