CAPTIVE CAPITAL

HOW LOWER GAINS TAXES UNLOCK WEALTH

by Barry Bracewell-Milnes

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Adam Smith
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The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left.

Adam Smith, *The Wealth of Nations*, Book V, Chapter II, Part II

Further reading: For a fuller treatment of the material in the present text, the reader should refer to Dr Barry Bracewell-Milnes, *False Economy: The Losses from High Capital Gains Rates*, (Adam Smith Institute, 1992). For ease of reference to this longer report, the figures in that report have been retained in the present text and not updated; updating would not significantly affect the argument.

Bibliographical information

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Contents

	Page
Summary	**1**
Our high taxes on saving	1
The loss to the Exchequer	1
Loss to the economy	1
Economic distortion	2
The boundary argument	2
Appropriate policy	3
Introduction	**4**
The Dupuit/Laffer curve	4
Taxes on saving: income tax	5
Taxes on saving: capital gains tax	5
Taxes on saving: inheritance tax	7
The case for cuts now	7
Conclusion	8
The boundary problem	**9**
Evidence	**11**
Evidence from the US	11
Lower taxes, more investment	13
Lower rates, higher revenues	14
Squeeze the rich — cut taxes	15
Capital taxes tax everyone	17
Lessons from America	17
Low rates boost the economy	18
Where the jobs come from	19
The UK evidence	**20**
Venture capital: United Kingdom	20
The income tax analogy	21
Malign influence on the non-rich	22
High rates breed complexity	22
Conclusion from the evidence	22
Conclusions	**23**

SUMMARY

Our high taxes on saving

The world's worst: The United Kingdom rate of capital gains tax, now generally 40 per cent, is among the highest in the world. Partly as a result, the UK tax regime has also become one of the world's most complicated. Taxpayers, the UK economy, and even the Exchequer, would all be better off if the rate were reduced.

Combining against saving: Capital gains tax is only one of the taxes which we impose on saving. There are also income tax, inheritance tax and other taxes. The combined weight of these taxes may be a large multiple of the current income from an asset.

The loss to the Exchequer

The Exchequer loses too: The combined weight of taxes on saving in the United Kingdom is far beyond the point at which the revenue yield would be maximised. Capital gains tax is an important component of this result.

The US case for cuts: US evidence confirms that even America's 28 per cent rate of capital gains tax is above the revenue-maximising rate, which seems to lie in the 9 to 21 per cent range (with 15 per cent the mid-point).

The case for larger UK cuts: The revenue-maximising rate of capital gains tax is probably lower in the United Kingdom than in the United States.

Loss to the economy

Optimum rate even lower: The revenue-maximising rate of capital gains tax is not the optimum rate. It secures the greatest possible yield, but only at disproportionate cost to the whole economy. The optimum rate is substantially lower.

The damage done to everyone: A tax charged above the optimum rate damages the economy because it puts the interest of the tax authorities ahead of the interests of taxpayers. A tax charged above the revenue-maximising rate damages the interests of both parties.

A tax on enterprise: The harmful effect of the tax on the supply of capital to new and expanding businesses is clear. When such enterprise is frustrated by taxation, the losers are not merely the potential entrepreneurs, but also their fellow citizens, whom they could have provided with jobs or better and cheaper products.

Economic distortion

The UK loses: The tax drives enterprise out of the UK. It lengthens the already long odds against the entrepreneur's being left with enough of the net-of-tax rewards of successful enterprise to make it worth his while to take the high risk of failure. The tax lengthens the odds far more in the United Kingdom than in our major European competitors.

A tax on active investment: High taxes on saving influence people's decision whether to save and invest at all, tilting their incentives towards current consumption. If they do decide to invest, they face capital gains tax when they cash in an asset, which tends to keep them locked into old investments,

The poor pay most: For many individuals, capital gains realisations are infrequent occurrences or even a unique one-off event. Realised capital gains tend often to be such non-recurring events as:

- the sale of a small business upon retirement;
- an elderly widow liquidating her husband's accumulated investments;
- the sale of stock to buy a house or pay a debt; or
- selling assets in anticipation of an economic downturn.

The boundary argument

Capital and income: Some policymakers worry that if capital gains tax rates are lower than income tax rates, people will simply cheat by taking their income in the form of capital gains. This fear is unfounded

Other countries don't worry: Out of some 150 tax jurisdictions other than pure tax havens, only three (United States, Canada, Australia) purport to tax capital gains as income.

Different animals: Most capital gains are very unlike income. There is little in common, for example, between last week's payslip and a gain on a house held for thirty years. Policy should be driven by this norm, not by the exception of the few people who can shuffle their income across the boundary to avoid tax.

Easy solutions: The boundary question can be resolved by taxing as income gains which are pre-ordained, certain, or firmly predictable. Other gains can be left untaxed. If rates of income tax are reasonably low, this boundary is not difficult to police.

Appropriate policy

Ten per cent ceiling: Since the evidence shows that the revenue-maximising rate of capital gains tax in the United Kingdom is 15 per cent or less, and since the optimum rate is significantly below the revenue-maximising rate, the UK rate of capital gains tax should be set well below the 15 per cent mark — probably not more than 10 per cent.

Larger gains with lower rates: A rate of 10 per cent would benefit both taxpayers and the tax authorities. The yield of the tax would still rise by comparison with the present yield if the rate were reduced further to 9 or 8 per cent.

Theory and evidence agree: Theory and evidence agree that capital gains tax, if it is levied at all in the United Kingdom, should not be charged at more than 10 per cent. Further benefits could be realised if the rate of tax were reduced below 10 per cent and ultimately to zero.

INTRODUCTION

Capital gains tax is sometimes a tax on saving and sometimes a tax on spending.

- It is a pure tax on saving when it is levied on portfolio rearrangements.
- It is a mixed tax on saving and spending when money that could be spent immediately is invested for subsequent spending out of capital growth.
- If the gain is eventually realised for consumption, capital gains tax is at that time a pure tax on spending.

As a tax on saving, it stands alongside income tax and inheritance tax. The total tax on saving is therefore the aggregate or combination of these three charges (plus stamp duty, where it is levied).

The Dupuit/Laffer curve

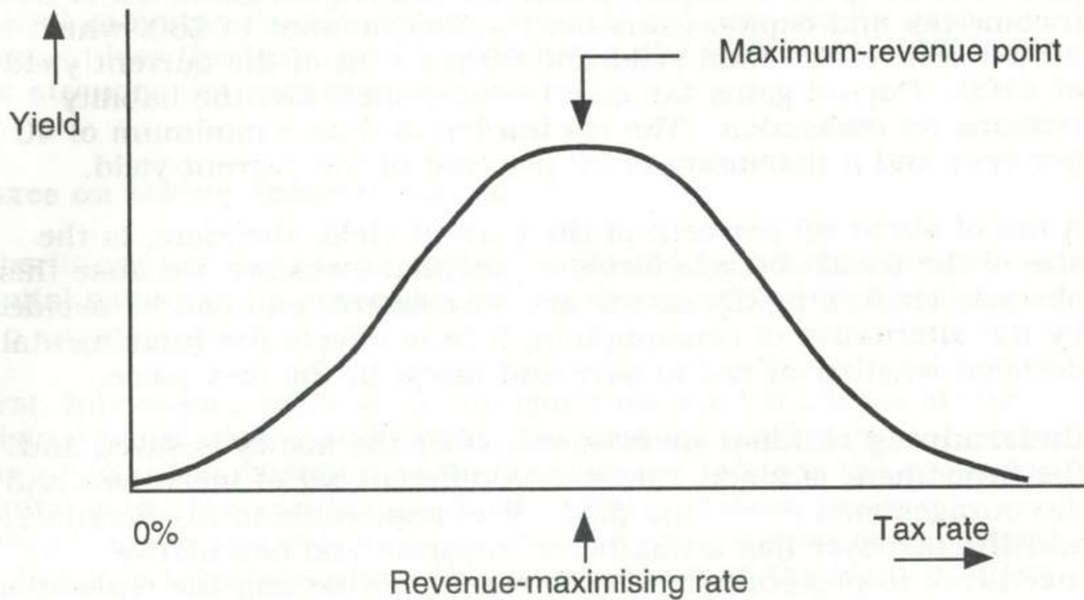
The critique of high rates of capital gains tax starts with the Dupuit or Laffer curve. Figure 1 summarises the familiar "supply side" argument — that tax *revenues* can actually start to fall if governments raise their *rates* above a certain point. The analysis is most often cited in respect of income tax, but it applies just as much to other taxes such as excise duties and capital gains tax.

For all these taxes, we can chart different tax rates against the revenue which they bring in for the authorities. We find that the revenue yield starts at zero when tax is zero, rises to a maximum and falls to zero when the rate of tax becomes prohibitive at100 per cent or less.

The high point on the curve is the "bliss point" as far as the tax authorities are concerned. If the actual rate is anywhere above it, then the yield would be increased by a cut in the rate.

This bell-shaped curve is now sometimes called the Laffer curve after the American "supply sider" economist Arthur Laffer, although it was apparently invented by Dupuit in the nineteenth century and the principle has long been understood.

Figure 1: The Dupuit/Laffer curve



Taxes on saving: income tax

Capital gains tax, inheritance tax, and income tax are all taxes on saving. Their combined effect can produce very large obstacles to saving, investment and entrepreneurship.

Income tax on investment income is at present levied at a lower rate of 20 per cent, a basic rate of 25 per cent and a higher rate of 40 per cent. But the higher rate is the most important for its effect on incentives and its distortion of economic behaviour.

Because saving is a "luxury" — those on higher incomes tend to save more than others — any further taxes on saving fall disproportionately on high incomes, where the 40 per cent income tax rate already bites. This makes the combined effect of the three taxes, and the incentive to avoid them, extremely powerful. And precisely because saving is a "luxury" and not a "necessary", it can indeed be avoided by taxpayers' simply switching from saving to consumption, or leaving the country for good.

Taxes on saving: capital gains tax

Capital gains tax at 25 or 40 per cent is additional to income tax at 25 or 40 per cent. The absence of any form of top-slicing or averaging means that occasional gains are likely to be taxed more heavily than steady income. The burden of capital gains tax, in other words, is *not* confined to the rich.

Undermining the decision to save: And the burden is high. For example, if a higher-rate taxpayer has assets of £2,000 yielding

£100 at 5 per cent gross of income tax, income tax at 40 per cent is £40. If the asset value is rising at 5 per cent a year, the capital gain is £100 gross of capital gains tax and capital gains tax is £40. Income tax and capital gains tax together amount to £80, which is 40 per cent of the total yield and 80 per cent of the current yield of £100. Capital gains tax may be postponed; but the liability remains on realisation. The tax burden is thus a minimum of 40 per cent and a maximum of 80 per cent of the current yield.

A tax of about 80 per cent of the current yield, therefore, is the size of the fiscal obstacle facing a potential investor. Because this obstacle confronts only saving and investment, and can be avoided by the alternative of consumption, it thus affects the fundamental decision whether or not to save and invest in the first place.

Undermining rational investment: Once the money is saved and the investment is made, however, a different set of incentives and discouragements come into play. It is impossible to tax accruals; and the taxpayer has a number of separate and cumulative incentives to postpone liability to tax by postponing the realisation of the asset. As under the present tax regime for pensions, the taxpayer gains from the tax-free build-up of his funds even if the whole of the yield is eventually subject to tax. The lack of top-slicing means that many capital gains are taxed more heavily than regular income in the year of realisation.

However, if tax is postponed it may never have to be paid at all, since capital gains tax might have been reduced or abolished by the time it would otherwise have been chargeable. The taxpayer might be able to avoid capital gains tax entirely by emigrating. And few of us willingly pay tax a moment earlier than we must. Equally, the longer the asset is held and the higher the ratio of accrued gain to original investment, the more reluctant the investor becomes to realise his investment and pay tax.

Thus capital gains tax is in practice likely to be levied on a small number of large portfolio rearrangements which the taxpayer regards as sufficiently profitable to support the tax charge. And because the taxpayer can choose freely whether or not to pay the tax now,[1] the rate at which the revenue from capital gains tax peaks is always likely to be low — probably well below 20 per cent.

CGT and income tax: There is no reason why capital gains tax has to be set at the same rate as income tax. As concerns the original decision to save and invest, the fiscal obstacle is the *total* of income tax, capital gains tax and inheritance tax; so the *higher* the rate of income tax, the *lower* the rate of capital gains tax required

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1 The case where the taxpayer is under immediate pressure or compulsion to realise his investment (for example, if he has to raise funds to discharge a debt) is probably less common.

for the Exchequer to maximise its revenues.

As concerns the subsequent decision to retain or realise assets, capital gains tax is *independent* of all other taxes. As we have seen, unless the taxpayer has no choice, the higher the CGT rate the stronger the incentive to retain.

Taxes on saving: inheritance tax

Inheritance tax is a tax on saving additional to income tax and capital gains tax. It increases the burden of capital gains tax in two separate ways.

First, inheritance tax and capital gains tax are both taxes on the original act of saving and investment, and their effect is cumulative; the existence of inheritance tax reduces the scope for capital gains tax and the maximum-revenue rate of the tax. Second, many assets that escape capital gains tax on death attract a charge to inheritance tax; this again increases the burden of tax on the original act of saving and investment and reduces the maximum-revenue rate of the tax.

Again, the tax burden can be many times the yield. If an asset worth £2,000 yields 5 per cent and grows at 5 per cent and a taxpayer dies after holding it for one year and spending the net-of-tax current yield, income tax is 40 on the current yield of 100. Inheritance tax is 40 per cent on 105 per cent of 2,000 or 840. Total 880, which is 4.4 times the total yield and 8.8 times the current yield of £100.

In the second year, the tax turns out to be 4.9 times the current yield. It is still 2.5 times the current yield after five years and 1.7 times the current yield after ten years.

The case for cuts now

We have argued that today's capital gains tax rates are well above the peak at which revenues are maximised. Officials who are paid to be cautious with the public finances may hesitate to accept this argument. But even if they did believe that revenues would fall, there would still be a strong case for cutting the rate. Indeed, even if the proposed cut was large enough to take us back so far below the peak that revenues would indeed fall, the case would still be strong.

Second-round effects of a tax reduction: First, the true cost of a tax reduction is much less than it appears. Through one means or another, the government absorbs over 40 per cent of gross domestic product. So if the Treasury leaves taxpayers £100 better off this year, it can be sure of getting over 40 per cent of that back next year and the year after as taxpayers spend or invest their

extra cash.

This "second-round" effect applies to any tax reduction; but it is particularly powerful in the case of capital gains tax. By contrast with (say) value added tax and the basic rate of income tax, capital gains tax is levied disproportionately on the most entrepreneurial elements of the economy. *Capital gains tax is thus exceptionally damaging per pound of yield by reason of the economic activity (and associated tax revenue) that it frustrates.* Reductions in capital gains tax release that entrepreneurship, investment and economic activity, and thus generate new "second-round" tax revenue. They are therefore correspondingly cheap (or self-financing) to execute.

New capital from abroad: Similarly, capital gains tax reductions would divert a stream of taxable activity to the UK from abroad. Since exchange control was abolished in 1979, the United Kingdom has been in competition with other tax jurisdictions as a home for personally owned capital. Funds and residents can be attracted to the United Kingdom by a relatively favourable capital gains tax regime. An unfavourable regime, by contrast, is an incentive to emigrate or stay away: and the United Kingdom's present treatment of capital gains is one of the harshest in the European Community.

Delayed effect on the Exchequer: One last point should embolden those who argue for capital gains tax reductions now. This is the simple point that capital gains tax is collected at least one year in arrears. So if a cut in capital gains tax is announced in November 1995, none of the first year cost will be borne in 1996-97 and (on the basis of Inland Revenue statistics) only four-fifths or so in 1997-98.

In other words, tight public finances now — a time when business confidence, consumer spending, economic activity and therefore tax revenues remain low — are no excuse for inaction.

Inaction also has its costs. For example, insuring a property imposes a visible cost; leaving it uninsured imposes a cost that is none the less real for being invisible. Similarly, there is a visible cost of cutting tax rates and an invisible cost of leaving them unchanged — the "opportunity cost" of the economic activity lost because the tax is so high, and of the tax revenue forgone which this activity would have yielded.

Conclusion

The present rates of capital gains tax are irrational because they are far above the rates which would maximise revenues, and there is no good reason to resist making reductions now. On the contrary, a reduction in capital gains tax would provide a large boost to investment, confidence and the subsequent health of the Exchequer.

THE BOUNDARY PROBLEM

Gains and income: The argument that moved Nigel Lawson in 1988 to the partial integration of capital gains tax with income tax was above all the argument that there is a crossable boundary between income and capital gains.

The point is not so much that capital gains are the same as income or a form of income, but rather that there is a boundary between capital gains and income which it is impossible to police. So (the argument runs), unless the two forms of profit are integrated and taxed at identical rates, there will always be possibilities for people to avoid tax by transmuting their income into capital gains.

American fashion: Some American economists take an even tougher line, arguing that capital gains are in reality simply a form of income, a view which inspired the reform of capital gains tax in 1986. The United States and its imitators, Canada and Australia, have gone furthest towards a tax system which purports to tax capital gains as income.

The United Kingdom comes near to these three, although capital gains and income have loss reliefs that are not interchangeable *and* capital gains have indexation for inflation which portfolio income does not *and* capital gains have a personal allowance which is separate from and larger than the allowances for income.

In the United Kingdom these American arguments have attracted minority support and majority opposition, although some academic support has been influential: Professor Mervyn King has been credited with catching Nigel Lawson's ear in 1988. They are little supported or even known in continental Europe, where all the tax jurisdictions that levy a tax on capital gains have some kind of cut-off after a holding period, with or without a taper within the period of charge. Time limitation is anathema to the American idea of taxing capital gains as income.

Few other cases: Any tax jurisdiction that taxes income has to decide how to tax, or not to tax, capital gains. It is significant that, out of some 150 tax jurisdictions other than pure tax havens, only three (United States, Canada, Australia) purport to tax capital gains as income.

Two others (United Kingdom, Ireland) tax capital gains as income subject to major qualifications.

All these countries are English-speaking: but another English-speaking country, New Zealand, recently decided not to tax capital gains at all after a lengthy public debate conducted at a high academic and professional level.

The majority of other tax jurisdictions have the same system as in

the United Kingdom before 1962. That is, capital gains are not taxed.

Gains and income are different: The justification for not taxing capital gains is that, away from the boundary between them, capital gains and income are unlike or very unlike. There is little in common, for example, between last week's income from employment and a gain on a house or a share held for thirty years.

It is rather like the difference between night and day. Certainly there is a dusky time in the evening where it is difficult to say confidently whether night has fallen or not. But at most moments in any 24-hour period, everyone is perfectly well aware whether it is night or day. We plan our daily activities, including sleeping and working, with these obvious differences in mind. If the otherwise insignificant boundary becomes important in some context, then we set an arbitrary cut-off point — as we do with "lighting up time", a convention to prevent people driving unsafely while the night is still deepening.

The boundary question can be resolved by taxing as income gains which are pre-ordained, certain or firmly predictable. Other gains can be left untaxed. If rates of income tax are reasonably low, this boundary is not difficult to police.[1]

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1 The boundary between income and capital gains is a main theme of Barry Bracewell-Milnes, "Capital gains tax: reform through abolition", in Barry Bracewell-Milnes (ed.) *A Discredited Tax: The Capital Gains Tax Problem and its Solution* (Institute of Economic Affairs, IEA Readings 38, September 1992).

EVIDENCE

The laboratory of change: In *A Discredited Tax: the Capital Gains Tax Problem and its Solution* (Institute of Economic Affairs, September 1992), John Chown says that legislative hyperactivity in the United States on the subject of capital gains tax makes the country "a superb laboratory for the study of the practical effects of capital gains taxation."

There is nothing comparable in the United Kingdom with this empirical material and the academic studies it has generated. That is why the United States material is more prominent in what follows.

Provisos: Nevertheless, it is worth noting that the revenue-maximising rate of capital gains tax may be significantly lower in Britain than in the United States. British taxpayers seem more reluctant to realise gains than Americans, so that the maximum-revenue rate of capital gains tax may be correspondingly lower.

It is also worth noting that four economies in the Far East which are among the most successful in the world have no capital gains tax at all: Hong Kong, Singapore, South Korea and Taiwan. It is reported that Prime Minister Lee Kuan Yew of Singapore regarded the absence of capital gains tax as a necessary condition of rapid growth.

And remember that the revenue-maximising rate of a tax is not the optimum rate, but substantially higher. Only at a significantly lower rate of tax does the marginal increase in government revenue from raising the rate balance the marginal loss to the economy through behavioural changes.

Evidence from the US

Academic support for cuts: The most thorough work done anywhere in the world on the relationship between the rate or rates of capital gains tax and the revenue it yields is the work done by Professor Lawrence Lindsey of Harvard University.

In 1987, he concluded that "sensitivity to tax rates is probably greater for capital gains income than for other kinds of income",[1] and again that "the prospects that the higher marginal tax rates on capital gains in the new tax law [of 1986] will produce more capital gains tax revenue seem remote".[2]

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1 *Capital Gains Rates, Realizations, and Revenues* (National Bureau of Economic Research, Reprint No.1017, 1987).

2 *Capital Gains Taxes Under the Tax Reform Act of 1986: Revenue Estimates*

An important reason for a decline in tax revenue resulting from an increase in capital gains tax rates is a decline in economic activity, and in the proceeds from business and personal taxes which that activity generates. In 1988 Lindsay found that "the anticipated tax code changes had a powerful effect on trading behavior [in 1986]"[1] and that "a cut in the capital gains rate on some or all capital assets would produce a higher level of realization transactions".[2]

A number of other investigators have come to similar conclusions:

> "Independent investigations by Feldstein, Slemrod, and Yitzhaki, the Department of Treasury, Lindsey, Auten and Clotfelter, and Minarik, all point to a large, though highly variable, amount of response by taxpayers to changes in capital gains tax rates... Of the 13 simulations run, 12 produce lower tax revenue from higher tax rates over the period of 5 fiscal years being simulated. The final simulation suggests a virtually unchanged level of revenue... In none of the simulations is any significant increase in the permanent level of capital gains tax revenues predicted".[3]

Political support for cuts: The reduction of the1986 structure of capital gains tax rates, to a maximum of 28 per cent, attracted political support at the highest level. In his Legislative and Administrative Message of 25 January 1988, Ronald Reagan said: "The most important piece of unfinished business is to reduce the capital gains tax rate to the level that will generate the savings and investment necessary for future economic growth".

In a letter of 28 January 1988, George Bush said: "Last fall, I proposed reducing the maximum capital gains tax from 28 per cent to 15 per cent for assets held at least one year. Reducing the capital gains tax would stimulate growth, entrepreneurship, job-creation, and risk-taking". Bush campaigned on this issue in the 1988 Presidential Election and, on taking office, proposed to Congress a reduction in the top rate of capital gains tax to 15 per cent. The 15 per cent in George Bush's (eventually unsuccessful) proposal was the average of the 9 to 21 per cent range of revenue-maximising rates noted in a survey of the academic literature by Lawrence Lindsey.

Under Various Assumptions (National Bureau of Economic Research, Working Paper No.2215, April 1987.

1 *Tax Induced Trading: The Effect of the 1986 Tax Reform Act on Stock and Market Activity* (with Paul Bolster and Andrew Mitrusi; National Bureau of Economic Research, July 1988).

2 In *Capital Gains -- Special Report* (with Jane Gravelle; Tax Notes, Tax Analysts, Arlington, Virginia, 25 January 1988), page 397.

3 Working Paper 2215, *op.cit.*

Similar arguments were reviewed in hearings of the House Committee on Ways and Means, in further National Bureau of Economic Research studies, in reports by the Heritage Foundation, and in many other places.[1] As far as is known, Chancellor Lawson and the Treasury were in ignorance of all this United States material when the rate of capital gains tax was increased to 40 per cent in March 1988.

Lower taxes, more investment

An analysis of the ebb and flow of venture capital over time indicates that there is a close correlation between the availability of such funds and changes in the capital gains tax rate.

As Figure 2 shows, when US rates increased between 1969 and 1978, Initial Public Offerings (IPOs) declined significantly, from an annual average of nearly $2 billion between 1969 and 1972 to an average of just $225 million between 1975 and 1978. But following the major rate reductions in 1979 and again in 1982, the capital raised through IPOs soared, stalling at a plateau of some $23 billion in 1986-87 when the rate was raised from 20 per cent to 28 per cent under the 1986 Tax Reform Act. Since then the amount raised has declined.

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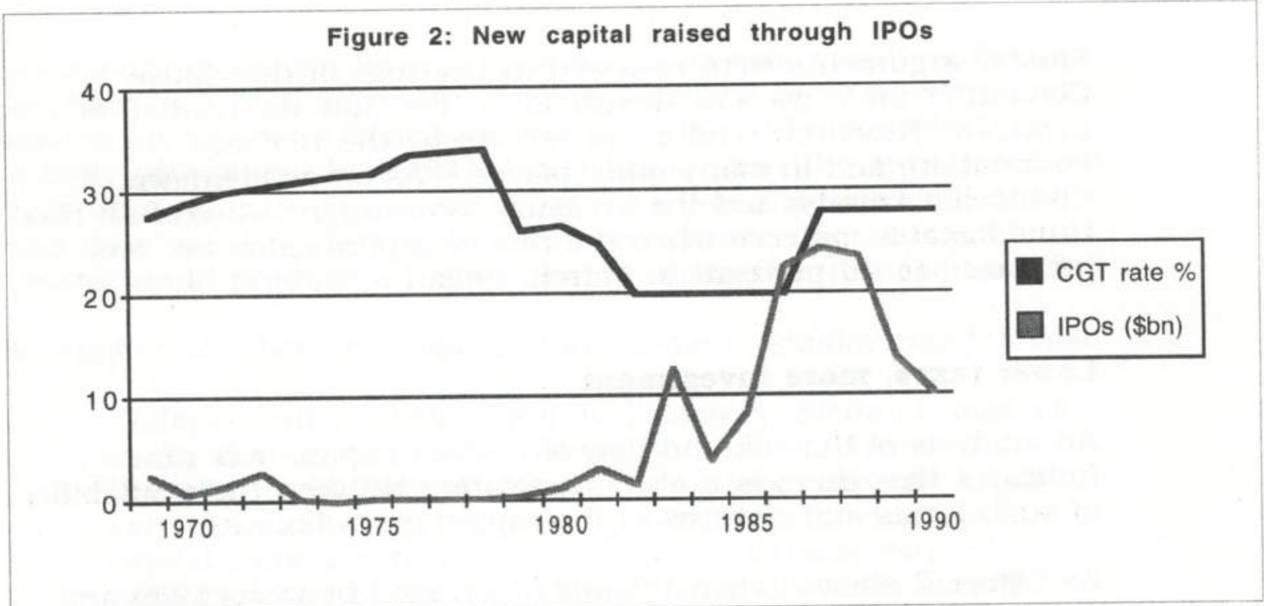
1 The taxation of capital gains was the subject of a hearing before members of the Committee on Ways and Means of the U S. House of Representatives on 2 February 1988. Those giving evidence included Professor Lindsey, Dr. Norman Ture, Dr. Paul Craig Roberts, Dr. Beryl Sprinkel and Mr. Oscar Pollock, all of whom spoke in favour of reducing the rates of capital gains tax. The proceedings were edited by Mark B. Liedl and published by the Heritage Foundation, Washington.

Ingalls and Snyder, New York stockbrokers and Oscar Pollock's firm, have produced a series of research reports on capital gains tax rates, emphasising the adverse effects of high rates on venture capital and stock market activity. *Venture Capital and Capital Gains Taxation* was the title of James Poterba's Working Paper 2832, published by the National Bureau of Economic Research in January 1989.

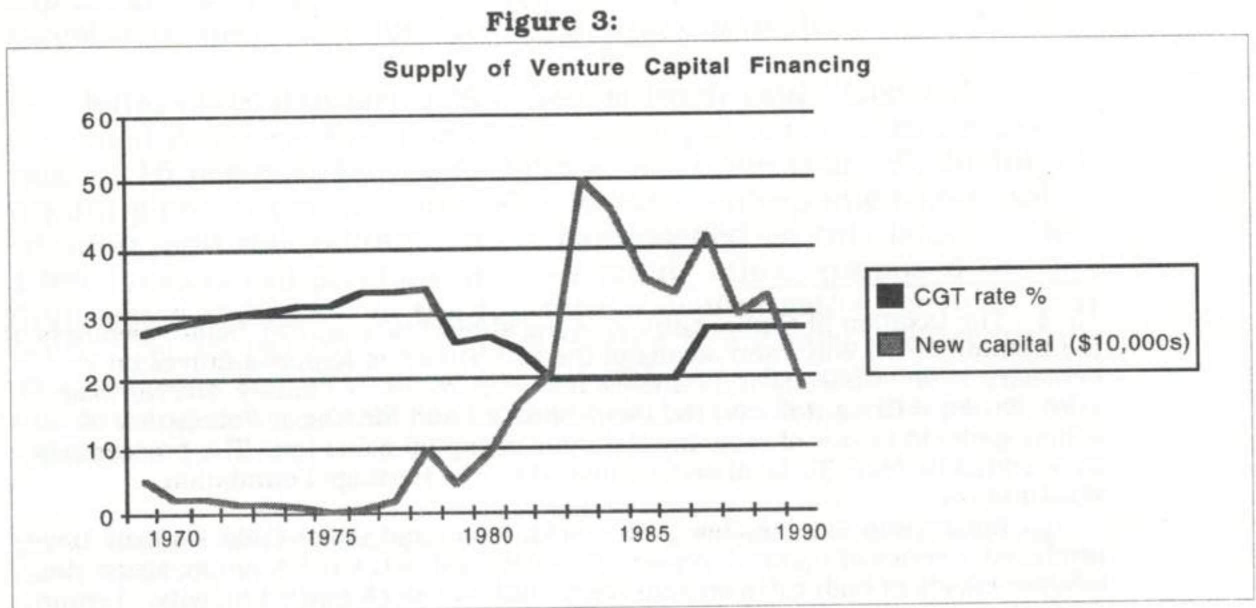
A survey of the current controversy by Ronald Utt (Heritage Foundation *Backgrounder*, 2 May 1989) points out the fallacy of the belief that the main recipients of capital gains are the rich. "Realized capital gains actually are distributed rather evenly throughout the income distribution. More than a quarter of realizations [in 1985] were experienced by households earning $20,000 or less, and households earning less than $75,000 received more than half of realized capital gains".



Source: *False Economy*, p.19.

Figure 3 illustrates the same connection between capital formation and capital gains tax rates using figures from the venture capital market. Venture capital here refers to funds raised by companies that specialise in investing in the shares of new businesses. As in the case of IPOs, the venture capital market has expanded when capital gains tax rates are cut and has declined or stagnated when rates are increased.

Figure 3:



Source: *False Economy*, p.21.

Lower rates, higher revenues

Every instance of a capital gains tax rate cut in the US has been rapidly followed by a significant increase in capital gains realisations and by higher taxes paid on those gains. By lowering the tax cost of selling assets, lower capital gains tax rates can lead

to increased realisations of capital gains and thus to increased tax payments by the owners of those assets.

Lower capital gains tax rates also increase the attractiveness of such assets relatively to other sources of income or profits. This encourages more purchases of such assets, which bids up their prices, leading to higher realisations of capital gains when the assets are sold. Again, this rise in value and volume can mean higher tax payments even at a lower tax rate. And to the extent that such tax rate reductions stimulate more investment, business formation and entrepreneurial activity, then general income tax revenues also rise.

The US rate cuts of both 1979 and 1982 were followed by large increases in reported capital gains and by increases in capital gains tax payments. Conversely, the tax rate increase enacted in 1969 was followed by declining realisations and lower capital gains tax revenues. The high level of revenue in 1986 was largely due to the realisation of gains at rates before the increases under the 1986 Act came into effect.

A 1985 US Treasury study concluded that:

> "the reduction in tax rates on capital gains in the 1978 Act caused a substantial increase in revenue from capital gains taxes in the first year after the tax cut, and in the long run either increased or only slightly decreased the annual Federal revenue from capital gains taxes."[1]

With three years' more experience and employing better analytical techniques, by 1988 the Treasury was reporting that the 1978 Act "produced large and continuing direct revenue gains." and that both it and the 1981 changes were "significantly revenue enhancing".[2]

Squeeze the rich — cut taxes

Supporters of a rate cut argue that tax rate reductions would actually increase tax payments from the wealthy because they would induce them to shift their wealth from tax shelters to taxable investments and to "unlock" gains that were not realised because of high taxes.

Evidence from past tax rate cuts: The evidence supports this assessment. Past cuts in tax rates have led to substantial increases in capital gains realisations and tax payments, and an

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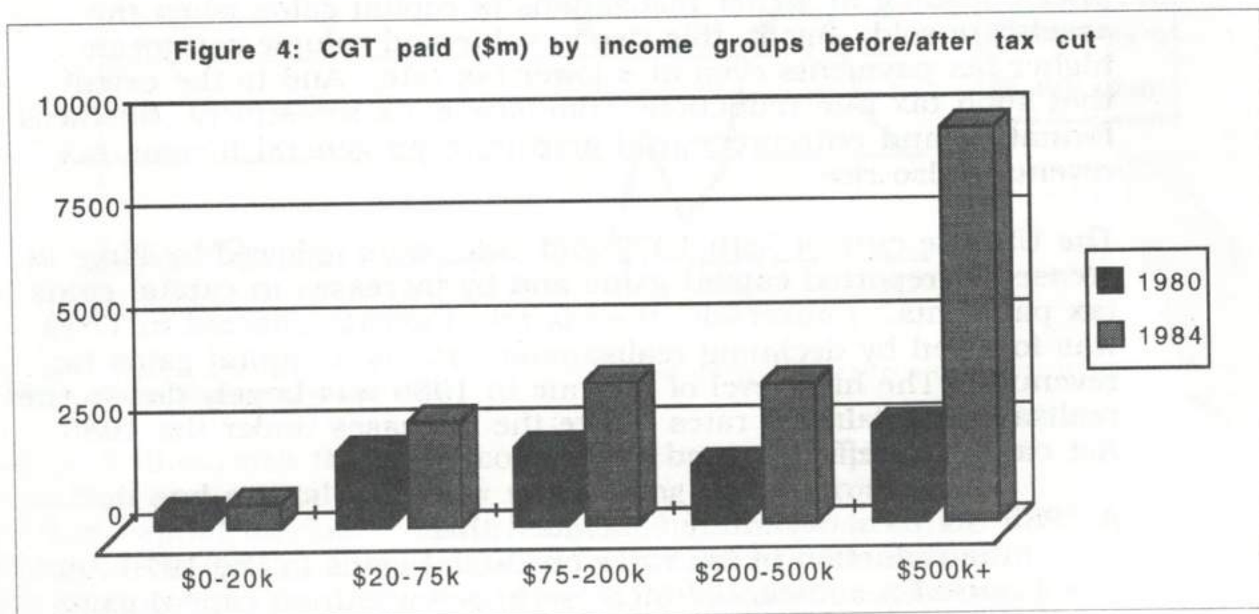
1 *Report to Congress on the Capital Gains Tax Rate Reductions of 1978*, U.S. Treasury Dept., September 1985.

2 Michael R. Darby, Robert Gillingham and John S. Greenlees, *The Direct Revenue Effects of Capital Gains Taxation: A Reconsideration of the Time Series Evidence*, (U.S. Treasury, Research Paper No. 8801, May 1988).

increased share of these tax payments comes from upper-bracket taxpayers.

Figure 4 demonstrates this. In the low-tax period of 1980-84, the tax payments by the richest segment increased by more than eight times as much as those of the lowest income group.



Source: Estimates by the Office of Tax Policy, U S. Chamber of Commerce, using Statistics of Income, Internal Revenue Service.

Critics may contend that the rise in revenues merely reflects an improving stock market. But over the period covered in the table, the New York Stock Exchange Composite Index rose by just 36 per cent compared with the 306 per cent increase in tax payments by the richest income group.

Shifting the burden to the rich: In contrast to the popular wisdom, the cut in taxes actually shifted the tax burden toward the richest groups. Between 1980 and 1984, the share of capital gains taxes paid by taxpayers earning $20,000 or less declined from 5.3 per cent to 2.9 per cent, while the share of taxpayers reporting incomes of $500,000 or more rose from 29.6 to 48.6 per cent of all taxes paid on capital gains.

These relationships are not new and can be illustrated from tax reductions going back many years. Figures in the Adam Smith Institute's 1986 report, *It Pays to Cut Taxes*, show the same effect resulting from tax reductions of the 1920s, the 1960s and the 1980s. On each occasion, the proportion of income tax contributed rose at the top of the scale and fell lower down.

Capital taxes tax everyone

Misleading statistics: Capital gains realisations are by no means exclusive to wealthier households. In fact, they tend to be spread rather evenly throughout the income distribution — when the income distribution is defined to include only "recurring" income, that is, reported income less capital gains realisations.

This distinction is important. When aggregated with other income, capital gains look as if they are concentrated among the very rich. So why not tax them at punitive rates?

However, for many or most individuals, capital gains realisations are infrequent occurrences and reflect a unique one-off event that makes the taxpayer *appear* rich for one year because they push him into higher income brackets.

Typical victims: In fact, realised capital gains tend often to be such non-recurring events as: the sale of a small business upon retirement; an elderly widow liquidating her husband's accumulated investments; the sale of stock to buy a house or pay for a child's college tuition; or the liquidation of an investment portfolio in anticipation of an economic downturn.

Indeed, realised capital gains are distributed rather evenly throughout the income distribution. More than a quarter of realisations in 1985 were experienced by households earning $20,000 or less, and households earning less than $75,000 received more than half of realised capital gains. Thus, in stark contrast to the claims of the critics, a capital gains tax rate reduction would provide significant benefits to *all* income levels, not just to the affluent.

Lessons from America

Thus the evidence accumulated since World War II makes a powerful case in favour of a substantial reduction in the capital gains tax rate. Whether the issue is encouraging savings and investment, fairness or revenue, the data and the studies demonstrate that concerns expressed by critics of a cut are either exaggerated or entirely wrong.

Disbelieving tax authorities: Of course, it can be intellectually difficult to accept the point that rate cuts can produce a rise in revenues, and sometimes a substantial rise.

As Figure 5 shows,[1] the Senate Finance Committee grossly underestimated the proportional contribution of incomes over

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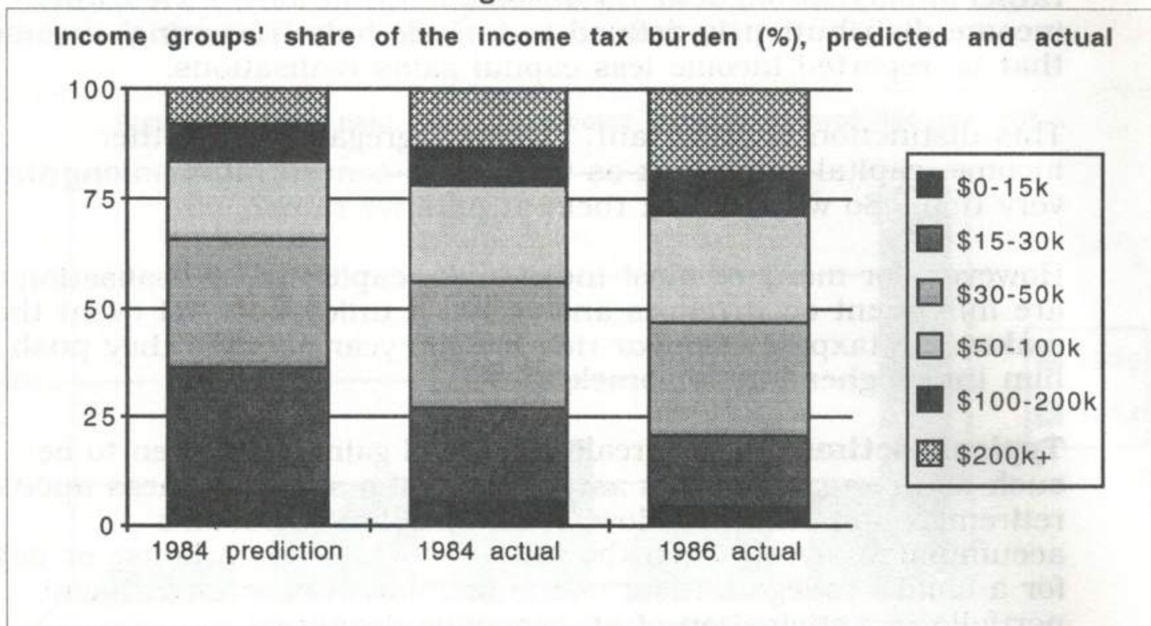
1 Taken from Thomas Griffin: *What's Wrong with Capital Gains Tax?*, Centre for Policy Studies, 1991

$200,000 for 1984 and overestimated the contribution of incomes under $15,000. And the distributive pattern established by 1984 became still more pronounced by 1986 and 1987.

Figure 5:



Sources: For predictions: Senate Finance Committee, 1981; For results: IRS (Published in the *Wall Street Journal*, 14 March 1990.)

A number of states, including New York, California, Florida and Texas, charge their citizens an additional rate of capital gains tax. In all four states the amount of capital gains reported in 1988 was less than half the amount reported in 1986 — and this despite a nationwide increase of more than 22 per cent in personal income during the same period. No other cause which could have produced this outcome can be identified. It is a striking demonstration of how confiscatory rates can reduce tax revenue.[1]

Low rates boost the economy

We noted already that the rational ceiling for any rate of tax is, not the maximum-revenue rate, but the significantly lower rate at which the increase in government revenue balances the cost to the economy.

At present, the cost to the United States economy is many times the yield of capital gains tax. The US Joint Committee on Taxation estimated that the cuts in tax rates proposed by President Bush

1 For this point, see the work by Alan Reynolds of the Hudson Institute, cited by Thomas Griffin: *What's Wrong with Capital Gains Tax?*, Centre for Policy Studies, 1991

would have cost $11.4 billion in lost revenue over the following five years but would also have increased economic activity by $100 billion — nine times as much.

It is a strange order of priorities that prefers an increase in tax revenue to an increase in economic activity nine times as large. Let us hope that this order of priorities is not shared by the British Treasury.

Where the jobs come from

More light is cast on this subject by Tom Griffin in *What's Wrong with Capital Gains Tax?* Venture capital disbursements to portfolio companies over the period 1970-1990 dropped sharply during the period of peak capital gains tax rates and recovered with great vigour as rates were lowered. Since the 1986 Tax Reform Act they have once again declined.

The reasons are not hard to find. Capital gains tax, being a tax on the return on capital, tilts the balance between risk and reward. The impact on private investors, who provide a high proportion of the finance for new companies, is particularly severe, as almost all of them fall into the top tax-rate category.

The effects of capital gains tax are therefore profound for the economy in general and for employment in particular. Griffin cites a recent US study dealing with the growth characteristics of newly listed companies. It shows that such firms increased their employment during the period studied (1983/87) at a rate of almost 30 per cent per annum, while employment in industry by public companies dropped at an average rate of 6.5 per cent.

A 1982 General Accounting Office study[1] reported that, between 1970 and 1979, an estimated $350 million in tax revenue was generated from employees of venture-backed companies, and more than $100 million in corporate tax revenue was produced from the companies themselves. More important, an estimated 130,000 new jobs were created by these companies during this period. All this was done with an aggregate venture capital investment of only $209 million.

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1 Cited by James R. Swartz of the National Venture Capital Group on 2 February 1988 before Members of the Committee on Ways and Means, U.S. House of Representatives.

Venture capital: United Kingdom

In *What's Wrong with Capital Gains Tax?*, Griffin points out that large institutions, such as pension funds, which pay no capital gains tax, supply the bulk of equity for listed companies, while the private investor, who is fully exposed to capital gains tax, plays a much larger part in supplying seed capital and the needs of corporate saplings. In other words, capital gains tax bears most harshly on new companies and venture capital.

There is a desperate shortage of experienced, successful executives who are prepared to leave the comfort and security of a big company to start a business of their own or to join a young start-up. Until 1988 the incentive was the capital gain from equity in the business. In 1979 the manager could swap income taxed at 83 or 98 per cent for potential capital gains taxed at 30 per cent. Now both are taxed at 40 per cent.

A survey of 37 member firms by the British Venture Capital Association in 1988 showed that the principal obstacle to the recruitment of managers by venture capitalists was that the managers considered that the possible gain did not justify the risk.

It is quite rational for managers in these circumstances to be tax-conscious and risk-averse. Figure 6 demonstrates why.

Figure 6: Tax impact on the manager/entrepreneur

	1979	1991
Income tax rate	83%	40%
Capital gains tax rate	30%	40%
Income lost (after tax) pa	£5,100	£15,000
Value in 5 years (invested at 9%)	£33,000	£117,000
Capital gain required:		
to break even after tax	£33,000	£117,000
to break even before tax	£47,000	£195,000
Company value required:		
to break even	£942,000	£3,900,000
to recoup four times lost income	£3,760,000	£15,600,000

Let us assume that a manager has the chance to join a young business with a 5 per cent stake, but has to take a 50 per cent pay cut to £30,000. This lost income could have been invested at an assumed 9 per cent, At 1979 tax rates, the manager would have to believe that the company would become worth £942,000 or more

to make him better off by joining it, and £3.76 million in five years to make him four times better off. At 1991 tax rates, however, the company would have to be worth £3.9 million for him to break even and a massive £15.6 million for him to be four times better off.

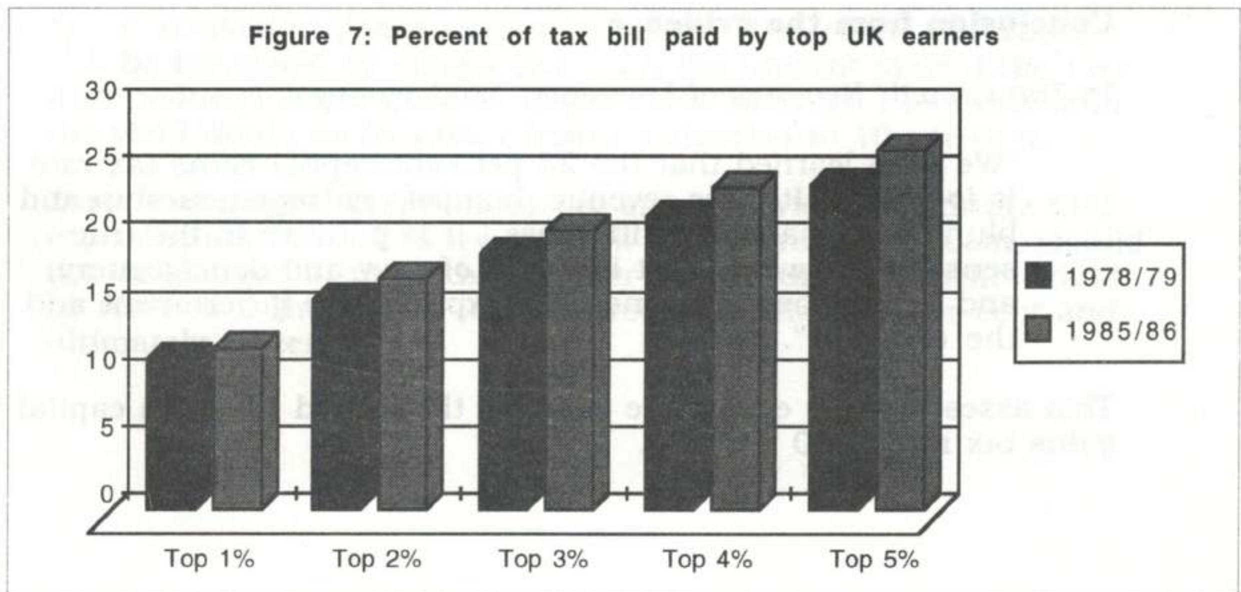
An increase in the rate of capital gains tax increases the tax charge disproportionately more as asset values increase above the rate of inflation. Thus a higher rate of capital gains tax primarily damages riskier ventures (such as venture capital investment and direct equity investment) compared with less risky assets (such as fixed interest savings). Therefore the long-term yield of capital gains tax is likely to be more sensitive to the volume of venture capital and direct equity investment than to the turnover of assets as a whole.

This behavioural effect of high rates of capital gains tax gives great cause for concern; and the behavioural effect is magnified by the impossibility of predicting the burden of capital gains tax with any accuracy.

The income tax analogy

The normal supply-side consequences of a cut in high rates of tax have been found in Britain since the income tax cuts of 1979. They were already in evidence by 1985-86, and the trend has continued since then.

Figure 7 shows the percentage of taxes paid by each of the top five percentiles of income earners before and after the UK's large income tax cuts. Every percentile shows an increase in its total share of taxes paid.



Source: UK Treasury

Malign influence on the non-rich

In the case of capital gains tax, all the critical measures of entrepreneurial behaviour have shown deterioration since the rate was raised in 1988, and there are many indications that capital gains tax in Britain exerts a malign influence, especially on small companies and risk-taking.

Over 38 per cent of the amount paid by individuals on assessments made to 31 October 1989 came from a mere 1,200 people. It seems likely that for many of these people this will have been their sole experience of being taxed as "super rich". It is possible that many will be people who have built up businesses and, for divers reasons, have sold out. Capital gains tax takes from such people a substantial part of the reward of a lifetime's enterprise and endeavour.

High rates breed complexity

Largely as a result of the indexation allowance, the United Kingdom capital gains tax must be one of the most complex and unintelligible in the world.

The complexity of the tax is well known to anyone who has attempted even the simplest disposal of chargeable assets. This is witnessed by the high level of computational enquiries that, for example, the Country Landowners' Association regularly receives from its members (including professional accountants) — far more than for all other taxes combined.

Conclusion from the evidence

In *The Growth Experiment* Lawrence, Lindsey says:

> "We have learned that the 28 per cent capital gains tax rate is too high. It loses revenue, hampers entrepreneurship and blunts national competitiveness. It is punitive in the true sense of the word, kept high out of envy and demagoguery, and it punishes everyone: the taxpayer, the government and the economy".

This assessment is even more valid for the United Kingdom capital gains tax rate of 40 per cent.

CONCLUSIONS

Capital gains tax is far too high: Evidence from the United States suggests that the revenue-maximising rate of capital gains tax is between 9 and 21 per cent, with a midpoint of 15 per cent. There is no reason to believe that the revenue-maximising rate of capital gains tax is higher in the United Kingdom than in the United States and good reason to believe that it is lower.

This means that the yield of capital gains tax would increase with each reduction in the rate of the tax from 40 per cent to the revenue-maximising rate of 15 per cent (or less).

Optimum rate is even lower: The revenue-maximising rate of capital gains tax is not the optimum rate, however defined, but substantially higher.

The revenue-maximising rate, if attained, secures the interest of the tax revenue only at disproportionate cost to the taxpayer. Any cost-benefit analysis that assigned a positive value rather than zero to the interest of the taxpayer would require the maximum acceptable rate of capital gains tax (or any other tax) to be significantly below the revenue-maximising rate.

Policy implications: Since the available evidence indicates that the revenue-maximising rate of capital gains tax in the United Kingdom is 15 per cent (or less) and since the maximum acceptable rate is significantly below the revenue-maximising rate, the policy implication is that the rate of capital gains tax should be several points below the 15 per cent (or less) at which revenue would be maximised. The rate of capital gains tax should be set at not more than 10 per cent.

The statistical evidence suggests that the yield of the tax would still be increased by comparison with the present yield if the rate were reduced further to 9 or 8 per cent, although the increase in the yield would be less than from a reduction to 10 per cent.

Zero-rate target: Thus the theory and the evidence indicate that capital gains tax, if it is levied at all in the United Kingdom, should not be charged at more than 10 per cent. Further benefits could be realised if the rate of tax were reduced below 10 per cent and ultimately to zero.

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