A 'capital gain' is a private tax

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The noisiest campaigners for lower taxes complain only about public taxes while ignoring or defending the unrequited tributes collected by private agents under the guise of market transactions. The noisiest campaigners for lower welfare expenditure complain only about transfers that pass through the hand of government, while ignoring or defending unearned private tributes for which government is not the middleman, but merely the enforcer of "contracts" and the protector of "property rights".

Consider "capital gains". True capital, by itself, does not confer any power to collect unearned tributes. True capital must be produced, maintained, and replaced. True capital depreciates due to wear and obsolescence. If, due to exceptional circumstances, true capital increases in value for any significant time, this induces production of more capital until competition reduced values to normal — unless the production of competing capital is restricted by limited licences, in which case what really increases in value is the licences, not the capital. A sustainable increase in the value of an asset therefore depends on non-replicability, which is not a property of true capital. Thus, in the long run, and usually even in the short run, true capital doesn't gain.

So the term capital gain is a misnomer. For what? For a private tax payable by the rest of us to the owners of non-replicable assets such as land, natural resources, and government-created licences and privileges. To receive the "capital gain" on such an asset, one does not need to do anything useful with it. One only needs to sit on it while it rises in value. The gain is therefore unrequited— it's a tax, not a fee for service! In the more polite terminology used by economists, albeit in hushed tones, it's an economic rent. To divert part of such a "capital gain" into the public treasury is not to impose a public tax on the fruits of good management, but rather to claw back part of a private tax that we already pay, so that there is less need for other taxes.

There are even cases in which the private taxes are subsidized by public taxes. If a government spends public taxes on infrastructure (e.g. transport), the benefit of the infrastructure, net of user charges, is shown in prices of access to the serviced locations — in other words, the benefit is shown in "capital gains" on land. A sufficiently high CGT on the beneficiaries would pay for the infrastructure without burdening other taxpayers. Land owners in general would then be better off, because they would receive "capital gains" from infrastructure projects that would not otherwise be funded. But such is their determination to be leaners rather than stand on their own feet (I'm not asking them to be lifters!) that they oppose this method of funding.

"But," you may ask, "don't the owners of non-replicable assets usually do something useful with them?" Usually, yes. But their reward for doing so comes overwhelmingly in the form of current income from assets, not "capital gains" on assets. Taxing a "capital gain", which is the reward for merely buying and reselling an asset, does not deter the owner from managing the asset so as to earn current income in the mean time; on the contrary, by cutting into the "capital gain", it makes current income more attractive by default, and more necessary.

Thus the need for efficient allocation of assets is a valid argument against taxing income from assets, but not a valid argument against taxing "capital gains". It is an even stronger argument against taxing income from true capital, which must be not only allocated but also produced, maintained, and replaced, and which does not offer "capital gains".

Similarly, the much-touted international mobility of capital, which enables desirable capital to flee from taxation, is a valid argument against taxing income from capital, but not a valid argument against taxing "capital gains", which overwhelmingly come from immobile assets: land and natural resources are immobile by nature, while government-created licences and privileges are immobile because they apply in particular jurisdictions. Hence the alleged justification for high taxation of labour income, namely that labour is less mobile than capital, is actually a better argument for high taxation of "capital gains", because the assets that yield "capital gains" are even less mobile than labour.

Why then do we have tax exemptions and concessions for "capital gains", but not for income from assets or income from labour? Obviously because the recipients of "capital gains" can afford to spend more on political donations, PR campaigns, and economic "research". Private taxes buy political influence, which in turn protects the private taxes.

"But," you may say, "true capital can be made to grow by reinvesting the profits. Isn't that good management?" Indeed. But a properly designed "capital-gains tax" (CGT) is not a tax on reinvestment; on the contrary, it treats reinvestment as part of the cost base, which is deducted from the taxable "capital gain".

More generally, and contrary to the Orwellian terminology of its opponents, a property designed CGT is not a tax on investment. From the viewpoint of the individual or firm (the micro viewpoint), CGT is by definition a tax on divestment with a deduction for the initial investment. That is the exact opposite of a tax on investment! From the viewpoint of society (the macro viewpoint), true investment requires an increase in the stock of true capital, not merely a change of ownership of an existing asset (replicable or not). A properly designed CGT, not being a tax on true capital, cannot be a tax on true investment.

Having said all that, I must complain of two situations in which a typical CGT is not "properly designed":

- If a company reinvests profits, causing a rise in its share price, the rise is then taxed as a "capital gain" in the hands of shareholders. This is a bug and should be fixed — e.g. by comprehensively taxing corporate economic rents in the hands of companies, so that there is no need to tax them again in the hands of shareholders.

- If you add true capital to a partly non-replicable asset, and then sell the asset, part of your taxable "capital gain" is the return on your true capital. This too is a bug and should be fixed (e.g., whereas the cost base should normally be adjusted for inflation, in this situation it might be carried forward with an "uplift" rate somewhat higher than the inflation rate).

- I must also emphasize that if the bugs are not fixed, they make a CGT only as bad as a tax on income from assets, and only in particular situations. In no case do they make a CGT worse than a tax on income from assets. Nevertheless, to ensure that the CGT only claws back private taxes, they should be fixed.

"But what about CGT on an asset that has been bought with taxed income?" someone will say. "Isn't that double taxation?" If that's a problem, then I submit, in view of the above, that the appropriate solution is keep the CGT and abolish the general tax on current income!