ADAM SMITH
INSTITUTE

The Effect of Capital Gains Tax Rises on Revenues

Introduction

When capital gains tax rises are being proposed in the UK as a short-term measure to increase revenues, it is important for policymakers to have a full understanding of the likely effect of such rises on Government revenues. Capital gains tax rates in the USA have changed considerably up and down in recent years and decades and provide a rich seam of data with which one can come to solid conclusions on the revenue effects of such changes.

This policy briefing summarises those revenue effects, considering evidence from other countries too, and draws conclusions for UK policymakers. The current policy debate in the UK is being conducted amidst a remarkable absence of facts. Policymakers need to proceed carefully and ensure they take an evidence-based approach in order to avoid unforeseen negative consequences of rushed, ill-informed decision-making.

Changes in US capital gains tax rates and revenues raised

The table below sets out changes in US capital gains tax rates and revenue effects:

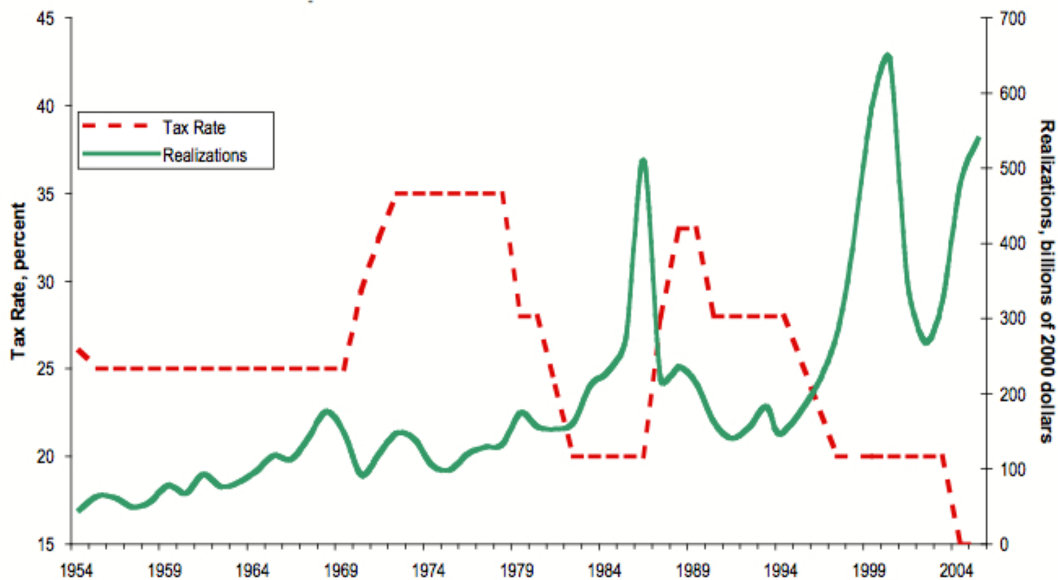
Total US Capital Gains Taxes (millions of 2006 dollars)

Year	Capital Gains Tax Rate	Capital Gains Taxes	Year	Capital Gains Tax Rate	Capital Gains Taxes
1955	25%	$11,020	1981	24%	$28,504
1956	25%	$10,392	1982	20%	$26,950
1957	25%	$8,270	1983	20%	$37,850

1958	25%	$9,131	1984	20%	$41,626
1959	25%	$13,302	1985	20%	$49,576
1960	25%	$11,490	1986	20%	$97,330
1961	25%	$16,728	1987	28%	$59,830
1962	25%	$13,044	1988	33%	$66,233
1963	25%	$14,118	1989	33%	$57,323
1964	25%	$16,141	1990	28%	$42,925
1965	25%	$19,219	1991	28%	$36,861
1966	25%	$18,076	1992	28%	$41,647
1967	25%	$24,820	1993	28%	$50,382
1968	25%	$34,429	1994	28%	$49,302
1969	25%	$28,976	1995	28%	$58,541
1970	29.5%	$16,425	1996	28%	$85,312
1971	32.5%	$21,653	1997	20%	$99,613
1972	35%	$27,529	1998	20%	$110,162
1973	35%	$24,365	1999	20%	$135,313
1974	35%	$17,392	2000	20%	$149,030
1975	35%	$16,990	2001	20%	$74,795
1976	35%	$23,459	2002	20%	$55,047
1977	35%	$59,060	2003	20%/15%	$56,251
1978	35%	$28,149	2004	15%	$78,552
1979	28%	$32,636	2005	15%	$100,129
1980	28%	$30,482	2006	15%	$110,000

Source: Office of Tax Analysis, U.S. Department of the Treasury.

The relationship between rates and revenues is clearly shown in the graph below:



Source: Congressional Budget Office; National Center for Policy Analysis.

The pattern shows that every time the capital gains tax has been cut, capital gains tax revenues have risen. Every time the capital gains tax has been raised, capital gains tax revenues have fallen. The following are some clear examples:

- In 1968, real capital gains tax receipts were $34 billion at a 25 percent tax rate. Over the next eight years the tax rate was raised four times, to a high of 35 percent. But with the tax rate almost 10 percentage points higher in 1972 than in 1968, real capital gains tax revenues were only $27 billion — 21 percent below the 1968 level.

- In 1978, when the top marginal tax rate was 35 percent, $28 billion in capital gains taxes were collected. By 1984, after the tax had been cut to 20 percent, revenues from the lower tax rate were $41 billion — 46 percent above the 1978 level.

- In 1986, the tax rate increased by 40 percent, from 20 to 28 percent. Tax revenues did not climb by 40 percent. Rather the opposite occurred. In 1990, the US government took in 13 percent less revenue at the 28 percent rate than it did in 1985 at the 20 percent rate. In 1991 (and again in 1992), the government collected more than 15 percent less revenue than it did in 1985.

- In 1996, the year before the capital gains tax rate was cut from 28 to 20 percent, net capital gains on assets sold were roughly $335 billion. A year later, capital gains had leapt to $459 billion. (The tax cut was retroactive to May 1997.) In 1996 the Treasury collected roughly $85 billion in capital gains revenues. In 1997 those tax payments jumped to $100 billion.

- After the 2003 capital gains cut, federal revenues increased in four years by $740 billion. CGT revenues grew from $55 billion in 2002 to $110 billion in 2006. Every indicator demonstrates that the 2003 CGT cut helped increase growth, share values and federal tax revenues.[i]

All of the data has been summarised in an important piece of research by Professor Paul D. Evans of Ohio State University, who looked at how taxpayers might respond to an increase in the capital gains rate, using taxpayer data from the most recent available years. In his study, *The Relationship Between Realized Capital Gains and Their Marginal Rate of Taxation, 1976-2004,*[ii] Evans found that taxpayers continue to exhibit significant sensitivity to the tax rate on capital gains in deciding how much of their gains to realize over time and would report fewer gains if the rate were raised. He found that at current US tax rates, a 1 percentage point reduction in the marginal tax rates on capital gains might trigger a 10.32 percent increase in realized capital gains. Behavior in recent years is broadly similar to that found in earlier studies.

He reviewed the many studies that seek to estimate the revenue-maximising rate, i.e. the answer to the question "What tax rate on capital gains would raise the most capital gains revenue for the government?" (The revenue maximizing rate is not of course the optimal tax rate for the economy). He found that based on 2004 data the revenue maximizing tax rate is just under 10% – 9.69% to be precise. He found that raising the US capital gains tax rate from the current 15% would reduce federal capital gains tax revenue and that additional revenue would be lost from other parts of the income tax and from other federal taxes due to reduced investment, employment, and income. He found that the optimal capital gains tax rate to maximize public welfare, and to help the federal budget, is closer to if not zero.

Revenue effects of changes in UK capital gains tax rates

There have been far fewer significant shifts in UK CGT rates, so it is more difficult to draw clear conclusions than is the case in the US. The most recent changes in UK capital gains tax rates, which saw the CGT rate on business assets increased from 10% to 18% and the rate on non-business assets reduced to 18%, are too recent to be able to draw any revenue conclusions. However, the earlier reduction in CGT on business assets to a rate of 10% for assets held over 2 years, does seem to have had a very positive revenue effect. That change took effect in the 2002-2003 tax year and a sharp rise in tax revenues followed. Revenues have continued to rise since. The figures are as follows:

UK Capital Gains Tax (£ millions)

Year of disposal	Tax paid
2000-01	1,581
2001-02	2,301

2002-03	2,356
2003-04*	3,061
2004-05*	3,896
2005-06*	5,362
2007-08*	7,601

Source: National Statistics.
** Provisional figures.*

It is difficult from available statistics to attribute the exact proportion of tax paid to business assets, which attract the reduced level of tax. It is notable though that the largest amount of CGT paid is from UK and foreign shares not listed on the London stock exchange (51% in 2006-07). The vast bulk of this is likely to be constituted by business assets. Although the sharp jump in CGT in the last two years in the table above is no doubt partially accounted for by the unsustainable boom that collapsed into recession in late 2008, the figures clearly show a strong upward trend that followed the CGT tax reductions on business assets.

Evidence from other countries

Evidence from other countries backs up the US evidence. For example, the Ralph Committee CGT reform in Australia in 1999 sought to address the very high Australian CGT rates by introducing discounts for individuals and funds, but not companies. Growth in CGT realizations and revenue from individuals and funds since 1999 has outstripped that from companies. Individuals received a larger discount than funds (50% versus 33%), yet CGT revenue collected from the former has exceeded growth in the latter. The CGT share of Commonwealth tax revenue has nearly doubled since the Ralph reforms, from 3.4% to 6.6%. The data shows that the Ralph reforms have seen more CGT revenue being collected, not less.[iii]

Why do CGT revenues fall so sharply with rate rises?

The Laffer effect with regard to income taxes is well known. When income taxes exceed a certain level revenues fall as the incentive to work decreases. But with capital gains taxes the effect of tax rises is much stronger and more immediate. The main reason for this is clear. Capital gains taxes are voluntary taxes, unlike income taxes. While everyone needs to work and bring in an income, the same is not true of making capital gains. No-one needs to pay capital gains taxes except in times of financial distress. Taxpayers can simply avoid selling assets that are subject to the tax and also avoid buying assets that are subject to the tax. CGT is largely a voluntary tax and when rates rise it is no surprise that the number of volunteers declines.

The bigger picture

Taxes on capital gains hit the economy's future and the living standards of its citizens. Between 1900 and 1996, wages in the United States rose six-fold. A worker in 1996 had to work only 10 minutes to earn what his or her 1900 counterpart took an hour to earn.

The reason wages have risen like this, not only in the US, but in every advanced economy, is because of increases in productivity. Each worker is now employed more efficiently and produces more output – this is what brings about the higher wages. It is capital that makes possible this productivity increase; it finances the new machines and the new technologies.

When capital taxes are lowered, the expected return to investors is raised, leading them to invest more. The reverse is true. When capital taxes are raised, the returns on it decrease and people do less of it. But it is when more capital is invested that productivity is increased, making the wage rises possible for ordinary workers.

A large part of the benefits of capital does not accrue to the owners of capital, but to the workers whose wages depend on it. And the higher productivity which makes higher wages possible can also mean lower unit costs and lower prices in real terms, making ordinary consumers also beneficiaries of capital investment.

If fairness is a factor in determining where taxes should be levied, it should also take into consideration those who ultimately benefit from tax changes, and those who stand to suffer from them. Capital investment benefits the economy and most of its participants, high and low, and taxes on capital punish them.

The myth of tax arbitrage

One myth that is consistently peddled by advocates of higher capital gains taxes is that lower capital gains tax rates will somehow result in people shifting income to capital gains. The facts do not bear this out. If it was so easy to convert income to capital gains then how do countries who have a GCT rate of zero still manage to raise significant revenue from income taxes?

For example, Australia’s personal income tax yielded at least as much revenue when the capital gains tax was zero as it did after adopting the highest capital gains tax in the world. Personal income tax was 12.5% of GDP in 1980, with no capital gains tax, and 12% in 1994, with a high capital gains tax. Before the CGT was introduced in 1985, why did Australian taxpayers pay income tax rates of up to 65% on ordinary income if they could have converted that income into capital gains and paid no tax at all? Similarly in the US, income tax revenues did not drop when the CGT rate went down.

What about Hong Kong, which has no capital gains tax? Taking the period 1984 to 1996, Hong Kong tax receipts increased by 17.8% a year, compared to

a 7.1% annual increase for the US, which had capital gains taxes of between 20% and 28% during that period. Or what about Belgium, which also has no capital gains rate but a top rate of 50% like the UK? Why can it still collect income tax at these high rates? Or the Netherlands, with an income tax rate of 52% versus CGT of zero? Or New Zealand, also with a rate of zero?

The evidence just isn't there for taxpayers being able to convert income to capital gains. Academic theorising about a lower capital gains tax rates inviting a loss on income tax revenues is just a theory in search of some facts. And the facts don't exist. Converting capital gains to income is actually very difficult and the tax authorities are perfectly capable of limiting attempts at shifting taxable income into non-taxable capital gains.

Capital Gains Tax Rates Around the World (assets held more than one year)

Australia	24.3%	Luxembourg	0%
Austria	0%	Mexico	0%
Belgium	0%	Netherlands	25%
Canada	23.2%	New Zealand	0%
Czech Republic	0%	Norway	28%
Denmark	62.9%	Poland	19%
Finland	29%	Portugal	0%
France	27%	Slovak Republic	19%
Greece	0%	Spain	15%
Hungary	20%	Sweden	30%
Iceland	10%	Switzerland	0%
Ireland	20%	Turkey	0%
Italy	12.5%	United Kingdom	18%
Japan	10%	United States	15%
Korea (South)	20%	**Average**	**15%**

The inaccuracy of official forecasts

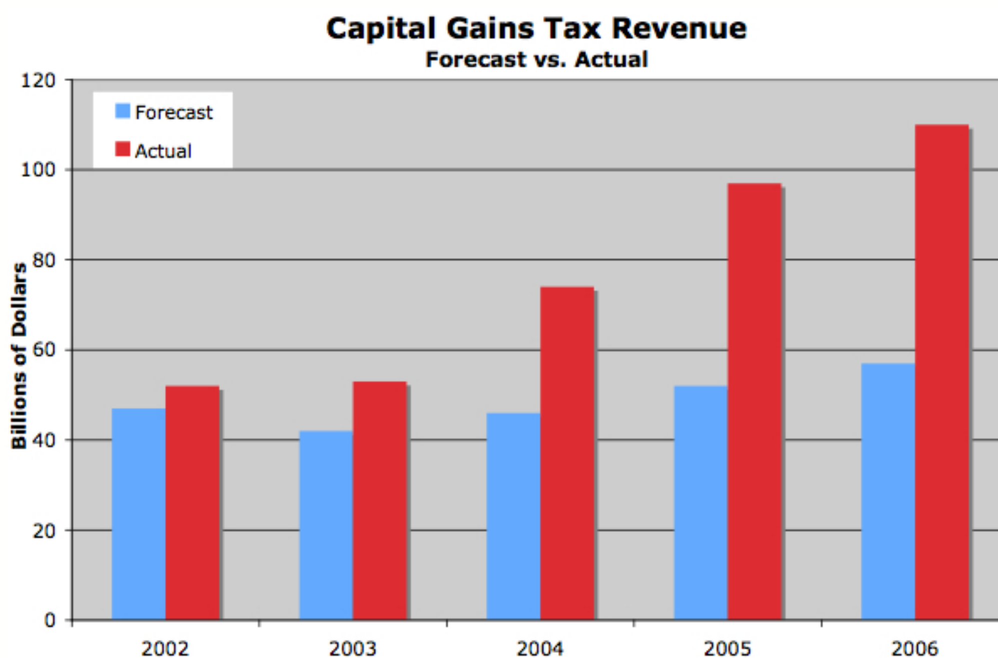
Government organizations, notably tax authorities, have been consistently wrong in forecasting the revenue effects of changes in capital gains tax rates.

For example, in April 1978 the US Treasury Department stated that capital gains tax relief would cost $2.2 billion in revenue, but in reality capital gains taxes paid by individuals increased by some $1.6 billion or 19%. Tax receipts were $3.5 billion – 56% higher than Treasury analysts predicted.

Official estimates were just as wrong when the US capital gains tax was increased after 1986. Their estimates of realizations and revenues turned out to be too high. Professor Martin Feldstein commented as follows:

> "The Treasury staff projected that capital gains would reach $256 billion in 1992, while the Congressional Budget Office projected capital gains of $287 billion. In fact capital gains have continued to decline since 1988, falling nearly 40 percent on real terms despite a 34 percent rise in the real level of [stock] prices. The actual 1992 level of capital gains was only 41 percent of the level projected by the Congressional Budget Office."[iv]

More recent estimates have continued to be wrong. The gains in tax receipts following the reduction of the CGT rate to 15% in 2003 were not expected by the Congressional Budget Office and the Joint Committee on Taxation, which officially score tax changes. The graph below compares actual capital gains revenues with the forecasts made when the tax cut was proposed:



Source: Source: U.S. Department of the Treasury; Congressional Budget Office; National Center for Policy Analysis.

Thus official estimates have consistently failed to be accurate. The static economic models used by official bodies fail to take proper account of the dynamic effects of tax rate changes.

Fairness

Since it is very clear that raising CGT rates actually decreases revenue, the remaining argument for CGT rises is that of 'fairness,' or – to put it more bluntly – taxing the rich. Supporters of CGT rises constantly talk of 'fairness' and 'fair taxes.' However, the idea that one should increase CGT in the name of 'fairness', irrespective of its effect on revenues and the wider economy, is predicated on a fundamental misconception: that CGT is paid primarily by the rich.

Data on which the supposition that CGT is paid by the rich is based includes capital gains. The statistics on the high-income earners are thus misleading. These apparently rich people often have much lower incomes in years other then the one in which they report their capital gains and pay the tax.

In Canada, Joel Emes examined this issue employing the same 1992 data used to produce the conventional statistics on the incidence of the capital gains tax, which showed that 78% of CGT was paid by families with incomes over $100,000.[v] He found that those Canadian families with *incomes other than capital gains* over $100,000 in 1992 paid only 26.8 percent of all such taxes. Families with less than $50,000 of such non-capital gain incomes paid 52.1 percent. As Professor Herbert Grubel points out:

> "These results can be explained most easily in the context of the normal life cycle of incomes. The owners of a small business often take out little income annually and reinvest much of their profits to expand their business, keep up with the competition and, most important, to build up a nest-egg for their retirement. When these owners of small businesses sell it to retire, they appear as "rich" Canadians in the statistics of that year. In fact, of course, their incomes both before and after the event often do not make them the kind of high-income earners at whom the capital gains tax is aimed in order to create greater vertical equity."[vi]

Data from other countries shows the same picture. 72% of all Australian gains are reported by people with other taxable income below AUS$50,000, and 16% of all gains are reported by those with no other apparent income.[vii] This is quite explainable. The "income" of many retired people, as well as those struck by unemployment or illness, often consists entirely of capital gains in some years.

What is clear is that a capital gains tax on individuals is, more than anything else, *a tax on the old*. In the US, CGT paid by individuals under the age of 65 amounted to only 5.2% of individual income tax, but 17.5% for those over the age of 65.[viii] A US study by the National Centre for Policy Analysis examining IRS data found that the average elderly filer had an income of US$31,865, 23 percent of which was capital gains. By contrast only 9 percent of the income of the average non-elderly filer was from capital gains. This is what one would expect. People build up assets during their life which they draw down when they are old. It does not classify them as rich.

Intending to tax the rich, politicians, without understanding the effects of their actions, are proposing measures which will decrease the Treasury's tax take, harm the capital base on which the economy's future depends, and simultaneously punish poorer and older people. This is not good policy.

The likely effect of capital gains tax rises in the UK

It is highly likely that the negative revenue effects of any capital gains tax rises that are introduced in the UK will be even more accentuated than those in the US and elsewhere. That is because investors know that these are likely to be temporary and will defer capital gains realizations until the rate reduces once more. Investors know that:

- There is a cited short-term need to raise revenues to pay down the debt accumulated by the last government and rate increases are only being proposed for the short-term.
- The other short-term argument for CGT rate rises is also temporary, namely that the current CGT rate is too far below the 50% income tax rate, and that people will seek to switch income to capital gains. There is almost universal agreement – including in large parts of the Labour Party – that the 50% rate is economically foolish and is being preserved temporarily for political reasons.
- Any increases would be introduced largely for political and presentational reasons – as part of horse-trading within a coalition – and not as a result of rational, evidence-based policy-making.
- The major party within the coalition does not believe in the CGT tax increases and will seek an early opportunity to reverse them
- Lastly, the CGT rises envisaged in the UK are significantly larger than those which occurred in the US and resulted in revenue declines there. They will thus have a bigger impact on investor behaviour.

Given these factors it will be entirely rational for most investors to defer capital gains realizations for a few years and to avoid the purchase of new assets that incur the tax. We therefore expect a much sharper decline in revenues in the UK than has occurred in the US. What will that decline be? A tax increase of 10 percentage points in the US led to a 21% decrease in revenues. On another occasion a tax increase of 8 percentage points led to a 15% decrease in revenues. What revenue decrease would result from a tax increase of 20 percentage points or more in the UK, especially when combined with the factors listed above?

What then is the correct policy response at the current time? It is clear that the proposal to align Capital Gains Tax with income tax rates, increasing it from 18 percent up to 20, 40 0r 50 percent is inappropriate. It fails to distinguish as it should between short-term speculative gains and long-term asset appreciation. There should be such a distinction, as there is in the US, where

gains realized within a year are taxed as income, and longer-term gains are taxed for most people at 15 percent.

The UK could respond similarly, taxing one-year gains at income tax rates, but keeping the 18 percent rate for longer-term appreciation. If the aim were to maximize revenue, that might be achieved by cutting the 18 percent rate to 10 percent. For maximum economic benefit a taper could be introduced to phase it out to zero for assets held for 5 years or more. Either of these policies would be far less damaging than the current proposal.

The Adam Smith Institute acknowledges the assistance of Peter Young in research and analysis for the preparation of this report.

---

[i] Stephen Moore and Tyler Grimm, NCPA Policy Report No. 307, January 2008
[ii] Dr. Paul D. Evans, The relationship between realized capital gains and their marginal rate of taxation, 1976-2004, Institute for Research into the Economics of Taxation, October 2009
[iii] Stephan Kirchner, Reforming Capital Gains Tax, Centre for Independent Studies, 2009.
[iv] Martin Feldstein, "Behavioural Responses to Tax Rates: Evidence from the Tax Reform Act of 1986." The American Economic Review, May 1995, p. 173.
[v] Herbert Grubel, Unlocking Canadian Capital: The Case for Capital Gains Tax Reform, Vancouver: The Fraser Institute, 2000
[vi] Herbert Grubel, Why there should be no Capital Gains Tax, Fraser Institute, 2001
[vii] Alan Reynolds, Capital Gains Tax, Analysis of Reform Options for Australia, Australian Stock Exchange 1999.
[viii] Ibid.