THE ROLE OF CAPITAL HAS POLITICIANS CONFUSED

THE NONCHALANCE with which politicians on both sides of the aisle discuss ever higher taxes as the solution to our endless budgetary ills is emblematic of a widespread and consequential misunderstanding of capital. Indeed, those who claim that higher taxes bring prosperity miss the point entirely. That is, they mistake means for ends.

You see, capital is not ends; capital is means. Capital is not what humans strive for, the triumphant reward of our material aims. Rather, it is what we strive with, the intermediate tool by which we attain those aims. It is the means of higher output per unit of input (bringing our species from its hand-to-mouth past to the present), whereby, when paired with more inputs—among which is labor—we get greater economic profit and real GDP growth.

But these means are typically far removed from their ends, both temporally (production takes time) and economically (production is costly); they are exceedingly indirect (or, as the Austrian economist Eugen von Böhm-Bawerk said, they are "roundabout"). The entrepreneur must navigate a circuitous path, and those who think it benign to hand their capital over to bureaucrats miss this path altogether; they see only the lucky pot of gold at the end. They fixate on the inanimate stuff of capital and overlook the human imagination, patience and effort to anticipate consumer desires and bring together the many factors of production to eventually satisfy them.

It is a tautology of corporate finance that growth in profits comes from the recursive reinvestment and compounding of past profits. For instance, GDP growth is a result of (in addition to population growth) the income reinvestment rate in the economy multiplied by the rate of return on that reinvestment (or the aggregate ROIC in the economy). So when taxes skim from the reinvestable-capital stock each year, they thus skim a proportional share from subsequent economic growth. (And, no, governments do not replace private ROIC with their own public ROIC.)

Politicians are certainly not alone

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in their profound misunderstanding of the process of capital and production (while the high-tax impresario himself, Warren Buffett, understands the compounding tax impact so well that he disingenuously structures his investments to evade them). This misconception is often at the core of much bad thinking among economists and investors alike (two groups that should know better).

Consider most economists' treatment of capital as a homogeneous blob fabricated by central bankers out of credit. They ignore that means, by necessity, are scarce (they are foregone consumption) and must be economized to attain the most desired ends. Circumventing that fact, as history has repeatedly shown (for instance, in past periods of economic growth despite high taxes), leads only to artificial booms canceled out by subsequent credit collapses.

In investing, ours is the age of immediate and direct ends. We have become a capitalism of momentum-based hedge fund punters, quarterly earnings growth and the cash-out IPO dream; and it is the age of pundits pushing an incomprehensible world, such that meandering aims seem to trump the commitment of entrepreneurial long-range designs.

Amid all of this messy thinking we miss the simple truth behind our material wealth: It has been achieved through the accumulation, by us and inherited from our forefathers, of a stock of highly configured and embedded tools that make human effort more effective and things possible that never were before. And we turn our backs on this truth when we turn more and more of these tools over to government bureaucrats.

Profits are but an intermediate end of capital investment. Its ultimate end, in fact, is the material progression of our civilization. How easily we lose sight of this, at our and our progeny's peril. We all want more economic growth, but we ignore the means to get there: the onerous choices and commitments made along the roundabout path to those ends. We even confuse the means with the ends. F

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