



The Daily Dish

Indexing Capital Gains

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Eakinomics: Indexing Capital Gains

The Trump Administration is reportedly contemplating using Treasury rulemaking to index capital gains for inflation. This has produced instant [class warfare](#) rhetoric over “tax cuts for the rich.” Cheap sloganeering aside, the idea raises a number of important questions.

1. Does it make sense to index capital gains for inflation? A simple example makes clear the appeal. Suppose you buy a stock for \$1,000, hold it for 10 years, and sell it for \$1,500. The capital gain — the rise in the value of the asset — is measured at \$500, and this would be subject to tax. If, however, inflation over that period averaged 2 percent annually, \$219 of that increase is simply to compensate for inflation — it now takes \$1,219 to buy the same things as that original \$1,000. The real increase in the ability to live better is the rise above \$219; i.e., the real capital gain is \$281.

The goal of the income tax is to tax only the increase in real personal prosperity. That is why the tax brackets, child tax credit, earned income tax credit, and myriad other aspects of the tax code are indexed for inflation. This idea is no different.

2. Can Treasury do this without Congress? That is far from clear, at least to me. This same idea was floated in 1989 and 1990 when I served under President George H.W. Bush, and the administration concluded that legislation was necessary. Perhaps the precedents are viewed differently from the perspective of 2018, but that case will have to be made, and any such move will be open to legal challenge.

3. Should this be done at all? That is a very different question. Once you get past the simple example of buy, hold, and sell, the tax administration gets complicated quickly. Suppose your stock was part of a dividend reinvestment plan so that there were 10 years of dividends with different bases and different holding periods contributing to the final value. Harder yet, suppose you made additional contributions of new dollars over the 10 years. How do you handle options contracts, forward contracts, and other complex investments?

Also, capital gains should not be singled out. The idea should be to index capital income for inflation. That means indexing dividends and interest as well. And it means indexing capital losses. So, for example, if a stock pays a 2 percent dividend and has a 2 percent capital gain, the nominal capital return is 4 percent. You can't separately adjust capital gains by 2 percent and dividends by 2 percent and get the right answer.

In an era of big data and advanced algorithms, one may be able to get the right answer. But no human being could likely fill out their taxes. And nobody could really be sure that they were being done correctly. This would undermine faith in the tax system and weaken an important pillar of a system of voluntary tax compliance. Is it really worth it?

4. Finally, who would benefit? The cheap answer of “the rich” was offered up by former Treasury Secretary Lawrence Summers in his [Twitter-based analysis](#): “Treasury proposal to index capital gains is pure crony

capitalism. Highly favorable for President @realDonaldTrump, illegal, destabilizing of the economy, budget busting and deeply regressive.” A real analysis would recognize that correcting the overtaxation of the return to investment would increase the accumulation of capital, raised productivity and real wages in the economy, and in the process shift the static benefit from the more affluent investors to the economy as a whole.

Indexing capital gains for inflation is a hard policy problem. It has obvious appeal and correctness that guarantees it will be a perennial proposal. But it carries sufficient administrative and other baggage that it seems unlikely to get over the finish line.