NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

CAPITAL GAINS TAXES

WHAT IS CAPITAL?

Capital is any good produced in order to aid in the production of other goods. Tools and equipment, employee training programs, and financial assets like stocks and bonds are all different forms of capital. In traditional economic analysis, capital combines with land and labor to make up the three necessary components of production. When building a new factory, for example, a company needs more than just land to locate the factory and the workers to operate it; they also need machinery, computers, and credit to finance the project. All of these are forms of capital that make this factory productive.

Capital is a fundamental building block of economic growth and a key driver of prosperity. According to Harvard Professor Dale Jorgenson, capital formation spurred nearly half of American economic growth between 1948 and 1980 (2).

TAXATION OF CAPITAL GAINS

An investor experiences a capital gain whenever his investment increases in value. Those gains are "realized" whenever an investor sells his investment at a profit. In the U.S., capital gains are taxed by the federal government at a rate of 15% (as of 2016) whenever they are realized (7). To illustrate: assume an investor bought stock in Example Corporation for $100 and sold that same stock ten years later for $160, a $60 increase. The capital gain is therefore equal to $60 ($160 minus $100), and the tax bill is $9 (15% of $60). After paying his capital gains taxes, the investor's net profit is only $51.

QUICK FACTS

- Higher capital gains tax rates discourage individuals from investing in new, potentially innovative ventures
- Lower capital gains tax rates encourage businesses to start hiring as they are taxed less for pursuing new, job-creating projects.

NOTABLE & QUOTABLE

"Jack up the capital gains tax rate in the United States and more Americans can be expected to send their capital else- where. That means sending jobs elsewhere, so that even people with no capital to invest lose employment opportunities."

- **Thomas Sowell**, Author and Economist (1)

Taxing capital gains reduces the incentive to take on risk and invest in new projects, which discourages investors from making capital investments in the first place. As economist Arthur Laffer explained, when the government taxes an activity too much, individuals and businesses stop engaging in the activity all together (for more on the "Laffer Curve," see AFP Foundation's Need to Know on the topic).

One study by the Cato Institute suggests that Dr. Arthur Laffer was right when it comes to capital gains taxes. In the case of venture capital funding—investments in new start-up businesses that oftentimes can be quite risky—authors Stephen Moore and John Silvia found that capital gains tax rate changes in the 1980s had a big impact. When the tax rates were lowered in 1981, the American economy saw a 70% increase in new venture capital investments. But when the tax rates were raised again in 1987, venture capital funding fell by 59% (3).

Another harmful aspect of capital gains taxes is that they too often force investors to hold on to their investments longer than they would otherwise. Economists call this the "lock in" effect. Because capital gains taxes are only levied when investments are sold and profits are realized, investors will often opt to hold on to their investments instead of selling them off. By locking funds into existing assets, these taxes discourage investors from putting money into new ventures that could be more productive or result in better returns.

THE IMPORTANCE OF CAPITAL IN A FREE MARKET ECONOMY

"The tax on capital gains directly effects investment decisions, the mobility and flow of risk capital... the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."

- President John F. Kennedy, 1963 (6)

Encouraging capital formation is essential to spurring economic growth. When investors put money into new businesses or projects, they help to build that business' operations. This leads to more economic growth and job creation. In order to operate new projects, factories, and ventures, businesses need employees. As economist Thomas Sowell explained, "When an investment is made, whether to build a railroad or to open a new restaurant, the first money is spent hiring people to do the work. Without that, nothing happens."iv Making it easy to move money between investments is likewise important in the free market: if money is locked up in one place it is difficult for investors to direct funds to their most productive uses—a useful new line of business or the next big technological advancement, for example.

A common misperception about capital gains taxes is that they only affect rich people. On the contrary, changes to the capital gains rate affect all income levels because their effects resonate in the economy. When the capital gains tax rate is low, businesses can afford to hire more workers. As a painting contractor in New Jersey remarked, "You're looking at a poor man who thinks the capital gains tax [cut] is the best thing that could happen to this country, because that's when the work will come back. People say capital gains are for the rich, but I've never been hired by a poor man" (5).

CONCLUSION

Capital is the lifeblood of modern economies. A dynamic free-market economy requires efficient and flexible capital markets to support it. High capital gains taxes make markets both less efficient and less flexible, creating troubling incentives that discourage innovators and entrepreneurs. Politicians should reconsider the effects of taxing capital gains and eliminate the barriers it creates to economic growth.

Endnotes:

1. Thomas Sowell, Taxing Times, National Review Online (Oct. 29 2008) (http://www.nationalreview.com/articles/226127/taxing-times/thomas-sowell)
2. Stephen Moore and John Silvia, The ABCs of the Capital Gains Tax, Cato Institute (Oct. 4 1995) (http://www.scribd.com/fullscreen/31267939)
3. Stephen Moore and John Silvia, The ABCs of the Capital Gains Tax,Cato Institute (October 1995) (online at http://www.cato.org/publications/policy-analysis/abcs-capital-gains-tax).
4. Thomas Sowell, Capital Gains & `Trickle Down', Sun Sentinel (Oct. 2 2001) (http://articles.sun-sentinel.com/2001-10-02/news/0110010385_1_gains-tax-capital-gains-tax-shelters)
5. Stephen Moore and John Silvia, The ABCs of the Capital Gains Tax, Cato Institute (Oct. 4 1995) (http://www.scribd.com/fullscreen/31267939)
6. William McKenzie, What Barack can learn from JFK, Clinton and Carter about lower capital gains rates, The Dallas Morning News (Aug. 1 2008) (http://dallasmorningviewsblog.dallasnews.com/archives/2008/08/what- barack-can.html)
7. https://www.irs.gov/taxtopics/tc409.html