

The Conundrum of Capital Gains

Robert D. Cairns

Dep't of Economics & Cirq, McGill University

CESifo Munich

Conflict in Accounting?

- Are capital gains income?
- Yes: Jorgensonian capital theory
- No: National accounts – net product $p \cdot c + q \cdot \dot{k}$
not in product \Rightarrow not in income
“pure passage of time” – no decision or effort
- Accounting practice to mark financial to market
not to mark physical to market; capital gain *if sold*

Standard Form in Economics

- Capital goods, $k_t = (k_t^1, k_t^2, \dots, k_t^N)$
- Linear prices, $q_t = (q_t^1, q_t^2, \dots, q_t^N)$
 - marginal productivity, equalized; VMP or MVP
 - \Rightarrow willing & able to buy & sell i at q_t^i ; gain \dot{q}_t^i
 - \Rightarrow capital reversible, a variable input

Reality I

- k_t^i sunk for long periods (at least partially irreversible)
- *Fundamental problem of accounting* (Diewert):
 - to recover the cost of sunk assets
- Typically, do not sell: worth more in current use
 - no transaction, no price
 - external price q_t^i : $WTP < q_t^i < WTA$: not relevant
 - cf. SR cost function $C(y, k, w)$

Economic Upshot

- Required: recovery of original cost with interest
- Certainty: user cost not unique ($\# \text{ eq'n} < \# \text{ unknowns}$)
- Uncertainty: user cost requires forward prices
 - depreciation
 - not unique; one of a few forms

Reality II

- In going concerns, $DCF > 0$.
- Residual due to properties of project or firm
 - Multifarious attributes; e.g., management, organization, patents, “effort”, market power,...
- *Non-marketed capital*: no price, no inv't, no depr.
- Capital?
 - Contribute to NCF & earnings through time

Practice

- $q_t^i > WTA$: sell
Capital gain assessed
- $q_t^i < WTA$: keep in use
Socially beneficial
- Gains in productivity: \uparrow cash flow & earnings
not recorded as investment; \therefore , not depreciated
add to non-marketed capital

In but not Perceptible

- Included in income as contribute to CF
- Unrealized gains increase DCF (nonmarketed residual)
forward C or I possibilities only
- Accounting practice resolves the conundrum
in spite of uncertainty