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It’s Time to Abolish the Capital Gains Tax

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President Biden’s ridiculously high spending proposals require equally ridiculous tax proposals. Among the craziest proposals is a massive increase in the capital gains tax rate. According to the Tax Foundation, Biden’s proposal would raise the top federal rate on capital gains tax to 43.4 percent. When accounting for state and local rates, the average top rate would be 48 percent, up from the current 29 percent. This is about nineteen steps in the wrong direction. Progressives, the largest proponents of the tax on capital gains, believe that this tax is a necessary and just tool used to rein in the greed of the rich and ensure that the selfless government can implement righteous social programs to help the needy. This belief could not be further detached from reality. The existence of taxes on capital gains significantly distorts the natural flow of investment in markets, which harms the social welfare of all Americans, and it is past time to abolish the capital gains tax.

The capital gains tax is imposed on the profits gained from the sale of an asset. This increases the costs involved in realizing the profits of an investment, therefore altering individuals and businesses' cost-benefit analysis and decision process when evaluating investment opportunities. This has a substantial impact on the reallocation of capital and the availability of capital, because investors have to take the capital gains tax into account when weighing if a new investment is worthy. Investors are forced to decide if the new investment has a profit potential that outweighs the impact of the capital gains tax and the future profit potential of whatever asset they may currently be invested in. Many investors decide it is not. This creates the “lock-in effect.” The capital gains tax creates the incentive for investors to retain their current subpar-performing investments even when more profitable investment opportunities are present. This keeps capital locked into inefficient and underperforming assets as opposed to more efficient and profitable assets. Therefore, these inefficient assets have an inflated value and worth compared to what a free market, undistorted by the capital gains tax, would have allocated to them. As capital is a scarce and limited resource, these distortions inhibit the growth of other industries and assets that are more worthy of investment and consequently harm the social welfare of all Americans, as these industries with a deflated worth are unable to provide the goods, services, and jobs the market would have otherwise provided. This is why an unaltered flow of capital and investment is integral to the health of a free economy. The great Henry Hazlitt explains in *Economics in One Lesson* (order your free copy) that when investors realize

they lose the whole dollar when they lose, but can keep only a fraction of it when they win, they decide it is foolish to take risks with their capital. In addition, the capital available for risk-taking itself shrinks enormously. It is being taxed away before it can be accumulated. In brief, capital to provide new private jobs is first prevented from coming into existence, and the part that does come into existence is then discouraged from starting new enterprises.

These new enterprises that are blocked from coming into existence would have otherwise created better and cheaper goods. In the end, not only is the investor harmed but so are the consumers and producers that are deprived of an improved standard of living. It is nearly impossible to dissect and weigh all of the societal harms that have occurred due to the implementation of the capital gains tax, because we have been robbed of a reality we could use as a control. The industries and companies that have been deprived of growth due to the capital gains tax are invisible.

However, we can examine the effects previous changes in the capital gains tax rate have had on investments. The clearest metric we can use to examine the flow of capital into new enterprises is seed-capital funding. Seed-capital funding is funding provided by investors to the creators of a new start-up venture in exchange for equity. This seed-capital funding is linked to the capital gains tax, because investors likely have to divest their capital from another firm or asset, a taxable event, to then invest in a new company in exchange for equity, which would then be taxed again if ever sold. In an examination of past changes in the tax rate of capital gains and the volume of new seed-capital funding, an article published by *National Review* found that when the capital gains tax rate was cut in 1977 from 49 percent to 20 percent, there was an increase in seed-capital funding from $68 million to $5.1 billion, a 700 percent increase. A later increase of the rate to 28 percent in 1986 resulted in a 60 percent decrease in seed-capital funding. This shows that funding for new ventures is intrinsically linked to the free flow of capital, which is instead obstructed by the capital gains tax. Investors are deprived of healthy returns on investment, producers are denied economic opportunity, and consumers are impoverished.

Examining just a few studies on the effects of the capital gains tax demonstrates the effects an abolition would have in boosting the quality of life for the lower and middle classes. First, economists from the Tax Foundation examined IRS data and found “that more than 80 percent of taxpayers who claim dividend income earn less than $100,000 and 76.4 percent of those who claim capital gains earn less than $100,000.” This shows that the burden of the capital gains tax falls on the middle class. This burden can be alleviated by removing the capital gains tax.

Furthermore, the Cato Institute discovered that a capital gains tax reduction is a way to attract investment funds to capital-starved areas and minority groups. In the ’80s, when the capital gains tax was slashed, the number of black-owned businesses increased by one-third. And later when it was cut again, that number increased by an additional 38 percent. While the precise results that the elimination of the capital gains tax would have are incalculable due to the stubborn fact that we lack omniscience, an elimination would unequivocally lead to the creation of a large number of jobs and economic growth, which would bring an improvement to the quality of life of poverty-stricken communities by encouraging a culture of private ownership and entrepreneurship.

Eliminating the capital gains tax would free up an unprecedented amount of capital, create countless new jobs, and result in the formation of new enterprises dedicated to providing cheaper and improved goods and services. The abolition of the capital gains tax would create an economically productive and stable society, yet the fallacy persists that the capital gains tax is beneficial. The failure of progressives to see beyond the increased government revenues is the reason we are shackled with the capital gains tax today. Progressives are failing Hazlitt's one lesson (not that anyone has ever accused progressives of being economically literate). As Hazlitt states at the end of his magnum opus, economics "is a science of recognizing secondary consequences. It's also a science of seeing general consequences. It is the science of tracing the effects of some proposed or existing policy not only on some special interest in the short run, but on the general interest in the long run." Progressives look at the immediate effects, increase in government revenue and funding for their social programs, and are blind to the havoc they have wrought in the market. This failure to comprehend the impacts of distorting the flow of capital results in the average American consumer being deprived of an indecipherable higher standard of living.