Getting It Right at Steven Landsburg

The New Yorker arrived today, leading off with this letter to the editor about income tax rates:

> *…The very rich pay at significantly lower rates, because most of their income consists not of compensation for services but of capital gains and dividends, which are capped at a fifteen per cent rate.*

This is wrong, wrong, wrong, wrong, wrong, wrong, wrong, and you can't begin to think clearly about tax policy if you don't understand why. Even if capital gains taxes were capped at **one** percent, income subject to those taxes would be taxed at a **higher** rate than straight compensation. That's because capital gains taxes (like all other taxes on capital income) are **surtaxes**, assessed **over and above** the tax on compensation.

It always pays to think through stylized examples. Alice and Bob each work a day and earn a dollar. Alice spends her dollar right away. Bob invests his dollar, waits for it to double, and then spends the resulting two dollars. Let's see how the tax code affects them.

First add a wage tax. Alice and Bob each work a day, earn a dollar, pay 50 cents tax and have 50 cents left over. Alice spends her fifty cents right away. Bob invests his fifty cents, waits for it to double, and then spends the resulting one dollar.

What does the wage tax cost Alice? Answer: 50% of her consumption (which is down from a dollar to fifty cents). What does it cost Bob? Answer: 50% of his consumption (which is down from two dollars to one dollar). In the absence of a capital gains tax, Alice and Bob are both being taxed at the same rate.

Now add a 10% capital gains tax. Alice and Bob each work a day, earn a dollar, pay 50 cents tax and have 50 cents left over. Alice spends her fifty cents right away. Bob invests his fifty cents, waits for it to double, pays a 5 cent capital gains tax, and is left with 95 cents to spend.

What does the tax code cost Alice? Answer: 50% of her consumption (which is down from a dollar to fifty cents). What does the tax code cost Bob? Answer: 52.5% of his consumption (which is down from two dollars to 95 cents).

So there you have it: A 50% wage tax, together with a 10% capital gains tax, is equivalent to a 52.5% tax on Bob's income. In fact, you could have achieved exactly the same result by taxing Bob at a 52.5% rate in the first place: He earns a dollar, you take 52.5% of it, he invests the remaining 47.5 cents, waits for it to double, and spends the resulting 95 cents.

Why is this so terribly hard for so many intelligent people to understand? Here, I think, is why. They see a guy with a million dollar capital gain on his investment, and they forget that in the absence of wage taxes, he'd have invested twice as much and earned a **two** million dollar capital gain. In that sense, the capital gain is **taxed in advance**.

There's plenty of room for reasoned debate about who should or should not be paying higher tax rates. But there's no room for reasoned debate about the actual impact of the tax code. This is a matter of arithmetic: Anyone who pays taxes on capital income is effectively paying at a higher total tax rate than anyone who doesn't. I've explained this before. Don't make me have to explain it again!

Edited to add: Several commenters have raised the issue of Carl, who never worked a day in his life, but inherited five million dollars from his grandmother and therefore never paid any taxes. But Carl's grandma, who earned ten million dollars, paid five million in taxes upfront. As a result, Carl inherited not ten million but five million, and every single day his income is halved as a result. So Carl is in fact already paying an implicit 50% income tax before you ever start taxing his capital income. You can reasonably argue that Carl is undeservedly fortunate; you can reasonably argue that he ought to be taxed even more; but you can't reasonably argue that he's not already giving up half his income to the tax code. (Unless of course his grandma worked in an era when wages were taxed at a much lower rate.)

Capital Gains Followup at Steven Landsburg

A short followup to yesterday's post on capital gains. This came up in the comments, and I think it's worth highlighting:

Suppose we rewrite the tax code as follows: Every March 15, women pay 20% of their incomes and men pay nothing. Every April 15th, women pay 10% and men pay 20%.

Now someone writes a letter to the New Yorker complaining that the April tax is unfair to men, who pay twice as much as women do. I think it would be fair to dismiss this complaint as silly. Yes, it's true that if you look at the April tax in isolation, men pay more than women. But there is no sensible reason to look at the April tax in isolation. If you look at the combined effect of the March and April taxes, women pay 30% and men pay 20%. By any sensible reckoning, women are taxed at a higher rate than men.

That's exactly what's going on with capital taxation. Some people (the savers) are taxed twice — once when they earn their income and again when they withdraw it from their savings accounts. Others (the spenders) are taxed once. It is true that the **second** tax on the saver is lower than the **first** tax on the spender. But there's no sensible reason to look at those taxes in isolation. If you look at the combined effect of the wage and capital income taxes, savers pay a higher percentage than spenders do.

A tax on wages **is** (among other things) a tax on capital gains, because your capital gains are proportional to your savings and a tax on wages reduces your savings. Capital gains, therefore, are taxed **in advance** at exactly the same rate as earned income. The capital gains tax (along with any other tax on capital income) sits on top of that. And it's only the total that matters.

If that's not crystal clear, then I encourage you to work through yesterday's numerical examples. That's always the only way to be sure you know what's going on.