

## January 17, 2008 **Inflation and the Tax Man**

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Rudy Giuliani's tax-reform proposal includes indexing capital-gains taxes for inflation -- that is, putting the original price of the asset in today's dollars. All of the Republican candidates have called for low or lower taxes on capital gains, while the Democrats favor higher capital-gains taxes. But inflation-indexing of capital gains should be part of every candidate's "economic stimulus" package, regardless of party affiliation.

Accounting for inflation in this way has the advantages of producing more short-term revenue to the Treasury as long-term gains are "unlocked." Furthermore, lowering the cost of capital would stimulate investment and the stock markets, and would increase the fairness of the tax system by not taxing phantom gains for people at all income levels. It would also square capital-gains taxation with the U.S. Constitution.



Assume you purchased a common stock in a company in 1984 for \$100 a share and sold it in 2007 for \$200 a share. Have you received any "income" from the sale of the shares of stock? The IRS would say "yes," but this is clearly wrong. The IRS will claim that you had a \$100 per share capital gain on the stock in the above example, yet actually the increase was solely a result of inflation. Because you cannot buy more goods and services with \$200 now than

you could have with \$100 in 1984, you have had no "income" or wealth accretion.

Over the years numerous economists, lawyers and others have tried to fix this problem and have gotten nowhere with Congress. But now, due to increased concerns about inflation, economic growth and judicial salaries, the time may be right to move forward.

Chief Justice John Roberts has just renewed his call for an increase in pay for federal judges. He, his predecessor William Rehnquist and other judges have complained about the "steady erosion" of judicial salaries over the past 20 years. According to Article III, Section I of the U.S. Constitution, compensation of federal judges "shall not be diminished during their Continuance in Office."

As inflation has outstripped the increase in judicial salaries, the judges have clearly had "diminished compensation" in real terms. Chief Justice Roberts currently makes \$212,000 per year, yet all but five of his predecessors in the past 200 years made more in inflation-adjusted dollars (Warren Burger's 1969-1986 income averaged about \$250,000 per year in 2006 dollars).

The debate centers on the definition of income. The 16th Amendment to the Constitution states, "The Congress shall have the power to lay and collect taxes on incomes," and the Fifth Amendment clearly states, "No person shall . . . be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use without just compensation."

If the portion of a capital gain due solely to inflation is not income, then taxation without inflation-indexing is an unconstitutional taking of property. Income is commonly defined as, "the amount of money or its equivalent received during a period of time in exchange for labor or services from the sale of goods or property, or as profit from financial investments."

To be money or its equivalent, the payment must have the power to command goods or services produced in the economy. Thus, if the money received from the sale of an asset cannot command more goods and services than the original capital invested, there clearly has been no income.

Too few judges and members of Congress have a basic understanding of economics. As a result, they do not readily see how small but steady losses in value over long periods (except when it comes to their own salaries) is damaging. Inflation of 2%, 3% or 4% per year may seem trivial, but over time it causes great distortions -- the U.S. dollar is now worth less than 1/20th of what it was worth in 1913 when the Fed was established. If the 12% inflation the U.S. experienced in 1979 had continued, the price level would have doubled every six years.

Congress, in order to prevent unlegislated tax-rate increases, has indexed the tax brackets and some other parts of the income-tax code for inflation, which recognizes that a dollar of income in 1998 is not the same as one in 2008. Yet they have failed to do this for capital gains or the AMT, which is now creating great heartache for them as well as for taxpayers. For the code to be logically consistent and to avoid an unconstitutional taking of property -- and for the word "income" to have the same meaning throughout the code - - any capital gain necessarily needs to be indexed for inflation.

The reasons capital gains have not been indexed for inflation (in addition to some members of Congress and judges who do not understand the proper definition of income) are that some argue it would be too complex, and that, since capital gains are taxed at a lower rate than regular income, the problem has already been addressed. Some claim it would result in a big revenue loss. But in the age of advanced tax software, indexing of capital gains is no more complex than many other provisions of the tax code. (The whole code needs to be simplified, but that is another issue.)

Taxing capital gains at a lower rate is done for a number of good economic reasons, and only offsets inflation for assets that have appreciated rapidly in a short time period. Adjusting capital gains for inflation would clearly increase revenues in the short run because of the "unlocking" effect, and probably over the long run because of the higher levels of investment it would stimulate. Over the past 30 years, the Joint Tax Committee,

using largely static models, has consistently erred grossly -- at times even getting the direction of the plus or minus sign wrong -- in forecasting capital-gains tax revenues as a result of tax-rate changes.

The Bush administration ought to make inflation indexing part of its "stimulus package." If properly explained, considerable bipartisan congressional and judicial support should be obtained. A number of legal scholars have argued that the executive branch could unilaterally make the change by requiring the IRS to correctly define the words "cost" and "income," given that it was the IRS that originally incorrectly defined them.

It is not likely that many judges or members of Congress would find it in their personal, political, or the national interest to argue that phantom gains are "income." After all, most Americans do understand the meaning of income, even if some in Washington do not.

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