Capital Gains Taxes

One of the many false talking points of the Obama administration is that a rich man like Warren Buffett should not be paying a lower tax rate than his secretary. But anyone whose earnings come from capital gains usually pays a lower tax rate.

How are capital gains different from ordinary income?

Ordinary income is usually guaranteed. If you work a certain amount of time, you are legally entitled to the pay that you were offered when you took the job. Capital gains involve risk. They are not guaranteed. You can invest your money and lose it all. Moreover, the year when you receive capital gains may not be the same as the years when they were earned.

Suppose I spend ten years writing a book, making not one cent from it in all that time. Then, in the tenth year, when the book is finished, I may sell it to a publisher who pays me $100,000 in advance royalties.

Am I the same as someone who has a salary of $100,000 that year? Or am I earning $10,000 a year for ten years' work?

It so happens that the government will tax me the same as someone who earns $100,000 that year, because my decade of work on the book cannot be documented. But the point here is that it is really a capital gain, and it illustrates the difference between a capital gain and ordinary income.

Then there is the risk factor. There is no guarantee to me that a publisher will actually accept the book that I have worked on for ten years — and there is no guarantee to the publisher that the public will buy enough copies of the book to repay whatever I might be paid when the contract is signed.

Even the $10,000 a year — which is less than anyone can earn on an entry level job — is not guaranteed. If my years of work produced an unpublished manuscript, I would not even have been among the first thousand writers who met this fate.

Very similar principles apply to businesses. We pay attention to businesses after they have succeeded. But most new businesses do not succeed. Even those businesses that eventually turn out to be enormously successful may go through years of losing money before they have their first year of earning a profit.

Amazon.com spent years losing money before turning a profit for the first time in 2001. McDonald's teetered on the edge of bankruptcy more than once in its early years. Desperate expedients were resorted to by the people who ran McDonald's, in order to just keep their noses above the water, while hoping for better days.

At one time, you could have bought half interest in McDonald's for $25,000 — and there were no takers. Anyone who would have risked $25,000 at that time would be a billionaire today. But there was no guarantee at the time that they wouldn't be just throwing 25 grand down a rat hole.

Where a capital gain can be documented — when a builder spends ten years creating a housing development, for example — then whatever that builder earns in the tenth year is a capital gain, not ordinary income. There is no guarantee in advance that the builder will ever recover his expenses, much less make a profit.

There are whole industries where no one can expect to make a profit the first year — publishing a newspaper for example. Virtually every major American airline has lost money in some years, and some of the biggest and most famous airlines have ended up going bankrupt.

If a country wants investors to invest, it cannot tax their resulting capital gains the same as the incomes of people whose incomes were guaranteed in advance when they took the job.

It is not just a question of "fairness" to investors. Ultimately, it is investors who guarantee other people's incomes in a market economy, even though the investors' own incomes are by no means guaranteed. Reducing investors' incentives to take risks is reducing the jobs their investments are likely to create.

Business income is different from employees' income in another way. The profit that a business makes is first taxed as profit and the remainder is then taxed again as the incomes of people who receive dividends.

The biggest losers from politicians who jack up tax rates are likely to be people who are looking for jobs that will not be there, because investments will not be there to create the jobs.

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