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Why Gains Aren't Indexed

The economic argument for indexing is overwhelming (at least to anyone concerned with taxing genuine income fairly). The technical arguments against indexing are unconvincing. Perhaps the reason that we don't have indexing is that the politicians don't want voters to really see what has happened to their money. Also, the budgeteers have little basis for estimating the effects of indexing on tax receipts.

In *Research Reports* for March 10, we discussed the history and rationale for the capital gains tax. We concluded that indexing gains, rather than taxing gains at a markedly preferential rate, or exempting gains on specific assets (homes), was the needed reform.

Taxing nominal gains in an inflationary era creates huge disparities in the effective tax rate on economic income. The gains tax on holdings that increase in price less rapidly than everything else are confiscatory "wealth taxes." In such situations, investors must pay the tax from the sales proceeds, which were less in purchasing power than their original investments.[1]

The effective gains tax rates on holdings that appreciate somewhat more than everything else can still be over 100 percent, if the real gain is less than sufficient to pay the tax.

On investments that generate real gains after taxes — where it is possible to calculate an effective tax rate on the economic gain — the effective rate can be much higher than that on other, contemporaneously earned, income. The exceptions involve transactions in which the original cost is only a small fraction of the selling price. In such situations, the effective rate on economic income may decrease to less than the top "surcharge" rates (31, 35, or 39.6 percent), but it will be more than the nominal 28 percent rate, unless the cost basis is zero: the inflation-adjusted value of zero is always zero, and all of the sales proceeds represent real income.

In short, the capital gains tax does not tax economic income, but rather a portion of the sales proceeds. The portion taken away in taxes depends on the amount of the nominal gains. The lowest percentage rate on economic income from capital gains is levied, quite perversely, on those who have achieved the largest percentage returns on their investment.

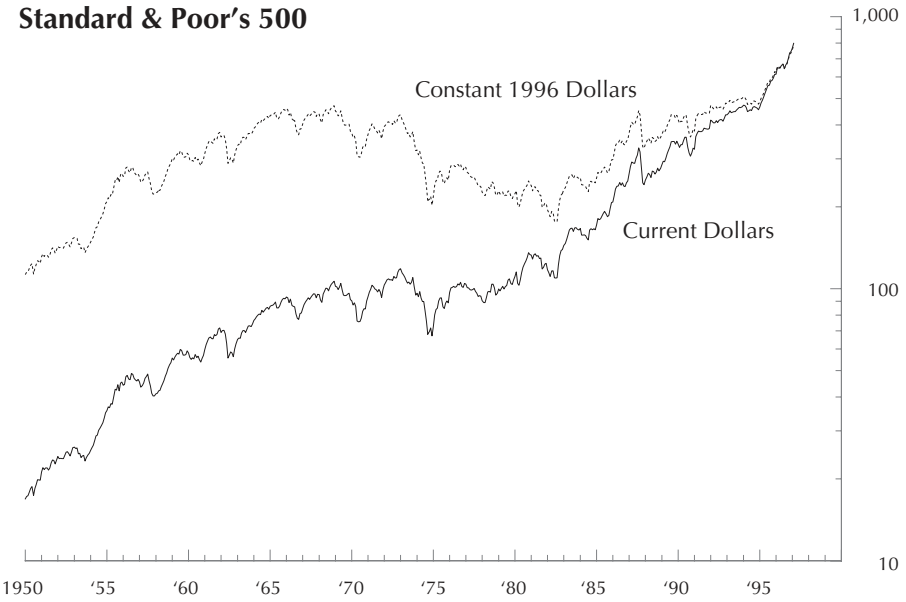
A decrease in the tax rate on nominal gains, say, from 28 to 20 percent would result in a proportional tax cut for those declaring capital gains. Bill Gates, for example, would pay 20 percent instead of 28 percent of the proceeds of any sales of his Microsoft shares, assuming that his original investment was virtually nothing. However, the "relief" would be less valuable for most investors. More significantly, it would leave those with real losses and limited gains paying confiscatory taxes.

This may explain, in part, the opposition to gains tax relief. A lower preferential rate on nominal gains would be of the most benefit to those with the largest unrealized gains — those who have built successful enterprises out of very little, such as Mr. Gates, for example. In this sense only, a lower preferential rate on nominal gains would benefit "the rich" most of all. But this does not mean that any form of gains tax relief would simply be a "tax cut for the rich."

Do Only The Rich Have Capital Gains?

It is indisputable that those without capital assets, who tend to be poor, cannot realize capital gains. Similarly, those reporting very large incomes usually report capital gains (an indeterminate amount of which may well reflect accounting and legal flim-flams designed to "shelter" income, rather than any genuine risk-taking by the taxpayer).

Analyses that purport to show that only the rich have capital gains are usually flawed, however. The reason is that, very often, it is the reporting of a capital gain in a given year that boosts the income on a tax return to a level that the analyst



[1] Investments that result in nominal losses are understated in real terms, because the economic loss is more than can be written off against other income.

deems to place the taxpayer among the rich. Although the average income on returns that include capital gains is larger than that for all returns, the difference is not that great and capital gains are found on tax returns at all income levels.

We suspect that those reporting only limited gains are overwhelmingly among those upon whom the present system of taxing nominal gains imposes the most punitive gains tax rates. It is these taxpayers that indexing would benefit most of all, by bringing their tax liabilities in line with their real incomes.

Complexity

Some opponents of indexing complain that it would add to the complexity of the tax code. It *would* make the calculations of those reporting capital gains more complex, by adding one more step in determining the gain or loss on each transaction.[2] For example, in the instance of every tax preparer's nightmare, someone who sold a mutual fund on which every dividend had been re-invested, or a stock in which the taxpayer had participated in a dividend re-investment plan, every purchase would have to be adjusted to its current dollar value. For tangible property, rental real estate in particular, where the purchase and subsequent improvements must be capitalized and then depreciated, indexing could be very complex indeed.

This sort of calculation is precisely what computers and tax-preparation software are good at. As anyone who has to report a gain or loss on Schedule D on an asset that has been accumulated on many occasions can attest, the work involved in determining the total dollar cost can be staggering. But once that is done, the indexing calculation would be trivial.

More significantly, doing the index calculation would *save* the taxpayer money. This would be in marked contrast to much of the most onerous complexity of the tax code, which is designed to limit the ability of taxpayers to avoid taxes, *i.e.,* to make taxpayers pay more.

What About Fixed Dollar Investments?

It is also asserted that indexing capital gains and losses would reduce the tax burden on equity investments, and so favor them over certificates of deposit, bonds, mortgages, and other fixed-dollar investments. Most economists believe that interest not only includes compensation for deferring current consumption (the time-value of money), but also a premium for price inflation, and, in the instance where there is some probability of default, an additional "risk" premium.

When there is no fixed maturity date, and funds can be added or withdrawn at any time, indexing becomes problematic. During the early days of the Reagan Administration, the Treasury proposed excluding a portion of interest received from taxable income. This was to have been done by a calculation such as taking the ratio of the increase in the Consumer Price Index to the average rate on 91-day Treasury Bills and allowing taxpayers to exclude that proportion of their interest income. For example, if the bill rate was 8 percent and the CPI increased 4 percent, then only half of interest income would have been taxable in that year.

This would have favored holders of riskier interest-paying investments, which pay more than the bill rate, and it would also have acted capriciously on the holders of instruments on which the interest rate had been fixed during an earlier period. However, there is no reason why it could not be applied to interest-bearing accounts, such as savings or money market accounts, or money market funds.

On the other hand, indexing would not seem to present a problem in instances where no cash interest is received until the instrument matures or is sold or "cashed in," such as U.S. Saving Bonds or, ignoring the IRS's seemingly spotty insistence of including the amortization of an original issue discount in taxable income before the instrument is cashed in, "zero-coupon" bonds of any kind. In these instances, all of the interest and principal is received at the same time, and indexing the amount of the initial investment would simply reduce taxable income by the amount by which that investment had lost purchasing power. Again, only real economic income would be taxed.

Where interest is paid prior to maturity, the inflation premium in the interest received would be taxed, and the indexing of the original purchase price when the instrument was sold or matured, would usually result in a "tax" loss. There are two problems with this. First, it makes such holdings a "reverse tax shelter" with taxes due up front and losses at the end. But it would be an improvement over the current situation in which all of the inflation premium is taxed as income. Second, investors who held mainly long-term fixed-dollar claims would be likely to run up against the limitation on deducting capital losses against taxable income. This limit could be relaxed for indexed losses on fixed-claims, but the question brings us to what we have long perceived as the major reason why capital gains and losses are not now indexed.

They Haven't A Clue

Most estimates of the change in revenues that will result from a change in the tax laws have been unreliable. The prospective increase in revenues from tax increases are usually overstated, and the revenues losses from tax cuts are usually underestimated. This is because the budgeteers generally employ "static" estimates, that do not allow for changes in taxpayer behavior in response to changes in taxes. As suggested by the chart on page 29, which shows the Standard & Poor's index of 500 common stock prices in current and constant (1996) dollars, indexing would greatly reduce the potential capital gains tax liability of most common stock investors. The divergent trends of the two series are probably similar for other types of assets.

But any estimates of the effect of indexing on revenue would be largely guesswork. The loss in revenue might be estimated by examining the capital gains, and perhaps interest, reported on a broad sample of tax returns and examining how indexing would have affected the total taxes due on those returns and extrapolating the results to all returns. However, this procedure would probably overstate the loss in revenue by a wide margin, inasmuch as many taxpayers with large unrealized nominal gains would probably sell and re-invest if their potential gains tax liability was reduced by indexing.

On the other hand, as we suggested in *Research Reports* for March 10, indexing might well be coupled with repeal of the estate tax. If this were done, a decedent's cost basis would be used to calculate the income tax due on the "final" return for assets liquidated by the executor. Assets transferred to the heirs in kind would carry the decedent's cost basis. This would close the "angel of death loophole" by which a huge portion of capital gains now escapes taxation entirely. In these circumstances, the revenue from the gains tax could very well increase by more than the "lost" estate tax revenue, and that revenue would be based on genuine economic income.

And They Don't Want You To Know

If the income tax is to tax income rather than whatever the tax collector can grab, the present system of taxing nominal gains is indefensible. All but the most innumerate politicians (Sen. Mitchell, who

[2] To be accurate, indexing should be based on the price level as of the month of purchase and the month of sale. As a practical matter, it would be more likely to be based on the year of purchase, with gains realized in fewer than 12 months to be not indexed at all.

led a filibuster against indexing before he retired, comes to mind), will privately acknowledge this. Some of the opposition to indexing may reflect their fear that their constituents will perceive that any gains tax relief is a "tax cut for the rich," but their biggest nightmare may well be the prospect of voters seeing what has happened to *their* dollars on their very own tax returns.

This would bring home to "the forgotten man" what the politicians have done and are doing to our money. This person is, in William Graham Sumner's words, "the quiet, virtuous, domestic citizen, who pays his debts and taxes." This would happen in a direct and personal way that dry reports of index numbers in the press and on TV can never do. Indexing would induce voters to see with unprecedented clarity (on their tax return in black and white) what the real income from their savings has been. Once they did so, they might rise up and *throw the rascals out*. ❑

BUSINESS-CYCLE CONDITIONS

The business outlook remains favorable. According to the leading indicators, further expansion can be expected for the months ahead.

Among the 12 primary leading indicators, three reached new highs in our latest appraisal of business-cycle conditions: the *ratio of manufacturing and trade sales to inventories*, the *index of common stock prices*, and the *M2 money supply* (M2, stocks, and all other dollar-based series are adjusted for price inflation). All three are appraised as clearly expanding. Although not at a new high for the cycle, the *average workweek in manufacturing* also is appraised as clearly expanding.

Revised data for the *3-month percent change in sensitive materials prices* raised some doubt about the cyclical trend for the series. It was appraised as clearly expanding, but the revised figures show a larger decrease in the data since July. Although this series is very volatile, the decrease was sufficient to warrant downgrading its cyclical status to probably expanding.

New orders for consumer goods and materials remains appraised as probably expanding. There was a large increase in the base data in January, but the increase in the 3-month moving average was not enough to warrant upgrading its appraisal. The strength in this series suggests that retailers are optimistic about the prospects for selling more goods in the future. The base data for *contracts and orders for plant and equipment* also increased sharply in January, but this series also remains appraised as probably expanding for now. The other leader appraised as probably expanding is *initial claims for state unemployment insurance* (inverted), which reached 341,000 in January.

The index of *vendor performance* remains at about 50. This is a diffusion index that measures the percentage of purchasing managers reporting slower deliveries from their suppliers plus half of the purchasing managers that reported no change in delivery speed. Slower deliveries suggest that suppliers are busy and therefore are taking longer to fill orders. Thus, January's increase in vendor performance may be a sign of expanding business activity. However, the series has shown no apparent trend for the past year or so, thus it remains appraised as cyclically indeterminate.

New housing permits increased this month, but not enough to alter the series' cyclical status. It remains appraised as probably contracting. The *M1 money supply* and the *3-month percent change in consumer debt* both remain below their cyclical peaks and are clearly contracting.

Overall, 73 percent (8 out of 11) of the primary leaders with apparent cyclical trends are expanding. This is unchanged from last month and the month before. The cyclical score, AIER's separate mathematical assessment of the 12 leading indicators, increased this month to a revised score of 69. Both of these aggregate measures of the leading indicators point to further expansion in the months ahead.

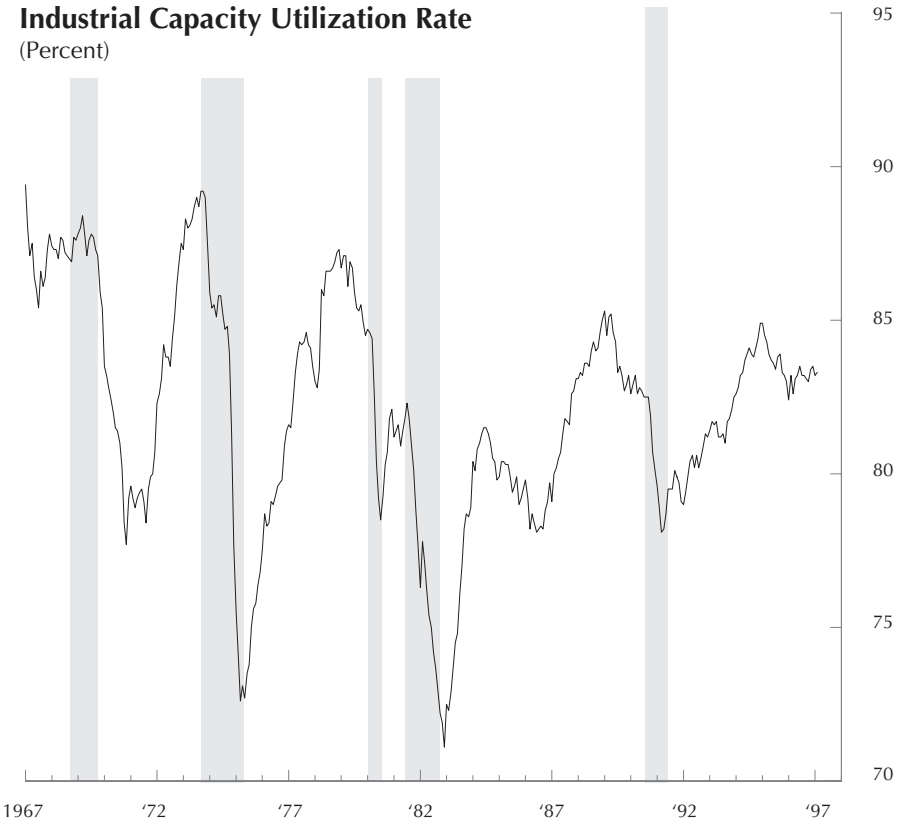
The primary roughly coincident indicators suggest the economy continues to expand across the board. *Nonagricultural payroll employment* increased by 339,000 jobs in February. Indicating strength in the industrial sectors, the *index of industrial production* rose 0.5 percent to 118.1. *Personal income in manufacturing* increased as well, despite a decrease in the monthly base series in January. Similarly, *manufacturing and trade sales* also increased despite a small drop in the base data. The *ratio of civilian employment to population* rose to 63.5 percent. According to revised data, *gross domestic product* (GDP) increased at an annual rate of 3.9 percent in the fourth quarter. GDP will

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Nov.	*Dec.*	*Jan.*	*Feb.*	***Primary Leading Indicators***	*Jan.*	*Feb.*	*Mar.*
-	+[r]	-		M1 money supply	-	-	-
+	+	+		M2 money supply	+	+	+
-	-	+		Change in sensitive materials prices	+	+	+?
-	-	+		New orders for consumer goods	+	+?	+?
-	-	+		Contracts and orders for plant and equipment	+?	+?	+?
+	+	-		Index of new housing permits	-?	-?	-?
+	+			Ratio of manufacturing and trade sales to inventories	+	+	+
+	nc	-	+	Vendor performance	?	?	?
+	+	+	+	Index of common stock prices (constant purchasing power)	+	+	+
nc	+	-	+	Average workweek in manufacturing	+	+	+
-	-	+		Initial claims for unemployment insurance (inverted)	+	+?	+?
-	+	+		Change in consumer debt	-	-	-
				Percentage expanding cyclically	73	73	73
				Primary Roughly Coincident Indicators			
+	+	+	+	Nonagricultural employment	+	+	+
+	+	-	+	Index of industrial production	+	+	+
+	+	-		Personal income in manufacturing	+	+	+
+	-			Manufacturing and trade sales	+	+	+
-	+	+	-	Civilian employment to population ratio	+	+	+
+	+			Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	100	100	100
				Primary Lagging Indicators			
+	+	-	nc	Average duration of unemployment (inverted)	+	+	+
+	-			Manufacturing and trade inventories	+	+	+
+[r]	+	-		Commercial and industrial loans	-?	?	?
-	-	+		Ratio of consumer debt to personal income	+	?	?
-	+	+		Change in labor cost per unit of output, manufacturing	-?	-?	-?
nc	+	-	-	Composite of short-term interest rates	?	?	?
				Percentage expanding cyclically	60	67	67

nc No change. [r] Revised.

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.



be revised again at the end of this month. All six of the coincident indicators are at new cyclical highs, and all six are clearly expanding.

With an expansion that is as mature as this one (now beginning its seventh year), watching the primary lagging indicators becomes even more important. The lagging indicators can warn of impending bottlenecks and imbalances in the economy that could choke off further growth. Currently, there are few signs of this. The *average duration of unemployment* (inverted) dipped slightly this month to 16 weeks. However, this leaves the series only one month off its high for the cycle, and it remains appraised as clearly expanding. *Manufacturing and trade inventories* also is a month off its high due to a decrease in December, but it too remains appraised as clearly expanding.

There are no discernable trends in three of the lagging indicators. *Commercial and industrial loans* has drifted sideways for the past several months, as has the *ratio of consumer debt to personal income*. Consumer debt now stands at 18.08 percent of income, which means that consumers, in the aggregate, would have to pay 18 cents of every dollar of income to erase their credit card balances, automobile loans, and other consumer debts. (Total household debt is even higher, as the consumer debt data do not include mortgages and home equity debt.) The *composite of short-term interest rates* fell to 5.34 percent in February from 5.39 percent in January, but the series' trend remains in doubt.

The latest data for the *percentage change from a year earlier in manufacturing labor cost per unit of output* indicates that labor costs are still falling but not by much. According to data through January, manufacturers' unit labor costs decreased by only 0.1 percent during the past year. The series remains appraised as probably contracting.

Overall, 67 percent (2 out of 3) of the primary lagging indicators with apparent cyclical trends are expanding. This is unchanged from last month. Apparent strength in the laggers this late into the expansion would be cause for concern. That there is little evidence of this bodes well for a scenario of further expansion in the months ahead.

Since bottlenecks and overextensions are so important to watch for this far into an expansion, it is worth looking at other series that might indicate them. Besides the six lagging indicators, there are other series that will signal "squeezes" in the economy. One of these is the capacity utilization rate. This measures the percentage of total capacity that industry uses. In the past, this series has served as a useful indicator of potential inflationary pressures. A long standing rule of thumb has been that a utilization rate of 85 percent or more signaled oncoming inflationary pressures, because manufacturers were often pressured to hire inexperienced production workers and/or use less efficient machinery to fulfill outstanding goods orders in time. Because of this, costs usually increased and when they did, the costs were passed on to consumers. It is highly unlikely that capacity utilization would ever be 100 percent, since factories and businesses would have to use every square inch of their plant and run every piece of their equipment 24 hours a day, seven days a week. Only during times of war has capacity utilization ever risen above 90 percent.

The chart above is a plot of capacity utilization. As the chart indicates, this series tends to lead the business cycle at peaks. The latest figure of 83.3 in February suggests that factories still have room to increase their production levels without creating any inflationary pressures. However, because of the increasing amount of foreign competition in the domestic market, some analysts question the reliability of capacity utilization as a predictor of pending inflation. In addition, it is questionable whether the Commerce Department's measurements of industrial plant and equipment have kept pace over time with technological and other changes in production capabilities. Thus, capacity utilization might increase above 85 percent and still not lead to an increase in prices. Still, with capacity utilization currently below 85, there is little evidence at present that factory production levels are increasing at a rate fast enough to suggest the economy is "overheating." The evidence suggests that there is enough room for continued economic growth. ❑

PRICE OF GOLD

	1995	*1996*	*—— 1997 ——*	
	Mar. 16	*Mar. 21*	*Mar. 13*	*Mar. 20*
Final fixing in London	$383.70	$395.80	$352.90	$352.70

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