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Capital Gains: Congress's Immoral, Irrational, and Unconstitutional Tax?

by Lawrence Summers and Steven Pahuskin

In light of the capital gains tax resetting from its 2003 levels to its pre-Bush levels, Dr. Daniel J. Mitchell and Dr. Richard W. Rahn argued today that capital gains taxes impede economic growth, and are potentially unconstitutional. The talk was hosted by the Cato Institute.

Dr. Mitchell first explained that capital gains taxation discourages savings by favoring consumption of disposable income. People who invest their disposable income, which has already been taxed under the income tax, are taxed through the capital gains tax, the dividends tax, and eventually the death/estate tax. These extra taxes encourage taxpayers to use their money quickly rather than saving their money for long-term economic prosperity and growth. Mitchell also argued that the capital gains tax is a form of preemptive double taxation. When an individual or corporation performs a service or sells a good, the money received is generally considered taxable income. Any after-tax income used to invest is taxed again upon realized gains. By taxing the investor's income twice, the government double-dips and potentially deters investment and savings.

Dr. Rahn took Mitchell's analysis a step further. He argued that capital gains taxation is unconstitutional under the 16th Amendment. The 16th Amendment states that "the congress shall have the power to lay and collect taxes on **income**, from whatever source derived..." [emphasis added]. Rahn pointed out that capital gains are not considered income under any definition of the word, in any dictionary, or any IRS definition. Rahn also argued that capital gains taxes are effectively a tax on inflationary gains, nominal changes that do not reflect real accumulation of wealth. In the event that the investment does not outperform inflation, the government is taxing twice on a loss instead of a profit. Therefore, imposing a tax on capital gains is an overreaching and unconstitutional exercise of Congress's power to tax.

Both Mitchell and Rahn argued that the government would raise more revenue if it decreased or repealed capital gains taxation. In 1977, capital gains were taxed at 40% and the IRS collected $7.8 billion, compared to $122 billion with a 15% rate in 2007. Even after factoring in inflation and other economic factors, the government collected more revenue with the lower rate. The decrease in rate created incentives for investors to inject more money into the economy, thereby expanding the tax base. Decreased capital gains tax rates also provide disincentives to wealthy investors in avoiding or evading the tax, increasing the amount of revenue generated by the capital gains tax.

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