# Taxing Capital Gains is Good for the Tax System, the Economy and Tax Administration

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**Outline of Submission**

Over the past fifty years, the compelling case for taxing capital gains has been made over and over again by tax reform commissions and tax policy analysts around the world. Income tax systems that do not include capital gains in the definition of income are widely perceived as being inadequate. The theme of the comments in this submission will be that taxing capital gains not only enhances the fairness of an income tax system but also increases the efficiency with which resources are allocated in the economy and thus raises the average standard of living. Moreover, including capital gains in the income tax base enables the administration of the income tax to be rationalized.

The first part of this submission deals directly with the case for taxing capital gains and with some of the arguments that are put forward to weaken that case. The second part of the submission sets out a number concerns that are often expressed in opposition to the taxation of capital gains and explains why they should be given little weight. To fully reveal my position on these issues, these frequently mentioned concerns are labelled myths about taxing capital gains.

This submission was prepared under somewhat severe time constraints and, therefore, in places is cryptic and incomplete. If the Committee would like an elaboration in writing of any of the points made in the submission, I would be pleased to provide it. Also, since these comments were prepared over the past couple of days, while I was away from my office, they contain no references. Again, if the committee would like references to any of the technical studies alluded to, I would be pleased to provide them.

Before turning to my arguments, since I over-heard witnesses before this committee yesterday explain that "capital gains taxes are being discredited around the world," I would like to begin by making a conceptual point. The empirical point that this assertion makes is that capital gains taxes are being "discredited," but I want to set aside that empirical point, in part because it is so clearly dead wrong, and make the conceptual point that it is somewhat misleading to refer to the amendments before the committee as implementing a capital gains tax. Capital gains are not something separate from income. The issue before this committee is not whether there should be a separate tax on capital gains, but whether what everyone admits is income, namely the gains on the sale of capital property, should be included in the income tax base.

Those who oppose taxing capital gains sometimes suggest that there is nothing wrong with an income tax but they are opposed to a capital gains tax. That is conceptually misleading. What they are saying, in effect, is that they are in favour of income taxes but only if, in the public interest, not all income is taxed. It is only a happy coincidence I am sure, but often the type of income they think should not be taxed is that received primarily by themselves and those they represent. To be sure, this is a trivial point, but to clarify thinking about the issues before you, I do think it is important to keep in mind that these amendments do not contemplate imposing a new tax. They are simply proposing that income for purposes of the income tax be defined more comprehensively.

A related conceptual point, which assists in clarifying thinking about whether capital gains should be included in the income tax base, is that the notion of capital gains, as Professor Rick Krever so ably demonstrated at yesterday's hearing, is a legal concept not an economic concept. And it developed in trust law, not tax law. The importance of this is that historically no one ever sat down and said: "Here are three policy reasons why we should give certain types of income preferential tax treatment - to avoid a bunching problem, the locked-in effect, and to encourage risk-taking. Based upon these policy reasons, now let's define the type of gains that should receive preferential tax treatment." Instead, for tax purposes, the concept of capital gains was simply incorporated from trust law. The consequence is that no matter what reasons one gives for providing capital gains with preferential tax treatment, in terms of these reasons the actual result of what gets defined as a capital gain in the tax courts can only in many cases be charitably described as goofy. After almost thirty years of studying these cases, my sentiments about the contours of the present concept of capital gains are echoed in the immortal words of the famous philosopher and roots rocker Elvis Costello, "I used to be disgusted/Now I try to be amused."

If capital gains were defined by reference to the policy reasons some people give as to why they should be given preferential income tax treatment, the category of gains that would qualify for special treatment would be much smaller than the present category of capital gains. However, if one were to engage seriously in that kind of exercise I am sure he or she would quickly conclude that the traditional reasons given for not taxing capital gains are not very persuasive and, therefore, no income should be given preferential tax treatment for income tax purposes. Which brings me to the first section of my paper - the case for including all capital gains in income for tax purposes.

## I. The Case for Taxing Capital Gains

The case for including capital gains in the income tax base is straightforward - fundamental notions of fairness, the need for economic efficiency, and improved tax administration.

## A. The Fairness Case for Taxing Capital Gains

### 1. Horizontal Equity

Considerations of elementary fairness provide the most compelling reason for taxing capital gains. The most fundamental axiom of social justice is that equally circumstanced people should be treated the same by the government. The consistent application of this principle is, in all areas of law, what gives the law its legitimacy.

In tax law, the notion that two individuals with the same ability to pay should pay the same amount of tax provides the ethical justification for a tax on income. Without substantial adherence to this moral imperative, the definition of income reflects simply the results of the arbitrary exercise of political power. Consequently, the legitimacy of the government to impose a tax on income is called into question.

It is simply observable that an individual who realizes $30,000 of profits from selling a capital property has the same ability to pay as an individual who receives $30,000 of interest income or someone who earns $30,000 from a business or as an employee, therefore, they should pay the same amount of tax.

### 2. Vertical Equity

In terms of vertical equity - that is equity between taxpayers in different income categories - any tax preference for capital gains will benefit primarily, indeed almost exclusively, high-income individuals. In Canada, for example, in 1996, the most recent year for which there is publicly available data, tax-filers earning over $250,000 (Canadian $), who constituted less than 0.3% of taxpayers, reported over 40% of all taxable capital gains. Taxpayers earning over $100,000, who represented less than 2% of tax-filers, reported over 65% of all taxable capital gains.

The regressivity of not taxing capital gains can be illustrated in another way: in Canada, an individual who earned between $20,000 to $40,000 in 1996 (which would include the typical worker) reported $150 of capital gains. The average person who earned over $250,000 reported capital gains of about $75,000. High-income taxpayers thus reported on average 500 times more capital gains than middle-income taxpayers.

Income and wealth is distributed relatively more equally in Canada than many other industrialized countries. In countries where income and wealth are distributed less equally, capital gains would be even more concentrated among the very rich.

Those who argue that capital gains should not be taxed make a number of arguments that would suggest that the inequity caused by not taxing capital gains is not as great as these figures would indicate.

First, it is often noted that low- and middle-income taxpayers account for the vast majority of people who realize capital gains, which is the case. For example, of the 1.5 million taxpayers who reported capital gains in Canada in 1996, 0.8 million, or over half those reporting capital gains had income under $40,000. However, this figure is meaningless in assessing the fairness of taxing capital gains. More people in low- and middle-income groups report capital gains than high-income individuals simply because there are so many more people in those income categories. Moreover, although some low- and middle-income individuals realize capital gains, the average amount reported by them is utterly trivial compared to the amount reported by high-income taxpayers.

By any measure, the number of low- and middle-income taxpayers who benefit from the non-taxation of capital gains is insignificant compared to either the aggregate tax savings per income class or the average savings per individual in each income class.

Moreover, although most low- and middle-income individuals who realize capital gains are likely holders of small amounts of mutual funds or other investments held outside pension funds, in fact, some of them are undoubtedly spouses or other family members of high-income individuals or even relatively wealthy individuals whose taxable incomes are low because they have been able to reduce their income subject to tax through the use of tax shelters and other avoidance strategies.

Second, proponents of the non-taxation of capital gains sometimes argue that distributional data suggesting that most capital gains are realized by the rich are misleading since they include in the category of high-income individuals realizing capital gains individuals who in fact have had rather modest incomes all their lives and then realized a large capital gain when they sold the small business or farm that they had been building up over the course of their lifetimes. This argument has been appropriately labelled the “king-for-a-day” myth.

In Canada, unfortunately there is no published panel data on capital gains, that is, data on the variations in income earned by the same taxpayers over successive years. However, in the United States there have been numerous studies that have attempted to compute the distribution of capital gains based upon the same taxpayer’s average income over a number of years. What these studies find is that the distribution of capital gains across income classes changes very little when computed over, say, a ten-year period instead of a one-year period. For example, in one study, covering the ten-year period from 1979 to 1988, almost 60% of capital gains were found to be realized by taxpayers whose average income over that period put them in the top 1% of taxpayers.

Although there might be a few people with modest incomes who realize only one large capital gain over their lifetime, most high-income individuals who realize capital gains realize them year-after-year or they are individuals who own so-called small businesses or farms but in fact have been receiving substantial salary or dividend income over their lifetimes.

The finding that capital gains are heavily concentrated among the richest members of a society is surely not counter-intuitive. Wealth, which yields capital gains, is distributed much more unequally than income. By way of example, in Canada, the wealthiest 1% of Canadians own more personal wealth than the bottom 80% of Canadians. Naturally, it is this small number of Canadians who are the ones realizing capital gains. Furthermore, most of the wealth of low- and middle-income families is held in the form of personal residences and pension fund assets that are generally not subject to capital gains tax.

There is simply no question that not taxing capital gains concentrates tax benefits like a laser on the well-to-do. All attempts to characterize the taxation of capital gains as being harmful to primarily middle-income families have been shown to be disingenuous.

**B. The Economic Efficiency Case for Taxing Capital Gains**

Many tax analysts, particularly those who truly believe in the role of free and neutral markets in fostering a dynamic economy, argue that the strongest case for taxing capital gains is not one based on equity considerations, but one based upon the importance of economic efficiency.

The economic efficiency case for taxing capital gains is straightforward. It rests squarely on the most fundamental assumption underlying a market economy; namely, to ensure the efficient allocation of resources in an economy, and to spur economic growth, market forces should be left to direct financial capital to where it will earn its highest rate of return. If capital gains are not taxed, capital will flow to those assets and sectors in the economy where tax-free capital gains can be realized, and away from investments with a higher before-tax rate of return. Such distortions in the allocation of financial capital reduces the efficiency of the economy and thus lowers average standards of living and reduces the potential for economic growth.

The question of how large the social waste is because of the misallocation of resources caused by not taxing capital gains has not yet been definitively resolved by empirical research. However, a number of factors suggest that it is likely substantial.

First, not taxing capital gains means that individual investors can borrow money and make an uneconomic investment but still earn an after-tax rate of return. For example, even though a capital gain realized by a high-income taxpayer is less than the interest expense incurred on the money borrowed to make the investment - therefore the investment was not economical - because the interest expense can often be deducted from other income and the capital gain is not taxed, the investor is better off after-tax. In such a case, the tax system has been used to convert a pre-tax investment loss into a post-tax profit. This aspect of a tax system in which capital gains are not taxed might be fairly described as a negative income tax scheme for the wealthy. It results in scarce financial capital being flushed down the drain.

Second, not taxing capital gains encourages not only investments in assets that might potentially yield a social rate of return, but also it encourages investments in assets such as antiques and other collectibles, commodity futures, real estate, tax shelters, and foreign securities. No one would suggest these types of investments have any value beyond that gained by the investor. An economy is clearly less productive to the extent that capital is attracted to these types of investments as opposed to real productive investments.

Third, not taxing capital gains distorts corporate financial policy. Such an exemption provides a tax advantage in favour of corporate accumulations. This is because, if capital gains are given preferential tax treatment, shareholders will be anxious to realise the return on their investments in the form of equity appreciation, thus corporations will be under less pressure to pay out dividends. This bias in corporate financial policy, caused by not taxing capital gains, has, in turn, a number of adverse economic effects. For one thing, it means that corporations will be less dependent on new stock issues to finance growth and thus the securities marketplace will be less able to perform its important function of allocating financial capital to projects where it will earn the highest rate of return. Moreover, this bias in favour of corporations retaining their earnings means that there is less financial capital available for new, innovative firms. This is a somewhat paradoxical effect of the non-taxation of capital gains since the non-taxation of capital gains is frequently justified as a means of providing assistance to small and new firms. In fact, because of the bias in corporate financial policy that it creates, the non-taxation of capital gains might well, on balance, hinder the development of new firms.

A fourth way in which not taxing capital gains leads to economic inefficiencies - and therefore a less prosperous economy - is that it exacerbates a problem which is well recognized as contributing to decreased productivity, namely the separation of management and control in public companies. By creating a tax bias against the payment of dividends, which are subject to the Secondary Tax on Companies, the tax exemption encourages shareholders to realize their share of corporate profits by selling their shares instead of holding them and receiving dividend distributions. This incentive to sell contributes to the point of view that shares are a commodity, to be simply bought and sold, rather than the representation of a part ownership in a business, which carries rights and obligations to monitor its corporate managers. As a result, it increases the propensity of shareholders to abdicate control of their corporation to corporate managers. Thus, not taxing capital gains leads to an increased separation of management and control in public companies, which in turn lessens corporate productivity in two ways.

Tax and other government policies should be designed to encourage corporate management to focus on the long-term competitiveness of their businesses instead of short-term profits. Yet, when management is separated from ownership, management becomes predisposed to maximize short-term profits at the expense of long-term profits in order to attempt to maximize immediate share values. Thus taxing capital gains - and increasing the stake of shareholders in the long-term profitability of the corporations they own - will improve corporate productivity by encouraging corporate managers to adopt a long view of their companies' businesses and to make the investment in research and development and other long-term planning programs necessary to succeed in future markets.

Taxing capital gains, and encouraging shareholders to assert control of the companies they own, will also increase productivity by reducing biases that otherwise favour corporate retained earnings. As mentioned above, not taxing capital gains encourages companies to retain their profits because in this way corporate profits can be realized tax-free by shareholders by selling their shares. However, not taxing capital gains also leads to excessive corporate retained earnings because of the effect of such a tax exemption on increasing the separation of ownership and control in public companies. The empirical evidence is clear on this issue: firms that are controlled by management retain a significantly higher percentage of earnings than firms for which ownership and control is not separated. The theory is straightforward: management prefers to retain rather than distribute earnings since it means they do not have to resort to capital markets for cash and thus can escape the scrutiny of capital markets; by retaining earnings they can increase the size of their companies and thus their compensation; and, by retaining earnings they can diversify their company's lines of business and thus decrease the risk of the firm becoming unprofitable and losing their jobs. The empirical evidence showing that firms earn a relatively lower rate of return on reinvested earnings compared to that earned on the investment of borrowed funds or on newly issued shares is equally unambiguous. Any policy that encourage firms to retain an excessive amount of their earnings has a deleterious effect on productivity.

Unless there is compelling evidence to the contrary, the efficient deployment of investment capital calls for a level playing field in which all forms of investment are treated equivalently. Not taxing capital gains distorts the allocation of capital. The exemption of such gains from tax amounts to a huge implicit government subsidy to investors who invest in capital property that yields capital gains. It is somewhat ironic that those who oppose including capital gains in income are often individuals who in other contexts are the most vociferous proponents of allowing market forces to determine the best allocation of resources and are often opposed to various forms of government "handouts" to other citizens.

### C. The Administrative Case for Taxing Capital Gains

In addition to being equitable and economically neutral, a good tax system is inexpensive to administer, convenient to comply with, difficult to avoid and evade, and easy to understand. In short, the tax system should be simple. Not taxing capital gains results in a violation of each of these administrative canons of a good tax.

Not taxing capital gains, or taxing them at preferential rates, contributes more to the complexity of the tax system than any other single characteristic of an income tax system. As an American commentator has noted, providing preferential tax treatment for capital gains "is the single most important tax loophole that is responsible for turning a generation of dedicated law and accounting graduates into the greatest masters of needlepoint in the history of the law."

First, when the difference between capital gains and other types of investment income becomes very large, the pressure that tax avoiding taxpayers place on that border generates an almost endless variety and number of tax shelters. Complicated rules are needed to prevent such tax sheltering activity; to prevent taxpayers from churning depreciable property in order to convert tax-free capital gains into a deductible expense; to prevent taxpayers from converting taxable dividends into non-taxable capital gains; and, generally, to prevent high-income taxpayers who earn income from capital and who can obtain the advice of sophisticated tax planners from turning the income tax into a voluntary tax.

A second and equally important form of complexity that not taxing capital gains imposes on an economy is the additional complexity required in planning business transactions. Under a simple tax system, taxpayers can respond to economic incentives without having to consider the tax consequences of alternative ways of structuring their transactions. Since a capital gain has no economic reality - it is merely a legal construct - taxpayers are often able, with the assistance of expert advice, to recast transactions so that, without changing their economic reality, they are able to attract capital gains tax treatment. This type of "transactional complexity" in the tax law has a number of serious costs: it diverts the attention of corporate managers away from effective management strategies, and investors from the economic advantages of alternative investments, to concerns about the tax consequences of alternative ways of implementing their decisions; it has a demoralizing effect on taxpayers who are unable or unwilling to play the game; it permits affluent taxpayers to play the tax audit lottery by giving themselves the benefit of any legitimate or even minimal doubt in all borderline transactions, and then hope they will not be audited and that if they are audited that they will be able to rely on the uncertainty created by the complexity of the law to avoid a charge of tax evasion; and, this type of transactional complexity leaves open the opportunity for corruption in the administration and the practice of tax law. In summary, distinctions in tax law, such as that between ordinary income and capital gains, that allow for different tax treatment for the same economic results depending on the form of the transaction, leads to serious transactional costs.

Thirdly, a tax system in which capital gains are not taxed is extremely difficult to administer fairly because it means that the tax department is not receiving full information about many important transactions taking place in the economy. Of course, a tax on capital gains will result in some taxpayers having to collect, retain and submit more information to the tax department. However, since the tax generally only affects a small number of taxpayers, and most of those who are affected will be sophisticated investors who would in any event be collecting and retaining this information, the additional compliance costs are minimal.

Instead of itemizing other ways in which the non-taxation of capital gains contributes to the complexity of the tax system, I will simply rely upon the authority of Boris Bittker, perhaps the most pre-eminent tax law commentator in the US. He has asserted that "the fact that long-term capital gains are subject to a lower tax rate than other types of income is perhaps the single most complicating aspect of existing tax law."

## II. The Myths Surrounding the Taxation of Capital Gains

### Myth #1: Some Percentage of Capital Gains Are Due Solely to Inflation and, Therefore, It Is Inequitable to Tax Them

It is sometimes suggested that even though it might be true that not taxing capital gains is inequitable and promotes economic inefficiency, this proposition only applies to the taxation of real capital gains. In fact, unless the income tax system indexes capital gains for inflation, gains that are purely nominal are taxed. This taxation of the inflation component of gains is unfair and justifies not taxing capital gains or taxing them at preferential rates.

It is the case that in an ideal tax world all income from capital and capital assets would be indexed for inflation, however, no major industrialized country has introduced comprehensive tax-base indexation and they are unlikely to do so. It is too technically difficult, and furthermore, because of aspects of the foreign tax credit and the tax treaty system, it would require a degree of international cooperation that is unlikely to be achieved in the immediate future. Moreover, if income from capital were comprehensively indexed for inflation, the amount of interest expense that taxpayers could claim would likewise have to be reduced by the rate of inflation. Many taxpayers, particularly heavily leveraged corporate taxpayers, would actually see their tax liabilities increase, not decrease, under a comprehensively indexed tax system. Therefore, so long as the rate of inflation is kept within reasonable bounds there has been little pressure on governments to index income from capital for tax purposes.

So the issue with respect to capital gains must be stated as, given the absence of comprehensive indexation for income from capital does it make sense to provide tax relief for capital gains as a crude proxy for indexing the tax base of capital property for inflation? A number of reasons would suggest not.

First, under a tax system in which capital gains are only taxed when they are realized, even if they are taxed at full rates capital gains receive extremely favourable tax treatment since taxpayers can choose when to pay tax on their capital gains by deferring the sale of their capital property. To the extent that taxpayers can defer paying tax on capital gains by deferring the sale of their capital property, they have received, in effect, an interest-free loan from the government in the amount of the tax they have been able to defer. For almost all historical periods (at least in Canada and the US), the value of this deferral advantage has more than offset the tax payable on nominal gains.

Second, many taxpayers who realise capital gains will have financed the acquisition of their capital property with debt. Consequently, they will experience two competing effects of inflation. On the one hand, their real economic income will be less than their purely nominal income because the real value of their capital property will be diminished by inflation. But, on the other hand, they will enjoy economic income from the shrinkage in the real value of their repayment obligations. In theory, if a taxpayer's debts equal his or her investment assets, inflation's under-measurement and over-measurement of taxable income will approximately balance. More generally, it would not make sense to allow investors who borrow to finance investments to deduct the inflation component of their interest expense, while avoiding tax on the inflation component of gains.

A third consideration that suggests the tax system should not contain indexation only for capital gains - or a proxy for it in terms of the non-taxation of capital gains - is that the recipients of all forms of income from capital suffer an extra tax due to inflation, including for example, savings account depositors. It would seem grossly unfair not to tax the nominal gains of those realizing capital gains, but to tax the nominal gains of those realizing interest income, particularly because many capital gains will be unanticipated, heavily concentrated among upper-income individuals and, unlike interest income, will have benefited from deferral.

Finally, it is worth noting that in most countries all sorts of government payments are not indexed for inflation, for example, children allowances and social assistance payments. It seems incongruous to be concerned about sheltering from inflation a single group made up primarily of affluent owners of capital assets while millions of other victims of inflation go unprotected. Does it really make sense to index a country's tax and transfer system starting at the top?

## Myth #2: Taxing Capital Gains Locks Investors into Relatively Unproductive Investments and, Therefore, Prevents Financial Capital from Flowing to Its Most Highly Valued Use

Those who argue in favour of not taxing capital gains, or of giving them preferential tax treatment, argue that while not taxing them might lead to some misallocations of resources, taxing them leads to an even more serious efficiency problem, namely, the locked-in effect. With a capital gains tax, investors will be discouraged from seeking investments they think will earn them the highest rate of return because they will have to pay tax on their capital gain if they sell their existing holdings and consequently will have less capital to re-invest.

Two issues must be resolved in assessing the seriousness of the locked-in effect that is created by taxing capital gains on a realization basis. First, to what extent does the locked-in effect actually influence investors behaviour? Second, to the extent that it does, what affect does it have on economic efficiency?

On the first issue, in theory, whether the lock-in phenomenon actually influences investors is speculative. However, it is important to note that even in theory it has no or little effect on many investors: it obviously has no application to tax-exempt institutions such a pensions funds; it does not apply in those situations where shareholders are forced to liquidate their investments because of a merger or acquisition; investors who have large diversified portfolios are unlikely affected by it since they will normally have some capital losses from which they can offset gains; it likely has little affect in those cases in which the taxpayer liquidates for the purposes of consumption; it does not apply to situations where a business is selling assets and acquiring similar assets since most tax systems provide a rollover for these transactions; it does not apply with much force even in theory in those cases where the gain on the assets is not great; and if the capital gains tax provides for a deemed disposition on death it has little significance to elderly taxpayers.

Thus, even in theory, the locked-in effect only applies to a relatively small percentage of total capital assets. For those investors who might be subject to the locked-in effect, since theory is not determinative, the resolution of the issue must be left to empirical studies. There have been countless such studies in the US, both cross-sectional and time-series studies. Not surprisingly, the studies reach contradictory results. However, the weight of the empirical evidence suggests that the level of taxation has little affect on the rate of realizations. Even those individual investors who in theory might be affected by the locked-in effect appear willing to continually seek investments they think will yield high rates of return.

Also, even to the extent that some American studies find evidence of the locked-in effect, they do not have much relevance to most other countries since, in part, they reflect the somewhat peculiar structure of the rules for taxing capital gains in that country. In particular, the results reflect the fact that in the United States there is no deemed realization of capital gains when a taxpayer dies and the basis in the transferred property is stepped up to its fair market value in the hands of the beneficiary. Consequently, by holding on to property until death, taxpayers can avoid the capital gains tax entirely. If there is a lock-in problem in the United States it is undoubtedly attributable, in large part, to this rule.

But even assuming that when capital gains are taxed some investors are reluctant to sell their investments because they will have to pay capital gains tax, a second issue that must be resolved before giving any weight to this argument for not taxing capital gains is what effect does this locked-in effect have on economic efficiency. Although there have been no helpful empirical studies on this issue it is difficult to see how, in theory, under any circumstances, the so-called locked-in effect could have other than a trivial effect on economic efficiency.

Those who make the argument about the adverse effect of the locked-in effect contemplate a situation where investors are locked into investments that yield a low-rate of return and in which they think they can earn a higher rate of return with other investments. But even in this case, economic inefficiency will result only if the person who is locked into an investment has special knowledge of a more lucrative alternative investment. Otherwise, the person to whom they propose to sell their present investment would invest in the more attractive investment. That is to say, it is difficult to see how capital formation can suffer much because some investors have capital locked into particular investments. While those investor’s funds might be tied up, the persons who otherwise might have purchased their investments now have funds available to use elsewhere. There are, of course, investors on both sides of every stock market transaction. And while individuals have varying investment aspirations and abilities, generally it is likely that potential buyers of a locked-in investment would use their available funds for much the same uses as would the locked-in investor. Consequently, given a sufficiently large pool of investment capital, the locked-in effect is unlikely to have any effect on the aggregate investment in particular firms.

Illustrations of individual investors who are locked into investments under a capital gains tax are misleading. The malady of the locked-in effect is the inefficient allocation of resources it is said to create in the aggregate. With the existence of large institutional investors such as pension funds to whom the locked-in effect cannot apply even in theory, and a large number of individual and corporate investors, it is difficult to imagine there are significant unexploited profit opportunities in capital markets that can only be eliminated by unlocking a relatively few individual investors by not taxing capital gains. Put another way, even if not taxing capital gains could mitigate the locked-in effect somewhat for a small number of individual investors, it is hard to imagine that it would, therefore, discernibly increase the efficiency with which capital is allocated.

The debate over the economic consequences of the locked-in effect normally focuses on individuals' purchasing securities. Economic efficiency requires that each security be held by the individual who thinks it will yield the highest rate of return. The locked-in effect may cause some investors to refuse to sell a security even though some other investor values it more. Again, even on the assumption that this might be the case in some instances, many analysts would question whether the economic consequences are very serious. Particularly in the past few years, it would appear that the gyrations of the stock market have little effect on the real economy. That is to say, there does not appear to be much relationship between the performance of the stock market (whether affected by a tax on capital gains or not) and the investment and production decisions of corporate managers.

Finally, it is worth noting that some tax analysts argue that the locked-in effect actually enhances efficiency because it reduces the incentive for excessive trading of financial assets for short-term gain and causes investors to focus on long-term productivity. Moreover, even if a capital gains tax creates a locked-in effect to which some investors are subject, the only solution is not to remove the tax. Any locked-in effect only exists because capital gains are only taxed when they are realized and not when they are earned. So simply ensuring that investors are required to pay tax on their accrued gains from time to time solves any locked-in problem. Deeming all capital property to be disposed of upon death is one obvious such rule.

The one area where the locked-in effect might conceivably have some adverse economic effect is with respect to small owner-managed firms that have experienced substantial growth. In the life cycle of some such firms, the owner-manger is no longer the appropriate person to continue to develop the firm. However, he or she might be reluctant to sell the firm because of a large capital gains liability. Even assuming some cases of this kind, it is doubtful if it presents very serious problems to the economy in the aggregate. Nevertheless, it is to cover this kind of case that some income tax legislation provides rollovers for the exchange of shares or provides for some limited ability to defer the payment of tax on the sale of a small business.

## Myth #3: Taxing Capital Gains Will Lead to a Reduced Rate of Personal Savings and, Therefore, a Less Productive Economy

Some commentators have expressed concern about the effects of a tax on capital gains on private savings in South Africa. If a tax on capital gains is to reduce savings, it must do so by decreasing the after-tax rate of return to saving. In fact, a tax on capital gains will only reduce the return to capital slightly and, in any event, the economic evidence is reasonably clear, private savings appear largely unaffected by the rate of return.

I do not know what the average annual rate of return to capital is in South Africa nor what percentage of this return accrues in the form of capital gains, but assuming that it is similar to other industrialized countries, only about one-third of the return to capital will be capital gains. Thus the tax will fall on a relative small percentage of the total return to capital and consequently decrease the after-tax rate of return to capital only slightly. Any tax concession designed to increase personal savings should be available to the returns from all forms of savings.

But even more fundamentally, this argument for not taxing capital gains assumes that an after-tax decrease in the rate of return on savings will decrease savings. In fact, the theoretical and empirical economic literature is reasonably clear on this issue: the rate of savings is relatively insensitive to the rate of return on savings. The evidence from common sense and experience is even clearer. As a matter of common sense, when people make a decision to save they generally make that decision based upon their consumption decisions and other needs and then to the extent that they have any savings, look to where they can earn the highest rate of return. That is, the rate of return they can earn generally does not influence their decision to save. The evidence from experience points in the same direction. The rate of return that can be earned on savings, that is the interest rate, varies considerably over time and from country to country. Yet, the rate of savings over time and between countries bears no relationship to variations in interest rates.

By way of specific illustration, although any inference about causation is undoubtedly confounded by other variables, in the US over the past 25 years, each time the capital gain rate of tax has been cut, in the period following such cut the rate of household savings has fallen.

Also, of course, what matters for a country's investment is not just the level of personal and firm savings (private savings) but the level of national savings, which includes government savings - its budgetary surplus and deficit. There can be no question that the best evidence would suggest that if South Africa is concerned about the rate of national savings, taxing capital gains and using the revenues to pay down the deficit and public debt would be a much more effective policy instrument for achieving that result than leaving capital gains untaxed.

## Myth # 4: Taxing Capital Gains Will Lead to Less Investment and, Therefore, Will Lower Productivity and Lower Wages

Some commentators have suggested that not taxing capital gains increases the amount of real investment, in plant and equipment for example, in the economy. However, not taxing capital gains can only increase real investment if it reduces the user cost of capital to firms. It can only reduce the cost of real investment to firms if it reduces the cost of raising equity capital for firms so that they can raise financial capital more cheaply by issuing new shares and then using that capital to make real investments. However, in a small open economy, like South Africa's, in which large numbers of domestic investors are investing in overseas companies, and large numbers of foreign investors are investing in South Africa, and in an economy in which there are a large number of tax-exempt investors, such as pension funds, it is almost certain that the government cannot do anything by way of giving tax breaks to individual South African investors for investing in the equity shares of domestic companies that will affect the cost of capital to those firms. In effect, their costs of raising capital are being set in international financial markets, not domestic markets.

Even assuming that a tax on capital gains might increase the user cost of capital, that is not the end of the story in determining what effect that might have on economic growth. Popular discussions of the tax on capital gains have assumed an almost direct link between the tax on capital gains and the level of capital formation. However, there are, in fact, at least three links in the argument from higher taxes on capital gains to reduced capital investment and reduced economic growth: the effect of the tax on capital gains on the user cost of capital (that is, the opportunity cost of capital - normally determined by taking into account the depreciation in the value of the capital asset purchased and the real rate of return given up by investing in the asset); the effect of the user cost of capital on capital formation; and, the effect of capital formation on economic growth. Each of these relationships are weak. A tax on capital gains does little to increase the real financial cost of capital, and the real financial cost of capital component of the overall user cost of capital is generally much less significant than the depreciation component. Even if the tax does increase the cost of capital somewhat, an increase in the cost of capital will only reduce capital formation by some fraction of the increase in the cost of capital. In turn, an increase in the capital stock of a country will only increase economic output by some fraction of that increase. If these three fractions are multiplied together, you get, of course, an even smaller fraction. While I have not assigned any estimated elasticities to these relationships, under any reasonable assumptions, the result is that the estimated effect of increasing the tax on capital gains on economic output is negligible.

## Myth #5: Taxing Capital Gains Will Discourage Entrepreneurship and Risk-Taking

Many of those who support giving preferential tax treatment to capital gains, or not taxing them at all, concede that tax policy considerations alone would suggest that capital gains should not be given preferential tax treatment, but then go on to argue that such a tax preference is necessary in order to deliberately channel savings into risky investments that yield capital gains. They argue that the economy will not have the optimal number of smaller, riskier businesses, or start-ups and high-technology businesses if capital gains are taxed. The argument has two components: first, that a subsidy for capital gains is necessary to encourage entrepreneurship, that is, to encourage individuals to start new businesses; and second, that it is necessary to encourage other individuals to invest their capital in such enterprises. Thus, the incentive provided by not taxing capital gains is thought to deal with the problem of encouraging new enterprises on both the demand- and the supply-side.

This argument is without merit, for the following reasons.

First, to state the question rhetorically - what is so great about financial risk-taking? There is no reason a priori to think that risky investments are more productive than prudent ones. Given the enormous rates of return that taking some financial risks obviously yield, why cannot market forces alone be left to decide where financial capital should flow? Why is there a need for an industrial policy in the form of an enormous subsidy for those who realize capital gains to encourage risk-taking?

A slightly more contentious way of putting this question is to ask why investors risking their financial capital should get a subsidy but not wage-earners risking their human capital? Risk-taking is one of the traditional justifications for the existence of capitalists. Why should they have to be subsidized by workers for simply discharging the responsibility that gives them their legitimacy in a market economy and that results in many of them earning extraordinary returns on their investments?

Second, even if the government should intervene in the marketplace to divert financial capital to risky investments, providing a subsidy for capital gains is not an effective way of achieving this objective. One reason that a capital gains subsidy can do little to increase venture capital investment is that funds from individuals who might benefit from the subsidy make up a small percentage of the funds available to venture capital in most countries. In the US, the country for which the best data is available, venture capital funds financed by individuals make up less than 20% of the total available venture funds. The rest comes from tax-exempt pension funds, corporations and foreign investors unaffected by the tax rates that individuals face. Thus reduced taxes on capital gains could have only a small effect on the supply of venture capital funds. There are much more effective ways of achieving this objective.

A third reservation about attempting to encourage risk-taking by providing a subsidy to investors who sell capital property is that such a subsidy is ridiculously target-inefficient. It is both over- and under-inclusive. On the one hand, it benefits many investments that do not involve the taking of risks. Indeed, many of the assets that benefit from capital gains are non-productive or are assets whose supply is inelastic. A prime example is speculation in unimproved land. Since land is a commodity whose supply for practical purposes is fixed, a higher price does not bring forth any additional supply. Thus the effect of increasing investment in land by not taxing capital gains is largely just to increase the price that those who might put the land to productive use have to pay. In Canada, in the 1980s, about one-half of the capital gain subsidy went to sellers of real estate and helped drive a real estate speculation boom that eventually burst and caused untold social waste as large commercial and industrial buildings sat vacant or partially vacant.

Although land is the most obvious case of an investment that unjustifiably benefits from the capital gains subsidy, examples of other types of such assets include art works, antique furniture, precious metals and gems, currency, short-term financial instruments such as options and futures, commodity futures, and foreign securities.

Even if the subsidy could be restricted to corporate stock, in the United States it has been estimated that venture capital accounts for only a trivial percentage of all capital gains realised on the sale of shares. When only a microscopic part of the total subsidy for capital gains goes to risky investment for which there might be some justification for subsidization, what are those who argue that capital gains must be given preferential treatment in order to encourage risk-taking thinking? Somewhat ironically, they are likely to be the same people who complain about the target inefficiency of direct government spending programmes.

Fourth, supporters of the capital gains preference also maintain that the capital gains preference is necessary to provide incentives to the entrepreneurs and managers who create the demand for venture capital investment. However, most entrepreneurs are driven by the attraction of such truly spectacular gains that they are unlikely to be deterred by even a substantial tax on their possibly large payoffs. It seems highly unlikely, for example, that the entrepreneurs who profited from the microcomputer revolution would not have been motivated if they thought they would only make tens of millions instead of hundreds of millions of dollars. Morever, a capital gains tax imposed on a realization-basis has only a small effect on the annual rate of return earned by an entrepreneur. For example, with an annualised pre-tax rate of return of say 75% over ten years, a 50% tax on a realisation basis would reduce the annual rate of return by only about ten percentage points per year. Are may entrepreneurs likely to abandon their expansion plans if they reckon they can only earn a 65% annualized rate of return instead of a 75% rate? It seems worth noting that the massive high tech investment in Silicon Valley in the US was made in the late 1980s and early 1990s when there was no special tax rate for capital gains.

Finally, because of other tax rules that are necessary if capital gains are not taxed, even conceding the reservations expressed above, it is not obvious that the taxation of capital gains would reduce the propensity to take risks. Most significantly, if capital gains are not taxed, then capital losses cannot be deducted. This substantially increases the downside cost of a risky investment. If capital gains are taxed, and capital losses deductible, then the government reduces the downside cost of taking risks by sharing in the investors' losses. And because the government is willing to share the risk, the individual is willing to increase his or her risk taking.

Standard economic reasoning does not demonstrate that increased taxation reduces the willingness of individuals to undertake risky investments and it is significant that to date there is no consensus in the empirical literature regarding the relationship between higher tax rates and the propensity to incur risks. Moreover, there is little evidence in history to connect periods of technical advance with lower tax rates or even high rates of return. The anecdotal evidence strongly suggests that innovators are driven by other than monetary incentives.

## Myth #6: Taxing Capital Gains Will Adversely Affect Small Family Businesses and Family Farms

The argument that small family businesses and farms will be adversely affected by a tax on capital gains is frequently played as the trump card in the case against taxing capital gains. Here I will simply make a number of somewhat random comments on this argument by way of illustrating that it has little force.

First, truly small businesses owners never realize capital gains. Their businesses consists essentially of their own labour and knowledge and that of a relatively few employees. To the extent the business has value because of the goodwill it generates it attaches to the personal services of the owner. The only valuable assets in the business might be land and buildings. There isn't any reason the small business owners of land and buildings should be treated any differently than anyone else who owns land and buildings.

Second, a witness yesterday suggested that the problem with introducing a capital gains tax at this time is that it will leave those taxpayers who have build up their wealth in the past untouched, but make it more difficult for others to accumulate wealth. This is wrong on two counts. On the one hand, a tax on capital gains will be imposed on those who hold wealth by taxing all returns to their wealth. Without a capital gains tax their wealth will be able to continue to accumulate tax free. On the other hand, a tax on capital gains will not affect most people's ability to accumulate wealth because the vast majority of middle-income families accumulate their wealth by saving a portion of their business income or wages. That is, labour income is the source of most wealth held by middle-income families, not capital income. If capital gains are not taxed, it means that those who labour for their living, or who operate small businesses, must necessarily pay more tax on the source of their savings. Thus, precisely the opposite to what was argued, not taxing capital gains makes it harder for them to accumulate wealth.

Third, reference was made yesterday to the $500,000 lifetime capital gains exemption for shares of small business shares in Canada. The explanation of why this exemption was introduced in the income tax system, and why it remains, is long and involved. However, it has absolutely nothing to do with good public policy. No one defends it as a sensible subsidy for small businesses (except those who benefit from it). It has cost billions and billions of dollars of lost revenue, it has benefited almost exclusively some of the wealthiest Canadians, it is subject to constant abuse through tax avoidance gimmicks, and it has done nothing to generate more small businesses in Canada. I do not have the exact figures with me, but an empirical study done a few years ago found that it generated only a trivial amount of new investment. The obvious problem with all of these kind of government subsidies, is that in order to encourage a few more entrepreneurs to start a small business, for example, the subsidy has to be given to all small business people, even though they would have started a small business without the subsidy, or even though they are already operating their own small businesses. That is to say, even though the subsidy is justified in order to change the behaviour of the person who is on the margin of starting a small businesses or not, it has to be given to all small business people. To make matters worse, the evidence suggests that there are very few people on the margin of trying to decide whether to start a small business who can be influenced by a tax break they might not realize until they sell their business thirty years later. The time horizon for most rational people simply does not extent that far. In terms of public policy analysis, such a tax break is ridiculously target-inefficient. The government ends up spending billions of dollars of lost revenue to generate a few million dollars of new small business investment.

Fourth, the contribution that small or new businesses make to growth of output or employment tells precisely nothing about whether small businesses should be subsidized by exemptions from capital gains or about whether too much or too little is now invested in such companies. Whether too much or too little is now being invested in small businesses depends on whether the expected rate of return to such investments is greater or less on the margin than is the rate of return on other investments.

Fifth, just to elaborate slightly on why an exemption from tax on capital gains is almost never a sensibly designed policy instrument. In Canada farmers also receive the $500,000 capital gains exemption. Just on its face, think how silly this is. In effect, it is a subsidy for farmers in the amount of the tax that they would otherwise pay on $500,000 of capital gains when they sell their farm. However: (1) In order to receive this subsidy, farmers have to sell their farm. Surely that is odd. A sensible subsidy for farmers would presumably be transferred to them while they were farming. (2) The amount of subsidy they receive is totally unrelated to their productivity as farmers. Indeed, in Canada, almost all of this subsidy is realized by farmers who happen to have the good fortune to be farming near a large urban centre and are able to sell their farm to a land developer or for a golf course. (3) The subsidy is subject to an enormous amount of abuse. Many of the “farmers” who benefit from it operate their farms from investment towers and law offices.

The point of all of this is that not taxing capital gains, or certain capital gains, as a policy instrument for achieving even a legitimate government objective is almost always wrong-headed.

## Myth #7: Taxing Capital Gains Will Discourage Foreign Direct Investment

The myth that taxing capital gains will discourage foreign direct investment is easily discredited, for two reasons. First, non-residents seldom pay tax on capital gains in the host country. If they are foreign portfolio investors, they will be exempt from the host country’s tax on capital gains. If they are foreign direct investors, their gains will normally take the form of income from business. Even if they pay some tax on capital gains, inevitably they will obtain a credit for the tax in their home country, hence, in such cases not taxing the capital gains of non-residents would simply amount to a tax transfer from the host country treasury to the home country treasury.

Second, taxes are not a major determinative of foreign direct investment. Foreign direct investment is attracted to countries by market size, agglomeration economies, a skilled and reliable work force, stable governments, and to a lesser extent by cost and fiscal factors. This finding is not counter-intuitive. Whatever taxes a company pays in the host country are usually dwarfed by labour, transportation, marketing and other costs. Moreover, most companies find that the public services that taxes pay for in the host country are good value, such as good quality transportation and communication systems, a highly trained work force, a professional civil service, security, and liveable cities.

## Myth # 8: Taxing Capital Gains Will Raise an Insignificant Amount of Revenue

One of the arguments frequently made against taxing capital gains is that the small amount of revenue such a tax will raise will not exceed even the additional costs of collecting the tax. This argument is surely wrong.

Including capital gains in the income tax base does raise a significant amount of tax directly. In Canada, the capital gains tax has relatively consistently raised revenues equal to about 1.5% of the total revenues raised through the income tax. In 1996 this amounted to over $1 billion of revenues. This is not a huge sum, but to put it in perspective, the Canadian government could easily fund a decent earlier childhood education program with $1 billion dollars a year. Parenthetically, one way to think about a tax on capital gains is to ask whether a country is more likely to set itself on a path to long-term productivity and social cohesion by providing a

$1 billion subsidy for a relatively small number of very wealthy investors and speculators or by providing the same amount for the care, education and well being of children. As a thought experiment, imagine that the money was being spent for early childhood education. Would a proposal to de-fund this program and use the money for a subsidy that would benefit almost exclusively the richest 1% of citizens in the country ever be given serious consideration?

It is, of course, difficult to draw conclusions about how much revenue the capital gains tax will yield in South African based upon the experiences of other countries because the distribution of capital property, the definition of a capital gain and the exemptions from the tax, among other variables, vary enormously from country to country. Nevertheless, in a country with a relatively unequal distribution of wealth, in which capital gains have traditionally been defined very broadly based upon the English common law cases, and in which the exemptions from the tax are relatively narrow, one might confidently predict the revenues will be substantial.

But, aside altogether from the direct taxes that are raised by including capital gains in the income tax base, the more important revenue effect of a tax on capital gains tax is that it serves as an important backstop to the rest of the tax system. When the tax rate on capital gains is low or zero, tax lawyers expend an enormous amount of time and ingenuity on transforming ordinary income into capital gains. It would be surprising, and an incredible fraud on their tax planning clients, if to some degree at least they were not successful. At the very least, when capital gains are not taxed, or taxed at very low rates, one would expect individuals to shift their investments from dividend paying investments to investments earning capital gains. Corporations would reduce their payout ratios. Owners of closely-held corporations would attempt to realize more of their earnings in the form of capital gains than salary.

Although some research has been done on what might be described as the payout/recharacterisation/portfolio response of a preferential tax rate on capital gains, it is still extremely tentative. Nevertheless, a tax on capital gains clearly results in more revenues being collected not only directly and but also more revenues being collected from other sources of income as taxpayers will convert less of these types of income into capital gains and also because taxing capital gains will reduce opportunities for income tax evasion.

Although it is clear that a zero rate on capital gains will result in no revenue, and a substantial loss of revenue as other forms of taxable income are converted into capital gains, there is an ongoing debate in the American tax literature as to the rate of capital gains tax that will maximize revenues. Indeed, in recent years, the issue that has dominated discussions of capital gains tax policy in the US has been the revenue consequences of raising or lowering taxes on capital gains. There has been a division of opinion over whether a lower tax rate for capital gains would produce more revenue directly by encouraging people who have been deterred by high rates to “unlock” their unrealised appreciation in assets. The contentious issue is how sensitive are capital gains realisations to tax rates?

Based upon a large number of studies, the answer seems to be that no one knows for sure, but that the better opinion is that while people might react to a tax rate change, there is little evidence that the level of taxation affects the realization rate. So that if a tax rate change were made, there might be a blip in revenue as people unlock investments they held under the prior rate, but in the long-term people will trade their securities by about the same amount as they did when the rate were higher. Consequently, the higher the rate of tax on capital gains the greater the revenue - within reasonable bounds of course.

## Conclusion

Although I have only been able to review the draft South African proposed legislation including capital gains in income rather quickly, compared to such legislation in other countries one cannot help but be impressed by its clarity, conceptual rigour and comprehensiveness. Hopefully, it will serve as a model for other countries. Naturally, the inclusion rate should be much higher and the exemptions fewer, but as it stands it will greatly improve the fairness of the South African income tax, the efficiency of the economy, and reduce the transactional complexity of the tax system. The case against including capital gains in income is built upon a stunning combination of flawed economic theory and social indifference to the fairness of the tax system and economic inequality.