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Other Voices

How Inflation Creates Inequality Through Capital Gains

By
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In recent years, critics of capitalism have spent much of their time self-righteously denouncing growing income inequality, which is now supposedly at a level not seen since the 1920s.

It is no accident that the present period is compared with the 1920s. Both are characterized by rapidly rising stock and real estate prices, whose rise serves to create corresponding capital gains. Not surprisingly, these capital gains accrue overwhelmingly to the wealthy, who are by far the largest owners of stock and real estate. The inclusion of these capital gains in the calculation of income is responsible for much or most of the perceived growth in income inequality.

In both the 1920s and the years since the mid-1990s, the underlying cause of the rise in stock and real estate prices was inflation, in the form of a rapid increase in the quantity of money manufactured by the Federal Reserve and the banking system. In both cases, this additional money entered the economic system in the stock and real estate markets, thereby driving up stock and real estate prices and creating capital gains.

Two essential facts to grasp about these capital gains and the income inequality that follows from them are that they are transitory and ultimately illusory.

As soon as the new money entering the stock and real estate markets stops flowing, the foundations of stock and real estate prices are pulled away and markets plunge, as in 1929, 2002, and 2008.

If inequality of income were recalculated in such years and the immediately following years, it would be dramatically less, because substantial capital gains were replaced by substantial capital losses.

THE GREAT DEPRESSION of the 1930s must appear as a kind of golden age of egalitarianism, given the breadth and depth of the capital losses that took place in the stock and real estate markets in that period, with their severe effect on the incomes of the wealthy owners of stock and real estate.

If, somehow, the flow of additional money into the stock and real estate markets could be maintained at a level sufficient to prevent a plunge in stock and real estate prices, the movement of capital gains from the stock and real estate markets into the rest of the economic system would serve to start raising prices there. With every rise in the prices of goods and services, the capital gains produced and then maintained by the increase in the quantity of money would prove ever more illusory in terms of actual buying power.

Capital gains bestowed by a doubling of stock and real estate prices become totally illusory when the increase in the quantity of money that created and maintained them doubles the prices of goods and services, as well.

TAXATION OF CAPITAL GAINS makes matters worse. An individual who bought stock for $100, which he later sold for $200 and on which he paid a capital-gains tax of 10%, would experience a significant loss in buying power if the prices of goods and services also doubled. He would not have twice the funds available to buy goods and services at twice the prices but only 1.9 times his initial funds, even though the price of goods and services fully doubled.

The combination of a policy of persistent inflation of the money supply with capital-gains taxation is a policy of taxing capital in real terms. To avoid the taxation of capital in real terms, taxpayers should be able to deduct an allowance for the rise in prices from their taxable capital gains during the time they held a capital asset.

Better still, there should simply be no tax at all on capital gains. Gains in invested capital ultimately increase the means of production employed by businesses and the saved funds that can be used to pay wages. Capital gains are an enormous benefit to everyone, not just the owners of capital assets.

Capital is the foundation of the supply of goods and the demand for labor. Increasing capital is the source of lower prices of goods and services and higher wages. The combination of lower prices and higher wages creates a corresponding increase in the general standard of living. In the face of inflation of the money supply, the effect of capital accumulation is wages rising more rapidly than prices.

The brouhaha over growing income inequality in the U.S. is a byproduct of inflation of the money supply entering the economic system in the stock and real estate markets. This, of course, is a direct result of the policies of the Federal Reserve System, which again and again dumps new money into the loan market in order to keep down interest rates.

The additional money drives up stock and real estate markets, thereby creating capital gains and the perception of growing income inequality. At the same time, it serves to depreciate the dollar against currencies whose quantity is increased more modestly.

Egalitarian attempts to tear down the rich under the cover of an alleged concern for the poor is a policy of economic destruction, the leading effect of which is to create an

illusion of prosperity that keeps the poor in poverty and makes everyone poorer than they need to be.

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