INTELLECTUAL AMMUNITION

Of Caterpillars and Capital Gains

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I live up a narrow, one-lane private road that winds up a steep, wooded canyon in Northern California. A couple years ago, during the *El Nino* winter that dropped record rains here, a side of the canyon collapsed and a massive mudslide closed the road. Heading uphill toward home, I was the first car to get to the tons of mud covering the road -- and I learned a lesson in economics I'll never forget.

And it's a lesson that the government policy-makers who are crafting an economic stimulus package right now would be very well served to learn. Sadly, they are not learning it -- so much the worse for the economy and the stock market.

Back to my story. Sitting in my car, the first thing I did was whip out my cell phone to call the county sheriff -- who told me there was nothing anyone could do for days. Soon five or six of my neighbors on the road near the slide started showing up with shovels. I got out of my car, they handed me a shovel, and we all started digging.

Within minutes we were all literally up to our waists in mud. As the rain continued to fall, for every shovel-full we dug out, five more took its place. But we kept digging because it didn't seem like there was anything else to do.

Ten minutes later there was more mud than when we'd started. But then we heard a roaring sound coming from uphill above the mudslide -- and we saw one of our neighbors driving down in a small Caterpillar front-loader. The shovelers got out of the way, and within about three minutes the Cat had completely cleared the road. I was home moments later, shivering, exhausted, clothes ruined.

Now don't ask me why one of my neighbors owns a Cat. He keeps it in his front yard. It's that kind of neighborhood, and he's that kind of guy. But I'm sure glad he does, because when he showed up with it and did in three minutes what six of us couldn't have done in a week with our shovels, it taught me in my bones one of the most fundamental principles of economics: *the difference between labor and capital*.

Not all the labor in the county could have cleared that road. But capital did it in three minutes. And what policy-makers should take away from that right now is this: if you want to clear the mud from the road of the American economy, *capital* has to be put to work. All the talk about "putting money in people's pockets" with tax rebates and low interest rates is like handing out shovels.

The most effective policy action right now -- something that would really stimulate the economy out of it's post-boom recession -- would be to slash or to outright eliminate the capital gains tax. Sadly, with virtually no support from **President Bush** or his economic team, this idea is totally off the table in the current deliberations. I which I could hand a shovel to Bush -- and **Alan Greenspan** and **Paul O'Neill** and **Robert Rubin** -- and get them to stand in the mud and learn what I have learned.

Where does economic growth come from? Ultimately it comes from labor -- the efforts of *people*: it comes from workers creating more wealth this year than they created last year. In other words, it comes from increases in *productivity.* And what makes workers more productive? It's *not* working *harder* or *longer*. No amount of extra effort or longer hours could have cleared my road with shovels. What makes workers more productive is *capital*.

My neighbor's Cat is capital that makes the road-clearing labor force of my road vastly more productive. It reduces road clearing to the part-time work of a single skilled laborer, who could command enormous wages for his efforts (believe me, I would have paid up big-time if he'd asked). That's the magic of capital -- how it bestows the gift of productivity upon labor. That's where wealth comes from.

But where does capital come from? *It comes from risk-taking*. It comes from people putting their savings at risk to invest in the development of new capital -- new technologies, new methods, new businesses.

But risk-taking is in short supply right now. Things were bad enough after the Internet bubble and the tech-wreck and the bear market. And now the September 11 terrorist attacks and the possibility of prolonged war have made matters even worse. Surely the most efficient possible way to coax investors to take risk again is to *raise the after-tax rewards they can expect* -- by cutting capital gains taxes. It's really that simple.

If a capital gains tax cut were passed into law, *two* things would happen. First, the stock market would instantly experience a powerful and lasting rally -- simply because the risk/return equation had been fundamentally altered. When you expect higher after-tax returns, you'll pay a higher price. This is axiomatic, and it has been borne out time and again in actual experience in markets around the world.

So much for the argument that capital gains taxes only benefit the rich. Millions upon millions of ordinary Americans invest in the stock market now, directly, through mutual funds, and through 401(k) or other pension plans. They would be no less delighted than **Bill Gates** or **Larry Ellison** to see the stock market go up for a change.

So much for the argument advanced just last week by former Treasury secretary Robert Rubin that a capital gains tax reduction would trigger massive selling in the stock market, because stockholders would no longer be held back by the wish to defer incurring taxes. If some investors want to sell, fine -- it will be at much higher prices, and that will simply free up otherwise frozen investment dollars which they will, likely as not, just invest in something else.

But a second and more important thing would happen, too. More money would flow into the private equity and venture capital markets, where a new generation of daring start-ups is waiting for funding. And that, combined with the lower cost of equity financing made possible by a rising stock market, would make possible the creation and acquisition of new capital like my neighbor's Cat. And soon enough, *that* would translate into higher productivity of labor. The investors will get rich. And so will the workers.

Now *that's* stimulus! But most of the ideas that pass for stimulus right now are just robbing Peter to pay Paul.

Sure, we can rebate Peter's payroll taxes to him -- but that won't make Peter any more productive, and Paul (or Paul's grandchildren) will just have to make up for it when the Social Security system goes bust a couple years earlier.

And sure, when Peter loses his job in an economy that wasn't stimulated by the tax rebate, we can extend Peter's unemployment benefits -- but that just pays him to be *un*productive, and Paul will just have to pay for that with higher taxes.

These are zero-sum games in which money that is “put in people’s pockets,” as the saying goes, inevitably has to come out of someone else’s pockets. Politicians love playing these games, because they get to play God and decide who gets the money and who gets robbed.

But cutting capital gains taxes is a positive-sum game. It’s not just moving money from one pocket to another -- it’s actually a process that makes *more money*. New capital like my neighbor’s Cat *creates wealth that wasn’t there before* by making people more productive than they were before.

Wouldn’t the Treasury be a loser, though, from foregoing revenues that they would have earned from higher capital gains taxes? No, quite the contrary. Capital makes laborers richer by making them more productive, and able to command higher wages as a result. The Treasury gets to tax those higher wages. Think about it -- which would you rather have: the capital gains taxes on Bill Gates’ fortune, or all the income taxes that will be collected till the end of time as the result of the increased labor productivity that Bill Gates made possible? That’s easy -- I’ll take door number two, Monty.

When capital gains taxes are lowered, there’s more incentive for people to try to be the next Bill Gates. Most of them will fail, but a few will succeed. Those few will make themselves wealthy, but they’ll make the rest of us even wealthier.

So think about *that* when you get your check for $300 from the IRS, check your 401(k) account balance, and find yourself not feeling quite as “stimulated” as the politicians expect you to be.

And remember that, as a nation, we do have a choice: we can stand there in the mud shoveling, or we can call the Cat. I’m bearish right now because the right choice seems so painfully obvious to me -- and yet we’re not making it.

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