Editorial

CAPITAL GAINS, SOCIETAL GAINS, OR NO GAINS AT ALL.

Taxes may be one of the only two sure things in life, but that doesn't make them popular. Nobody is happy to pay them, and the bigger the amount due, the unhappier the taxpayer. Conversely, politicians know that coming out in favor of a tax cut is the equivalent of voting for apple pie and motherhood. It's a sure-fire success at the ballot box.

Therefore, it should come as no surprise that Congress – in spite of the massive federal deficit – is again considering cutting taxes, this time on capital gains. No matter that the benefits of such a cut are debatable at best; that cutting taxes in the face of the largest deficit in our history is based on logic right out of *Alice in Wonderland*, or that a capital gains tax cut will probably benefit comparatively few Americans. Tax cuts of any kind play well in Peoria and everywhere else. According to Speaker of the House, Tom Foley, if you tell an ordinary taxpayer that he will reap $10 from a measure that will save the likes of Donald Trump an average of $25,000 in one year, he will say, "Fine, give me my $10.00."

Perhaps that's true. Certainly it makes a convenient excuse for our elected officals when they are explaining why they are going to take the easy way out – again.

Before we go farther, I think it's important to remind ourselves of a fundamental fact about tax law. Unlike the rules in engineering, mathematics, or

other kinds of accounting, tax laws do not follow any clearly apparent logic. There is no particular inevitability about them because, contrary to what may appear on the surface, the purpose of taxes is far more than just raising money to pay for running the government. The power of taxation is the power to engineer society, to redistribute wealth, to encourage certain economic practices and make others prohibitively expensive.

Given this enormous implicit power, we should think long and hard about exactly what we are doing when we support tax law changes. Before we jump on the capital gains tax cut band wagon, we should ask the all-important question, *Cui bono?* Who benefits? Will anyone? Will a cut in the capital gains tax get the money to where we want it to go to do the things we as a country want and need to have done?

My own feeling is that the answer is "No."

Some of the economic issues which we need to focus on in the next decade(s) include lowering the deficit, increasing the personal savings rate of Americans, lowering the cost of capital, and encouraging more long-term investment, all of which will improve our economic health and make us more competitive. I don't think the capital gains tax cut is the most effective way to achieve any of these goals.

This tax cut will not, in the long run, do anything to lower the deficit – probably our number one economic problem. All the voodoo economics to the contrary, somewhere down the road, the piper will have to be paid. The only way the deficit is going to come down is by raising taxes or cutting spending or – inevitably, I think – both. The logic that a cut in the capital gains tax will spur productive investment is debatable to begin with; and while it may provide an initial surge in revenues – approximately $3 to $4 billion annually for the first couple of years – after that, it would begin costing the Treasury an estimated $5 billion a year in lost receipts. That's $4 or $5 billion a year we can't afford if we are interested in cutting the deficit.

Treasury Secretary, Nicholas Brady, told the American Business Conference last year, "We have been willing to mortgage our future, to cut corners in pursuit of immediate payoff." Voting for a politically palatable tax cut now for any segment of the economy and worrying about the consequences later is another case of that currently all-too-popular American pastime – taking the money and running.

Even if any kind of a tax cut made sense, of equal importance is the fact that the capital gains tax cut does not address those other crucial concerns in our economy – encouraging savings by individuals, lowering the cost of capital, and encouraging long-term investment in improving national productivity. Whatever its benefits, the capital gains tax will impact a relatively few, relatively prosperous Americans. It will do little to encourage the average American, whose income is below $50,000, to save. Consequently, reintroducing some form of tax-deferred or tax-free savings, like the IRA, might be a better move toward the goal of encouraging Americans to save more and spend less. It would affect far more people than the capital gains tax and address a crucial societal need.

In a recent article in the *Wall Street Journal,* Peter Drucker points out that historically, tax exemptions or deferments on savings are most often taken advantage of by lower and middle income people. Even when the rate of return on such plans is small, they are popular with the majority of people – and they work. According to Drucker, the tax exempt savings account was one of the chief instruments in turning Japan from a country with one of the lowest savings rates (prior to World War II) to a country with one of the highest in the world.

Increasing savings would go a long way toward decreasing the cost of capital in the U.S. The advantage that other countries have over us in this area is one of the factors that strip us of our competitiveness in global markets. A U.S. firm might have to pay as much as 10-15% to borrow money for a project with a 10-year payoff, while a Japanese firm, only 5%.

It is true that a cut in the capital gains tax would encourage some forms of investment and some industries, but given that the taxing power has implications far beyond the mere raising of money, I wonder if these are the industries and investments we wish to encourage right now. Some of the chief beneficiaries of a capital gains tax cut would be real estate and the securities markets, and we must ask if strengthening them benefits the economy as a whole. People in these businesses do not make things; they make deals; and the question is, are more deals or more *competitive products* what the country needs now? Real estate markets are already over-inflated in many major metropolitan areas. Do the buyers and sellers of real estate need more encouragement to keep up the pace of turnover just to benefit from a capital gains tax cut? In securities trading, the question is even more pertinent. Many economists and securities traders themselves are beginning to question the benefits of leveraged buyout fever. Many viable companies have been gutted and trashed by high-powered investors seeking short-term profits. A cut in the capital gains tax, unless it applied only to assets held over some long-term period, like five years, would only encourage this kind of short-term, short-sighted profit taking.

Instead of subsidizing this kind of deal-making mania, a look at tax incentives that would encourage more saving and long term investment in the *production and manufacturing* portion of the economy would seem to set the right priorities. Those of us in capital intensive businesses like gear manufacturing are all too aware of the burden that the high cost of money places on us. And we are acutely aware of the need for more money to be spent on research, development, and purchases of resources to get and keep America's manufacturing base viable and competitive. A tax break that would lower the cost of borrowing and long term investment would be a direct benefit for us, but, more important, it would be a step in the right direction for our economy as a whole.

Altering the taxing practices and spending habits of a generation addicted to consumerism and instant gratification will not be easy, but not impossible. There are plenty of suggestions out there from reinstituting the IRA to giving tax breaks to companies engaged in long-term research, but because they are not quick, simple, or politically popular, they die on the vine for lack of interest. If the members of Congress would devote as much creativity to structuring the tax code to encourage savings and long-term investment as they do to avoiding the political consequences for voting their own pay raises, we might all be better off.

But in the final analysis, the crucial question is not really one of taxes at all. Which taxes sound like the best ones will depend to a good extent on whose pockets get emptied. As George Bernard Shaw says, "The government which robs Peter to pay Paul can always depend on the support of Paul."

The issue here, it seems to me, is whether or not we have a Congress with the courage to use the taxing power as it was meant to be used. Does it have the courage to tell the American people what it can afford and what it can't? Can it risk the short-term displeasure of the few – or maybe even of the many – for the long-term gain of the whole society? Does it have the nerve to do the right thing rather than the politically expedient thing?

I don't know. I do know that getting America back on track economically is not something that will come cheap or easy or overnight; that the power to tax is a crucial tool for making the economic and social policy required to get the job done; and that it will take leaders, not politicians, in government to use that tool properly.

EDITOR'S NOTE: As we go to press, there is talk that the President might reintroduce the capital gains tax proposal, along with a plan yet to be formulated, to encourage savings. We'll all have to watch how the President and Congress handle yet another opportunity to be statesmen instead of politicians.

Michael Goldstein

Michael Goldstein,
Editor/Publisher