Long term capital gains tax rate discounts and you

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There are two kinds of people in this world: those who benefit from the capital gains tax discount, and those who have no idea what capital gains are. With a setup like that, it is not surprising that the first group has won out in the legislature.

Defining capital gains

For those of you in the second group, capital gains are profits from capital. If you bought the stock or the house for $100,000 and sold it for $150,000, then you made $50,000 from the rise in value of your capital.

As a general rule, the wealthier you are, the more likely you are to be living off of capital gains instead of income from work. This isn't just stereotypes about capitalists in top hats—you can find the same results by taking a few ratios from this IRS spreadsheet, which breaks down how people in different income brackets made their money. [All data from 2002.]

I took the ratio of long term capital gains (column AC) to wages/salaries (col E), and Figure One shows the result. For the vast majority of humans, the average comes out to about 15%: for every dollar of capital gains, they're making six or seven dollars in wage/salary. But for those in the million plus range, the average quickly rises: for those making ten million per year and up, they're pulling down $2.50 in capital gains for every dollar in salary (we'll assume they're not getting an hourly wage).

¡b¿Figure One:¡/b¿ yes, the wealthy really are capitalists. The graph goes from $0 to $10 million, so you will find yourself in the clump at the far left.

[To give a bit more detail, here's a little table of the figures. The first figure is the minimum of the income range (i.e., the first line is people making $1-$4,999), and the second is (long term capital gains) divided by (wages and salaries). I'm giving you the table because the chart clumps almost all of these brackets into a little blob at the left—and thus gives a very clear picture of where we five-digit earners stand in the grand scheme of things—but there's something of an interesting side story in that blob in the corner. For very low incomes (less than $20,000 or so), the amount of capital gains is actually higher than for moderate incomes ($20,000 - $75,000). So we have a few people, possibly people who are

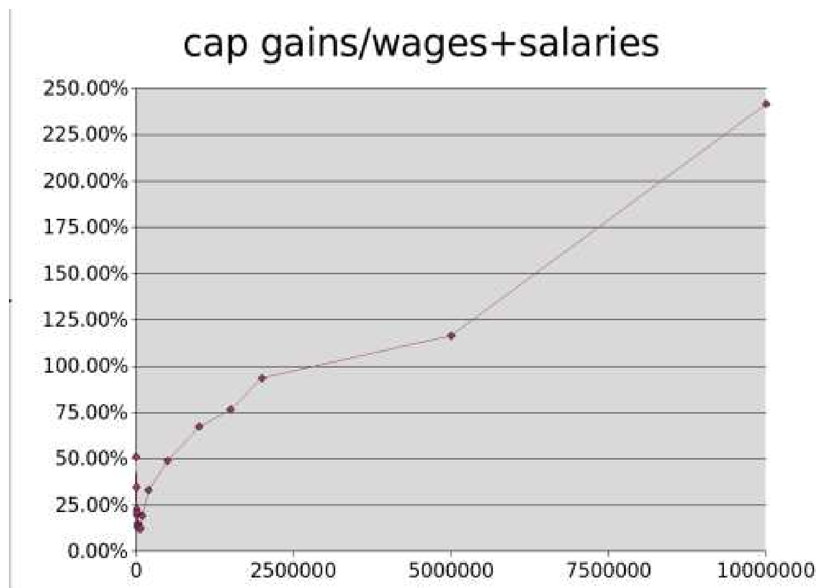

Figure 1: Yes, the wealthy really are capitalists. The graph goes from $0 to $10 million, so you will find yourself in the clump at the far left.

kids or otherwise not in the mainstream labor market, who are making a large portion of their money from capital trading, but those who we would consider to be middle class are really much more focused on working than on capital gains. Once we hit six digits, there's a steady increase in the focus on income via capital gains.

bracket	cap gains/wages
1	51.03%
5,000	34.66%
10,000	22.72%
15,000	19.66%
20,000	20.96%
25,000	15.22%
30,000	13.69%
40,000	12.38%
50,000	13.27%
75,000	12.52%
100,000	19.25%
200,000	33.14%
500,000	48.97%
1,000,000	67.35%
1,500,000	76.67%
2,000,000	93.60%
5,000,000	116.38%
10,000,000	241.65%

So the moral here is that the top-hat stereotype more or less holds out: the wealthy get a larger proportion of their income from capital gains than the middle class do, who make most of their money by working.]

Regressive taxation

For most of us, to the extent that we have an ethical belief about taxation, it's that the wealthier should pay more in taxes, both in relative and absolute terms. This is based either on the gut ethics of it, or the formal Benthamic argument that the marginal utility from income is decreasing. For wages/salaries, the tax system takes this into account: you pay a lower tax rate if you earn less. If you make under about $7,000 you pay a tax rate of 0%, while people making more than $319,000 in taxable income are theoretically paying a 35% tax rate (ignoring adjustments and exemptions and thousands of pages in forms). The lingo for a system where the tax rate rises with income is a *progressive* tax system, and most people generally approve of having a progressive system—or at least a *neutral* system, where everybody pays the same rate.

Now back to capital gains. The tax rate on long term capital gains is generally 15%. Coincidentally, 15% is also the tax rate for those earning under $29,000/year. [Again, lots of details, lots of brackets and rules. Capital gains taxes cap out at 28%, which is about the tax rate on income in the $100,000/year range.][1]

[1] The rates I'm giving may be misleading for those unfamiliar with the rate structure. First, you pay zero dollars on income up to the standard deduction/exemptions, meaning that your first $7,000 or so is untaxed. Then you pay a 10% rate, which means that if you make $7,010, you'd pay $1 in taxes: 10% of that $10 above the cutoff. Similarly at the next bracket, which starts at $7,150 in taxable income: If you make $15,000, you'll pay 0% on the first $7,000,

To summarize, thanks to the discount in capital gains taxes, the guy making $10 million/year pays a *lower* tax rate on his/her/its income than you do.

Political economy

Those making over a million/year reported total long term capital gains of $127.6 billion. The difference between a 15% and a 35% rate on that amount of bank would be $25 billion. If we include those with six-digit incomes, then this would be around $46 billion. I don't know if $46 billion seems like a lot or a little to you; in 2003, the US government took in $1.8 trillion, so $46 billion would have been an expansion in government income of 2.5%.

Which brings us to the resounding question: why is is that long term capital gains are taxed at a lower rate, thus giving the top-hat set an easy loophole that allows them to pay a lower tax rate than you do?

The official story is usually about long term lock-in of capital. You pay taxes when gains are realized. If you hold stock for a decade, and it rises in value by $10,000/year, then you pay zero in taxes on that—it's paper value, not cash in hand, so it's not yet taxed. Now say in the tenth year you sell the stock, so your cash rises to fully $100,000 over the original price you'd paid. In the year that you realize your gains, you have to pay taxes on all hundred thou at once. That's a lot in one clump, which gives you something of an incentive to just leave the money there; that is, the cash is locked in, which is generally suboptimal for the economy, which benefits from money moving freely. [This story is why most of the discounts are on long-term gains held over a year, but long-term gains outnumber short-term gains by ten-to-one, so either this incentive is working really well or short-term gains aren't all that interesting to investors to begin with.]

This is something of a fallacy: if you sell only some of the stock so you realize only $10,000 in profits—one year's returns—then you'd only pay one year's worth of taxes. It looks like a lot when you pay it all at once, but that doesn't mean that you're actually somehow paying more in taxes. As far as only that $10,000 is concerned, paying all your taxes at the end of ten years is the same as an imaginary pay-as-you-go system where you're putting down taxes for unrealized gains every year. A single dollar in profits is no more locked in than before (especially for divisible assets like stock).

But this rationalization, along with a 'we need to give people incentives to save' story, is a consistently given justification for letting the wealthy pay a lower tax rate than you. Frankly, it's a weak justification, so we need to look to other stories for why this persists.

One is the opening paragraph: the only people who lobby about capital gains tax rates are the people who profit from them. A concentrated few are saving billions of dollars a year on this, and the rest of America has no idea what any

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then 10% on the next $7,150 (or $715), and then 15% on the remaining $850 peeking out over the bracket's cutoff, for a total tax of $843. So you're in the 15% bracket, but you're only paying 6% of your income in taxes. For this essay, I decided to not to deal with all this, and just state that you're paying the tax rate indicated by the last dollar earned.

of this is about [which is why you should forward this essay to everybody you know].

The other story is that people are sort of myopic. The people in the middle class in the above table are still realizing some amount of capital gains, and they're saving a few bucks on their returns because they're paying 15% instead of 25% on those gains. For our middle-class hero to lobby against the capital gains tax would be to ask the government to impose marginally higher taxes on herself. But this is indeed myopia, because if she could somehow get capital gains taxed as normal income, then government revenue would expand on the order of $50 billion, which may or may not mean that the overall tax rates could be adjusted down in the long run, so our middle-class hero may wind up paying less in taxes. Alternatively, the government may print less money, meaning that her savings won't dwindle by inflation as much, or she may just get more services out of that additional $50 billion.

I'm a bit reluctant to call the capital gains tax discount a loophole, because that word implies that it is a detail of the law that you need to hire a creative tax lawyer to piece together. Instead, it is a fundamental piece of the system, covering well over half of the average millionaire's income, which guarantees that they pay a lower tax rate than you do.

Finally, a comment from Ms DH of Ann Arbor, MI: There's a longitudinal aspect to this too. From 1973 to 2000 the average real income of the bottom 90% of Americans fell by 7% whil the capital gains for the top one percent rose by 148%.