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Capital Gains Must Be Protected from Inflation

by Richard W. Rahn

If your employer gives you a 2 percent wage increase, and inflation is 3 percent, has your real income increased or decreased? Assume you bought a horse barn and 40 acres of land for $200,000 in 1988 for a riding school you operated. You have just retired from your business and sold the land and barn for $360,000. In the 30 years from the time you originally bought the property, the value of the dollar has fallen by about one-half due to inflation — so, rather than having a $160,000 gain from the sale of your property — in real (inflation-adjusted) dollars, you suffered a $40,000 loss.

The IRS will claim that you had a $160,000 gain, and charge you a capital gains tax on it (at a current rate of up to 23.2 percent, not counting any state capital gains tax rate). After adjusting for inflation and taxes, there was a real loss of roughly a third of your investment.

The government causes inflation by "printing" too much money — i.e., expanding the money supply faster than the increase in goods and services. To put it more directly, the government has stolen about half the value of your money over the last 30 years and then the IRS has had the unmitigated audacity to tax you on the government theft of part of your property. Such actions by government agencies not only show a lack of moral compass by those who promulgate such rules, but deep-seated corruption, which is damaging to both economic growth and civil society.

There is no law that requires the IRS to tax inflation as if it were income. It is nothing more than an administrative rule, which could be changed if the IRS chooses. More on this below.

It has been long recognized that most long-term capital gains are a result of people willing to take the risk that a proposed new investment will indeed be profitable. A large percentage of all investments are not profitable and result in a loss of capital. Capital investment is necessary for an economy to grow and for new jobs to be created. Low investment levels result in less growth, and high investment levels normally result in higher growth. A capital gains tax, in effect, raises the risk and price of the investment, resulting in lower investment and slower growth and job creation.

To some extent, the capital gains tax is a discretionary tax in that people can avoid the tax by not selling assets, such as corporate stock, real estate and other properties. If people think the capital gains tax is too high, they might defer sales, but if the tax is lowered, they might sell the asset and "realize" the gain. Some at the IRS and elsewhere have justified taxing the inflation portion of the gain on the basis that "the government needs the money" — while ignoring the facts that taxing inflation is economically damaging and immoral, and that the government receives no revenue on assets that are locked up.

The capital gains tax rate has been lowered and raised several times over the last four decades. Because people are sensitive to the effective tax rate, most often when the capital gains tax rate has been reduced, revenues have risen and vice versa. The huge increase in capital gains realizations has produced enough revenues to offset the reduction in the rate. There have been a number of studies, going back to the Reagan Treasury, indicating that capital gains rates above 15 percent are revenue losers over the long run — again, because of the discretionary nature of the tax.

Well-regarded tax economists who have looked at the issue have argued that indexing capital gains for inflation would result in several hundred thousand new jobs and a significant boost to GDP. Larry Kudlow, who just became President Trump's chief economic adviser, argued in an article he wrote last year that the time was long overdue for indexing capital gains for inflation.

Some have argued in the past that it would take an act of Congress to allow indexing of capital gains. However, Charles Cooper, former assistant attorney general of the Justice Department, along with a couple of his colleagues, looked at the issue back in 1992 and concluded in a paper published in the Harvard Journal of Law & Public Policy that the IRS had full authority to allow indexing of capital gains for inflation.

In the years since, there have been several related court rulings that further clarify that the IRS has the authority to make the change. The IRS merely needs to define "cost" in the same way economists do, and that is to adjust the number for inflation in order to determine real cost. Note that the government already adjusts Social Security payments for inflation so the recipients don't suffer a loss in purchasing power.

Now that Larry Kudlow has the president's ear, I hope he will convince Mr. Trump to issue an executive order to index capital gains for inflation — which the president has full power to do. By doing so, the government would move toward more consistency in the definition of cost, spur economic growth and job creation, increase government revenues, and most importantly stop the immoral practice of taxing government-caused inflation.

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