1 Capital gains taxes in Canada

The case for the elimination of capital gains taxes in Canada

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Introduction

In this part of *International Evidence on the Effects of Having No Capital Gains Taxes,* I present theoretical arguments about the economic benefits and costs that may be expected to arise from the elimination of the capital gains tax in Canada. I also consider the effects of such a policy on the distribution of income and on the incentives by taxpayers to shift taxable income into non-taxable capital gains.

Throughout the chapter, I refer to material contained in the papers printed in Parts 2 and 3 of this volume and presented at the 2000 Fraser Institute Symposium on Capital Gains. My chapter concludes with the case for, and the case against, the full indexation of capital gains. In doing so, I summarize the main findings from some of the papers found in Part 2.

Optimal tax theory and capital taxes

The economic theory of optimal taxation was developed during the last 25 years and the Oxford economist James Mirrlees received a Nobel Prize for his contributions to this body of knowledge. This theory argues that the economic cost of taxation is higher the more easily the tax can be avoided by those required to pay it. By these

standards, the capital gains tax is the worst tax of all. Taxpayers can avoid paying it simply by not realizing their capital gains. They can reduce their level of savings and invest in assets with low probabilities of generating capital gains. Foreigners, especially Americans, keep their assets at home or come to Canada only if the pre-tax returns make up for the taxes they have to pay.

All of these tax-induced changes reduce the rate at which gains in labour productivity—and, therefore, living standards—is increased. Capital that is "locked in" earns lower economic returns. Less investment by Canadians and foreigners reduces labour productivity directly and slows the introduction of new technology embodied in capital. Less investment is made in high-risk projects and the engine of innovation and growth is starved.

The Canadian Department of Finance has published estimates of the losses in output resulting from an extra dollar of tax. Unfortunately, the estimates do not include the capital gains tax but the corporate income tax may stand as a proxy for the capital gains tax since both fall on the capital and create very similar incentives and opportunities to avoid them. The estimates, published by the OECD (1997), suggest that an extra dollar raised by the corporate income tax costs $1.55 in output. The analogous figures are $.56 for the personal income tax, $.27 for the payroll tax and only $.17 for the sales tax. These data suggest strongly that the elimination of the capital gains tax and a simultaneous increase in other taxes to maintain total revenue would cause national income to increase—and lead to overall higher tax revenues as people with higher incomes paid more taxes.

How big is the effect on output?

It is very difficult, however, to make reliable, reproducible, quantitative estimates of the direct effects of capital gains taxation on productivity and living standards. In Canada and other economies there are too many other influences operating on productivity and output. These confounding influences are a function, for example, of the level and structure of the personal and corporate income taxes, the effects of terms of trade, environmental legislation and other regulations, labour market flexibility, inflation, interest rates, and

shocks like the energy crisis. There are not enough observations and too few changes in the rate of taxation, and the interrelationships are too complex to permit separating out the effects of high capital gains taxes on economic growth in Canada.

However, there are two ways, less rigorous but still useful, to shed light on the empirical effects of capital gains taxes on economic performance. The first involves the judgement of persons who have access to input from a wide range of practitioners. The following quotations are from two distinguished persons in this position.

> The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital . . . the ease or difficulty experienced by new ventures in obtaining capital, and therefore the strength and potential for growth in the economy.
>
> *President John F. Kennedy, Special Message to the Congress on Tax Reduction and Reform, January 24, 1963 (quoted in Joint Economic Committee 1999)*

> The point I made at the Budget Committee was that if the capital gains tax were eliminated, that we would presumably, over time, see increased economic growth . . . Indeed, its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero.
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> *Federal Reserve Chairman Alan Greenspan in testimony before the Senate Banking Committee on February 25, 1997 (quoted in Joint Economic Committee 1999)*

The second method for obtaining information about the effect of capital gains taxation on economic growth is to consider the experience of countries with different capital gains tax regimes. Simple and imperfect as the evidence might be, it is interesting to note that according to my own calculations (Grubel 2000: 39), five countries without capital gains taxes (Hong Kong, the Netherlands, New Zealand, Singapore and Switzerland) during the years 1990 to 1997 had average annual rates of growth in real per-capita income equal to 2.2%. The remaining member countries of the OECD grew at only 1.2% annually during the same period.

Objections to abolishing the capital gains tax

If we accept the evidence that the abolition of the capital gains tax will increase economic growth in Canada, what are the objections to this policy? I discussed these objections in *Unlocking Canadian Capital*. Below is a summary of my findings, supplemented by new information obtained through the recent symposium and the papers in this volume.

What effect on revenue?

The first justification for capital gains taxes is that they are needed to raise revenue and thus permit lower taxes on personal and business income and sales (the GST). This justification is valid only in a static view of the world. In fact, in most countries, lower capital gains taxes have increased the realization of capital gains and thus resulted in higher revenues. The evidence on this process is very strong for the short run but many analysts insist that it also works in the longer run because of the effect of lower capital gains taxes on economic growth.

The higher growth rates of countries without capital gains taxes discussed above imply that if Canada abandons the tax, revenues from other taxes will eventually increase enough to compensate for the lost revenues. According to our estimates explained in table 1 of Grubel (2000), the 1992 capital gains tax revenues were only $716 million or 0.3% of all Canadian government revenues of $277.5 billion. Therefore, if the elimination of the capital gains tax raises the *level* of income and, therefore, the tax base by a mere 0.3%, the losses will be wiped out and remain at zero into the indefinite future. If the rate of growth is raised, the losses will also be eliminated and surpluses will arise thereafter.

How likely is it that the elimination of the capital gains tax will bring such benefits? The data on OECD countries with and without taxes has already been presented above in support of the notion that growth will increase. However, the relevance of these data for Canada might be questioned because of the special characteristics of the countries without the tax. Hong Kong and Singapore are regarded increasingly as countries with such unique conditions that their experience is irrelevant for the industrial countries of the West. The success of the Netherlands is based on policies that

would be considered unacceptable in Canada and may well have brought only short-lived benefits.

Evidence from Switzerland by Kugler and Lenz

It is important, therefore, that the chapter by Peter Kugler and Carlos Lenz (p. 55) presents unique, powerful empirical evidence on the effect the elimination of the capital gains tax has had on income in Switzerland. According to the authors, the federal government of Switzerland does not impose a capital gains tax. However, most cantons in that country have had such taxes for some time but, in recent years, some of these cantons have eliminated the capital gains tax and others retained it. These conditions supply us with a rare opportunity in the social sciences, the equivalent of a controlled experiment. One sample of countries changes one policy while the control group of countries does not, all while other policies and external conditions affecting economic conditions in the country as a whole remain unchanged.

Kugler and Lenz calculated the trend in the economic growth rates of all cantons before and after the elimination of the capital gains tax. They then calculated average growth rates for two groups of cantons, one in which capital gains taxes remained unchanged and one in which they were eliminated. They found that the cantons that eliminated the capital gains tax enjoyed an average short-run 2.2% jump in the *level* of national income relative to the other group of cantons. In the longer run, the jump in income is 3.1%.

It is possible that the cantons increased their incomes simply as a result of drawing capital and labour from cantons that had retained the capital gains tax. If this is true, the higher output in the gaining countries is matched by lower output in the losing countries and overall Switzerland is no better off. Moreover, if the argument is true, the process involves the inefficient relocation of the resources and, therefore, an actual reduction in output of all cantons. The authors examined their data for evidence on such shifting of capital and labour and found none.

What about the effect of the removal of the capital gains tax on economic growth rates rather than levels? The authors note that the time series available to them is too short to estimate such an effect.

In spite of the limitations of the study of the Swiss experience, the results are consistent with so-called "supply-side economics"

and its hallmark "Laffer curve." According to this theory, it is not surprising that the recent tax cuts of Ireland, the United States and the continued low taxes in Hong Kong and Singapore resulted in more rapid economic growth than that experienced in countries with higher levels of taxation. The incentives to working, investment, risk-taking and innovation activated by lower taxes are almost certain to bring higher economic growth.

I believe that the available evidence makes a good case for the elimination of the capital gains tax in Canada. However, many economists and politicians argue against this policy because it is seen to have socially adverse effects on the distribution of income and it results in tax avoidance maneuvers as taxpayers attempt to shift taxable income into non-taxable capital gains.

What effect on income distribution?

The argument in favor of a capital gains tax has two aspects. First, it suggests that increases in the value of assets upon realization provide their owners with resources that can be used, just like higher salaries, interest, or dividend incomes, to raise consumption expenditures. Horizontal equity in taxation requires that all increases in spending power be taxed equally, regardless of their origin. This reasoning underlay the recommendation by the Carter Commission in the 1960s that a capital gains tax be imposed, using the catchy slogan "a buck is a buck." The Commission's report in turn drew on the academic analysis of Simons (1938) and Haig (1921), which made a theoretical case for a comprehensive definition of the taxable income base, which included capital gains.

The second argument in support of the capital gains tax rests on the principle of the "ability to pay." This seductive slogan is the rallying cry of the political left, which considers it self-evident that persons earning $100,000 a year can afford to pay a higher proportion of their income than those earning only $20,000. The argument from the "ability to pay" has resulted in the progressive income tax system in Canada. It forces high-income earners to pay more than 50% on marginal increases in income while those at the bottom of the scale pay no taxes at all or rates on extra income of only about 20%.

It is widely believed that only high-income earners make substantial capital gains on the grounds that lower income earners do not have savings to accumulate wealth and enjoy the capital gains it

can bring. For these reasons, the capital gains tax is believed to fall mainly on high-income earners able to pay it.

What arguments can be made in response to these justifications of a capital gains tax? First, the “buck is a buck” slogan is seen faulty by many because it does not distinguish an essential feature of capital gains that make them different from ordinary income. The following slogan makes this point succinctly: “tax the fruit of the tree but not the tree itself.” The idea that captial gains are different from income in this sense and, therefore, should not be taxed long dominated the tax policies of the United Kingdom and countries of its former empire like Australia, New Zealand, and Canada. The idea lost its grip only after the end of the second World War, when governments everywhere took on a much larger role in society. It was also used for a long time to fight against the imposition of a capital gains tax in the United States.

The economic analysis underlying this notion of “fruit and tree” is that taxation should fall only on sources of income that are not part of society’s future productive capital essential to the maintenance of living standard. Under this principle, it is all right to tax profits, interest, and dividends but not the financial and real capital that give rise to this income. In a world without inflation, all capital gains by definition are equal to increases in the present value of the future income stream flowing from the asset. Therefore, a capital gains tax reduces an economy’s productive capacity and the future stream of income.

In the presence of inflation, some capital gains simply reflect the higher cost of reproducing the capital. The taxation of such nominal capital gains reduces the country’s productive capacity even more severely than does the taxation of real capital gains. In addition, the taxation of such phantom capital gains is unfair since such a punitive confiscation of real property is inconsistent with the principles of horizontal equity and ability to pay.

The “fruit-and-tree” analogy and the fact that capital gains taxation reduces the stock of productive capital provides another explanation of empirical phenomenon, noted above, that countries without capital gains have larger capital stocks and correspondingly higher labour productivity and incomes.

Canadian politicians embraced the “buck-is-a-buck” slogan very happily when it first was developed in the Carter Commission

Report in the late 1960s. It allowed them to defend their support for the tax by appealing to an easily understood and populist idea. Public-choice theory explains why demands for such a tax bring large electoral support. The number of voters with incomes below average and without capital gains in the 1960s was much greater than the number of voters with high incomes and potential capital gains. In effect, the politicians offered voters with lower incomes a transfer of income at the expense of the "rich." The electoral success of the advocates of the tax led to its adoption in 1971. The same reasons that made the tax attractive to politicians in the first place prevent its elimination now. The conventional wisdom suggests that the number of voters with low incomes and no capital gains is much greater than that of voters with high incomes and capital gains. Therefore, no political party can expect to win with a policy proposal that violates the interest of the largest segment of the population.

How correct is this conventional wisdom? Simple statistics support it. Canadians with incomes of more than $100 thousand in 1992 represented 7.9% of all taxpayers. They paid 77.9% of all capital gains taxes. The remaining 92.1% of voters paid few or no capital gains taxes.

However, this figure and the conventional wisdom are incorrect for two reasons. First, the ownership of mutual funds has spread enormously in recent decades, especially among those with modest incomes. Canadian tax laws require that capital gains made as a result of the operation of mutual funds have to be reported and are subject to taxation in the owners' annual income-tax return. This tax burden tends to come as a complete surprise to most new owners of mutual funds. (It should be noted that the tax is not payable on mutual funds held in tax-exempt Registered Retirement Savings Plans). It is clear that the tax on the realized gains falls to a considerable degree not on the rich but on Canadians with modest and even low incomes, who in recent years have increasingly become the owners of mutual funds both in, and outside, their tax-sheltered retirement plans.

Second, income earners in the highest income bracket often have such high taxable income because in the particular year they realized large capital gains. Their other, normal income before and after the year in which they realized their gains often put them into the middle-income and even lower-income brackets. Here is how

this happens. Consider a person with a modest income, who has accumulated some shares and real estate to provide an income upon retirement. When such a person dies, the capital gains are deemed realized and the tax is due. Another example involves a person who owns a small business, like a restaurant or a garage. Upon retirement, the business is sold. After much hard work and plowing profits back into the business over a long time, the sale gives rise to a substantial taxable capital gain and tax obligation. Yet the often-modest income of the owners of such small businesses hardly qualifies them as "rich."

Capital gains arising from circumstances like these certainly are not in the conventional wisdom, which has it that capital gains taxes are paid by the very rich. The analysis in the preceding paragraph suggests that the elimination of the capital gains tax would not allow the "rich to get richer." Instead, it would permit many Canadians with moderate incomes to enjoy a higher living standard in their old age.

How important is the challenge to the conventional wisdom implicit in the above examples? Joel Emes at The Fraser Institute quantified the phenomenon, using statistics supplied by Revenue Canada for 1992 (SPSD/M 6.1). He subtracted capital gains from taxpayers' reported incomes and then classified these taxpayers according to the size of their remaining other income. He found that Canadians with such other income above $100,000 paid only 26.8% of all capital gains taxes. People with other incomes below $50,000 paid 52.1% of the total.

In sum, the equity arguments in favour of capital gains taxation—"a buck is a buck" and "ability to pay"—are politically appealing and explain why Canada enacted a capital gains tax. However, this appeal is reduced substantially by the little-known fact that the bulk of capital gains taxes is paid by people who have modest incomes and hold mutual fund shares. More important, many taxpayers have modest incomes in years other than the one in which they enjoy large capital gains. In addition, for anyone concerned about the absolute living standards of the low-income earners, "taxing the tree as well as the fruit" in the longer run reduces the living standards of the very people the tax is supposed to help.

I believe that for these reasons, the traditional equity argument in favour of retaining the tax has lost much of its validity and

political appeal in recent years as Canadians in increasing numbers have become capitalist holders of financial assets directly or through their pension funds. The political appeal has also declined along with the much-diminished rhetoric about social classes of workers and capitalists that occurred with the end of the Communist empires. Politicians might well be surprised to find strong electoral support for the removal of the tax, especially if they explain effectively the basic facts about who pays the tax and what effects it has on income in the longer run. The absence of public objections to the lowering of the tax in 2000 supports this conclusion.

What is the incidence of the tax?

Ideologues concerned about the distribution of income between capital and labour—one of the central concerns of Karl Marx—consider the capital gains tax to be beneficial because it reduces the income of capitalists and increases that of workers. According to Marx, such a redistribution of income is considered to be essential for economic prosperity since it raises spending on consumption by workers and reduces the savings of capitalists. These results prevent the regular crises of unemployment brought on by overall under-consumption and too much saving. It also prevents imperialism and the opportunity it brings for industrial countries to unload surplus production on developing countries and thus prevent over-production and unemployment—while destroying the indigenous industries of these countries.

The idea that capitalism is prone to unemployment crises due to too little spending has been made respectable by Keynesian economics and still dominates the thinking of the political left in Canada. It is used to argue in favour of higher taxes on the rich and capitalists and more government spending to raise the income of the lower-income classes and workers.

At the first (1999) Fraser Institute symposium on capital gains taxation, Professor John Chant pointed to a puzzling phenomenon in the theory of tax incidence. Public-finance textbooks make much out of the proposition that tax burdens often are shifted away from producers and sellers of products and in the end are borne by consumers. For example, a tax on the sale of wood products may appear to lead to lower incomes for their producers. In fact, almost all of the cost of the tax is passed on to consumers through higher prices of the goods.

Chant pointed out that these same books do not apply an equivalent analysis of the incidence of the capital gains tax. Yet, if they did, it would be obvious that the traditional incidence model produces clear and simple results for a small country. Since Canada is a small country and capital is imported freely, the rate of return on capital is set abroad. Now, if the government of Canada imposes any tax on the holders of capital—including a capital gains tax—returns in Canada are lowered below the world level. Foreigners refuse to accept the lower rate and Canadians shift more of their capital abroad. As a result, the stock of capital in Canada is lowered and pre-tax rates of return increase correspondingly until post-tax rates of return reach those prevailing in the rest of the world.

In this new equilibrium, the capital per worker in Canada is lower than it was before the tax was imposed. The lower capital endowment reduces the productivity and, therefore, the income of workers. Through this process, the tax on capital ends up being borne by workers, which is not at all the effect desired by the ideologues mentioned above who want the capitalists' share of income to be reduced to assure higher spending on consumption. And, it certainly is not the effect desired by those who are concerned about the absolute standards of living of workers at all levels of income.

Professor Zane Spindler, who participated in both Fraser Institute symposiums on capital taxation, recently has entered the debate over the institution of a capital gains tax in South Africa (Spindler 2001). He uses a model based on the incidence analysis just presented to show how a capital gains reduces the stock of domestic capital. He then goes on to argue that this lower capital stock has two additional negative effects on welfare not accounted for by the lower labour productivity associated with the smaller stock of capital per worker.

The rigorous analysis of these additional costs is too technical to be presented here. Suffice it to note that one of these effects is what economists call the deadweight loss caused by the government tax. Deadweight loss tends to be relatively small because it reflects essentially the lost opportunity of individuals to trade freely. A Canadian who would have borrowed capital at 8% in New York in the absence of a capital gains tax, is forced to pay 10% to a domestic lender. At this interest cost, the project might not be undertaken at all. The Canadian turns his or her labour to other investment

projects that, by definition, are inferior to that prevented by the existence of the capital gains tax.

The second negative effect of the capital gains tax is that it gives rise to government revenue, which is matched by costs to the taxpayers. As Professor Gordon Tullock (1967) has pointed out, these taxes invite payers to lobby with politicians and bureaucrats to exempt them from the payment. This activity by taxpayers is called "rent seeking" and uses up real resources in the form of labour and other resources spent on persuading the bureaucrats and politicians to provide the special concessions. The invitations to fancy entertainment and travel, the offer of lucrative positions in the private sector, and so on are well known in principle but difficult to observe directly. However, Tullock argues persuasively that as long as there are taxes payable, it pays to lobby to be exempted. The process ends only once all of the potential tax revenue is matched by the costs of lobbying.

It may well be that the theoretical Tullock model overestimates the real resource costs of lobbying for exemption from government taxes and regulations. But, as a former elected member of the Parliament of Canada, I can testify to the fact that anyone in such a position can be entertained over dinner virtually every day of the week. My experience as a member of an opposition party surely is only indicative of the costly lobbying that goes on with members of Parliament who serve in cabinet and have real power to influence the bureaucratic administration of laws and regulations.

Finally, it is worth noting that in the preceding analysis it was assumed implicitly that the real investment undertaken by foreigners or financed by Canadians with borrowed funds only yields returns reflected in profits and dividends. This is not true, according to the modern theories of economic growth and trade (Porter et al. 1988) and Romer 1986). Direct foreign investment brings knowledge and training to domestic workers that they can use in other employment. Some former workers of multinational businesses use their knowledge and skills to form companies that compete with their former employers, fill the need for specific inputs used by the foreign company, or offer specialized marketing services. These new activities of former employees of foreign direct investment raise overall productivity in Canada in ways that are not attributed to the

initial foreign investment. These so-called externalities are lost to the extent that a capital gains tax reduces the magnitude of direct foreign investment.

Another form of externality arises from the cluster of industries in related activities (Porter 1980). Outstanding examples of such clusters are the centers for high-tech firms in the Silicon Valley in California and the Ottawa Valley in Ontario. In these areas, the technical, financial, marketing, and other experts of individual firms meet regularly in formal or informal gatherings. Valuable information, the driving force of modern industry, is exchanged in, often subtle, ways and raises the productivity of all firms in the areas. Direct foreign investment, especially by multinationals, contributes to these externalities, often by contributing knowledge gathered at other clusters around the world. These externalities raise productivity and incomes in Canada. They are lost to the extent that capital gains taxation reduces the inflow of direct foreign investment.

What are the administrative and efficiency costs?

One of the most important objections to the removal of the capital gains tax is that it would create powerful incentives for taxpayers to shift taxable income into non-taxable capital gains. Such practices cause the misallocation of resources and greater income inequalities since people with lower incomes would not have opportunities to reduce their overall tax burden.

Many economists consider the argument over the shifting of taxes very important. The practice allegedly was widespread in the years before the creation of the capital gains tax and the Department of Revenue in Canada had to spend large amounts of resources to stem the practice. A review of capital gains taxation by the Department of Finance (1980) summarized the issues in the following quotation, which is italicized in the original publication: "The inability of the government to check surplus stripping abuses was, in fact, the primary impetus for the comprehensive review of the tax system in the early 1960s. It led to the establishment of the Royal Commission on Taxation."

Some leading investors and fund managers working in the Canadian capital market during the 1950s and 1960s have told me that the problem of surplus stripping was quantitatively relatively

minor. They believe that the creation of the Royal Commission and its recommendation for the creation of a capital gains tax was symbolic of a swing towards larger government and the need for higher revenues to finance it. The alleged economic success of Communism in the Soviet Union and Cuba and of Social Democracy in Sweden had created an intellectual and political environment in all industrial countries, including Canada, for the expansion of government and higher taxes.

The present opposition to the elimination of the capital gains tax in Canada focuses strongly on the problems raised by surplus stripping. It is important, therefore, to understand the concept fully. For this purpose I present the following theoretical illustration of how such "surplus stripping" would operate. It was given to the economists at the Fraser Institute symposium in the hope that they would be able to report the extent to which the practice is used in the countries that do not have a capital gains tax and how local revenue authorities have coped with it.

Surplus stripping

Table 1 illustrates how surplus stripping would work. In all parts of the table it is assumed that there is no tax on capital gains and that the marginal rate of taxation on personal income is 50%. The business tax is assumed to be 25%. (For the sake of simplicity the analysis disregards the fact that Canada uses a complicated system to reduce the double taxation of business income.)

The first part of the table shows the amount of taxes payable if earnings of the business are distributed and enter into the owner's personal income tax return. The second part shows what happens if the dividend is not paid out but reinvested. I then describe the legal maneuvers involved in stripping the reinvested dividends as tax-free capital gains.

The illustration in table 1 demonstrates clearly the incentives to reduce taxes by otherwise legal maneuvers in a tax regime that taxes personal income from assets but does not tax capital gains on such assets. The illustration also suggests that the incentives are an increasing function of the rate of taxation on personal income and a decreasing function of the tax rate on business profits, facts that help to explain Hong Kong's benign experience with zero capital gains taxes described in chapter below by Hsu and Yuen (p. 39).

Table 1 : Surplus stripping—the avoidance of personal income taxes in the absence of a capital gains tax

(1)	Pre-tax income of Company A	\$100.00
(2)	Less corporate income tax at 25%	\$25.00
(3)	Equals corporate surplus available for distribution to owner	\$75.00
(I)	**Withdrawal of corporate surplus as dividends**	
(4)	Dividend received by shareholder	\$75.00
(5)	Less personal income tax at 50%	37.50
(6)	Total corporate and personal income taxes (lines 3 + 5) paid by Smith, the owner of the business	\$62.50
(II)	**Withdrawal of corporate surplus as capital gains (with capital gains tax rate at zero)—stylized facts.**	
(1)	In line 3 above, it is assumed that \$75 of after-tax business income is distributed to Smith. The tax evasion strategy requires that this sum is reinvested in Company A, which then shows in its balance sheet \$*X* in real assets and \$75 in cash.	
(2)	Smith incorporates a new Company B, which borrows a sum of money from a bank. The cash is used to buy all shares of Company A. The price of the shares does not matter. Company B now is the sole owner of all of *A*'s real assets plus \$75.	
(3)	Company A uses the cash it has obtained through the previous transactions to repurchase its shares held by Company B. But B returns to A only the real assets keeps the \$75 in cash.	
(4)	Company A has the same balance sheet as before the reinvestment of the \$75. The value of its shares matches that of its real assets.	
(5)	However, Company B in the end has all the cash borrowed from the bank plus the \$75 in cash. B repays the bank loan and keeps the \$75 residual. This sum is a capital gain, which arose from the perfectly legal purchase and sale of the shares of A. It is paid to the owner in cash. Company B is dissolved or kept as a legal shell.	
(6)	The owner reports this capital gain in his personal income tax return, but owes no tax.	
(7)	Total tax paid on \$100 corporate income and under the surplus stripping policy:	\$25.00
	Conclusion: Taxes avoided by reinvestment of profits and accompanying legal maneuvers:	**\$37.50**

Converting personal income into capital gains

The absence of a capital gains tax also creates incentives to convert ordinary taxable income normally paid as a salary into non-taxable income. The opportunity to avoid taxes through this process tends to be open to professionals like physicians, lawyers, and accountants and to plumbers, carpenters, and other skilled craftsmen who conduct their affairs through a wholly owned and controlled corporation. Table 2 illustrates how under these assumptions tax burdens can be reduced.

Again, it should be noted that the amount of savings from the evasion strategy is an increasing function of the personal income tax rate. It is also less the higher the rate of business taxation.

Evaluation

The preceding analysis makes it clear that the elimination of the capital gains tax in principle opens perfectly legal opportunities for the evasion of taxes, which has important implications for the overall fairness of the taxation system. However, in practice, the use of the method is limited by two factors.

First, as the description of the process shows, tax evasion through these methods is complicated and costly for small and wholly owned businesses. Second, widely held and publicly traded firms face accounting rules and market discipline, which make it virtually impossible to engage in such maneuvers.

As John Dobson, a successful Canadian portfolio manager pointed out during the symposium, the real world importance of surplus stripping and income shifting as an argument against the elimination of the capital gains tax in Canada cannot be settled by reference to the theoretical analysis alone. Needed is empirical information about the phenomenon.

As was noted above in the context of the effects of the capital gains tax on productivity, answers to complex empirical questions for which sophisticated studies cannot be made can be sought through two methods. The first involves the judgement of practical people working in the field of investment. Thus, the following quotation taken from Jude Wanniski:

Table 2: Income Shifting: The Avoidance of Personal Income Taxes in the Absence of Capital Gains Taxes.

Assume that Smith owns an incorporated business A, which receives all of his professional income and which pays all expenses. To simplify the illustration, assume that after the payment of $100 as a salary to Smith, the company has no profits.

(I) No Tax Avoidance

(1) The corporation pays Smith a salary of $100.

(2) Smith faces a marginal tax rate of 50% and therefore pays taxes of $50.

(II) Tax is Avoided

(3) The corporation A does not pay Smith a salary and, therefore, shows a profit of $100. It pays a corporate income tax of $25, leaving the business with all of its assets and liabilities plus $75 in cash.

(4) Smith now goes through the same legal maneuvers of creating Company B, taking out a cash loan, buying and selling Company B and so on described in Table 1. After the maneuver is completed, Company B is left with a capital gain of $75, which goes to the professional as a non-taxable capital gain.

(5) Total taxes paid under strategy II: $25

Conclusion: Income shifting results in tax savings of $25.

> Alan Greenspan has labored in the Wall Street vineyards before he got his academic degrees in economics. He told me he had spent decades trying to figure out how to convert ordinary income to capital gains, and couldn't figure out how to do it. As he put it in a conversation in his office at the Fed, perhaps a decade ago, any tax on capital gains is a tax on the national standard of living. (Wanniski 1999)

The second approach to the gathering of empirical information is to study history and the experience of foreign jurisdictions. As the papers in this volume show, the shifting of ordinary income into non-taxable capital gains can readily be prevented by appropriate legislation. The following are the main findings of economists who studied their countries' experience with a zero capital gains tax regime.

What is the evidence from abroad? Countries without capital gains taxes.

All of the papers printed below convey an important message. In practice, the tax systems of all countries are extremely complex and are in constant flux. Readers should be warned that for this reason alone, the summaries to be presented by their very nature involve much simplification and cannot tell the full story.

Hong Kong

The chapter on Hong Kong by Berry F. C. Hsu and Chi-Wa Yuen, ***Tax Avoidance Due to the Zero Capital Gains Tax: Some Indirect Evidence from Hong Kong*** (p. 39), is perhaps the most definitive in documenting that a zero capital gains tax does not bring major distortions and problems for the tax authorities. In that special administrative region of China, the battlefront between tax collectors and those wanting to reduce their tax burden is found in the operational definition of gains from trading and capital gains. The following excerpts from their paper make the main points:

> Problems arise when assets are traded as a matter of routine business, as in the case of a real estate firm specialising in the purchase and resale of buildings and land. Profits from such trade in assets are taxable. In principle, profits from the increase in the value of such property held as trading inventory are not taxable. In practical law, however, the concept of "trade" has not been precisely defined in the Inland Revenue Ordinance. As a result, courts are often asked to adjudicate disputes between citizens who claim that income is from capital gains rather than from trade and the tax authorities who argue that the income is due to trading.
>
> Believing in the basic principle of simplicity, the Inland Revenue Ordinance from the outset has been designed to contain very little strict anti-avoidance legislation. However, over time, the growth of sophisticated tax planning arrangements has led to the introduction of many sub-sections in the Inland Revenue Ordinance aimed at closing loopholes. Now the Inland Revenue Ordinance contains two general anti-avoidance

> provisions. The first sets out to disregard any 'artificial or fictitious' transactions that do not in fact take place and any that reduce or would reduce the amount of tax payable. The second applies a 'sole or dominant purpose' test to determine whether a transaction is conducted mainly for the purpose of obtaining tax benefits through the avoidance or postponement of the liability to pay tax or the reduction in the amount thereof.
>
> In fact, the court decisions…have not prevented attempts to avoid taxes through transactions that turn income into non-taxable capital gains. This is at least in part due to the fact that it is not always clear whether a given transaction is designed to avoid taxes or whether it is a genuine commercial activity that only appeared to involve tax evasion. As a result, a number of rulings by the Commissioner of Inland Revenue that specific transactions are for tax avoidance have been appealed to the Board of Review of the Hong Kong Inland Revenue. These appeals may be considered to reflect the extent to which the absence of a capital gains tax has induced shifting of ordinary income into capital gains.

After a review of the nature and magnitude of these appeals, the authors come to the following overall conclusion:

> On the basis of the indirect evidence available to us we conclude that the absence of a capital gains tax in Hong Kong has resulted in little, if any, inefficiencies and inequities.

Important in the light of my analysis above, they also conclude:

> Casual empirical evidence suggests to us that only small businesses tend to make efforts to avoid taxes by increasing capital gains through excessive reinvestment of profits and low personal compensation of owners. The economic importance of such small businesses is relatively minor in Hong Kong.

While the conclusions of Hsu and Yuen support the arguments of those in favour of eliminating the capital gains tax in Canada, there

are questions about the relevance of evidence drawn from the Hong Kong experience. Hong Kong is unique in many ways. Most important for the present analysis is the fact that the zone's personal income tax rates are about 15% and, therefore, are very low relative to those of most other industrial countries of the world, including Canada. Because of these low personal income tax rates in Hong Kong, the incentives to shift ordinary income into capital gains certainly is less than it would be in countries with higher rates.

On the other hand, this condition raises a point discussed widely among economists. To maximize the incentives for savings and capital formation, which increase economic growth, more of a given amount of revenue should be raised through the increased use of indirect taxes, like value-added taxes and a decreased use of direct taxes, like those on personal and business income. If Canada would adopt such a mix of taxes, its personal income tax rate could be much lower than it is and the incentives to income shifting would be reduced correspondingly.

Switzerland

In ***Capital Gains Taxation: Evidence from Switzerland*** (p. 55), Peter Kugler and Carlos Lenz note that the federal government of Switzerland does not have a capital gains tax but that such a tax is imposed by some of the cantonal governments. What makes this paper most interesting is that some of these cantonal governments in recent years have abandoned the tax while others have retained it. This virtually controlled experiment has provided important empirical information about the effects of the tax on economic growth. As noted above, the evidence suggests that the cantons without the tax experienced an increase in cantonal income not matched by those cantons that retained the tax.

The authors did not discuss the problems faced by the Swiss government due to the incentives to shift ordinary taxable income into non-taxed capital gains at the federal level. They report that the Swiss federal government has for some time faced political pressures to impose a capital gains tax. However, these pressures have not come from the revenue department or others concerned about the problems created by these incentives. Instead, they have come from the political Left concerned over the large inequalities in wealth and income created by the stock-market boom of the 1990s.

In this sense, Switzerland is like Canada and most of the other industrial countries. Its government faces pressures from citizens with a very static view of the world. These citizens are inclined to focus on income distribution and the living standards of the poor in the short run. They neglect or minimize the negative effect capital gains taxes have on economic growth. Switzerland's per-capita income is one of the highest in the world. According to my analysis presented above, at least some of this higher living standard should be attributed to the historic absence of a capital gains tax at the federal level.

New Zealand

Robin Oliver brings to the writing of his chapter extensive experience as a tax consultant and as an adviser to the revenue department of the government of New Zealand. His chapter, ***Capital Gains Tax: The New Zealand Case***, reflects this background. He reports at length on the nature of tax planning and legal maneuvers employed by New Zealanders trying to reduce their tax burden through the shifting of income.

His analysis reflects the conditions that existed in Canada before the introduction of the capital gains tax. As noted in the quotation from Department of Finance 1980 (above, p. 15), these conditions were one of the main justifications for the introduction of the tax in Canada.

Oliver concluded that the zero capital gains tax regime in New Zealand is very costly. There are many lawyers and tax consultants paid to find ways for their clients to avoid taxes through the conversion of other income into capital gains. The government's efforts to prevent these practices in turn results in additional costs. In spite of these government efforts, it is impossible to prevent some tax avoidance, which reduces the efficiency and equity of the entire tax system. It seems that the private sector's ingenuity always finds legal and institutional ways to create new loopholes after old ones have been closed by appropriate changes in government regulations. For these reasons, Oliver recommends the introduction of a capital gains tax in New Zealand:

> I would assert, after my long experience with the New Zealand tax regime as a private consultant and government

> adviser, that the best possible system is not one, which simply excludes capital gains from taxable income.

However, he tempers this recommendation by pointing to the particular bias he brings to the issue through his professional background and current position:

> This paper has canvassed the problems posed for New Zealand's tax system by the absence of a general capital gains tax. Undoubtedly, if we had a capital gains tax, the paper would have canvassed the problems posed by having such a tax.

In my view, Oliver's analysis is an important reminder about a fact well known to economists: there is no free lunch. In this sense, his analysis is consistent with the general arguments made above. It reminds us that the merit of moving to a zero capital gains tax rate depends on the outcome of a set of complex calculations. These calculations involve the benefits in terms of greater economic growth against the costs of dealing with attempts to avoid taxes and the effects of incomplete success on the horizontal equity of the system. The weights that analysts put on the costs and benefits are determined to a large extent by their personal and professional backgrounds, which is quite benevolent as long as readers are aware of the analysts' background.

Mexico

Francisco Gil Diaz, the author of ***Capital Gains Taxation in Mexico and the Integration of Corporation and Personal Taxes*** (p. 89), brings to his analysis a background entirely different from that of Robin Oliver. He holds a PhD in economics from the distinguished University of Chicago. Under President Roberto Salinas, he served as his country's Minister of Revenue, in which capacity he has been credited with increasing the integrity of the system, lowering taxes, broadening the tax base, and increasing enforcement of tax laws and regulations. When he wrote and presented his paper, he was the chief executive officer of a large telecom company in Mexico. After the election of President Vincente Fox, he was appointed Minister of Finance.

On the issue of capital gains taxation, Diaz takes a different approach, as is evident from the following, selective quotations.

> If distributed profits and capital gains are taxed differently, people will tend to engage in tax arbitrage and to choose the lower taxed vehicle. Therefore, the correct, neutral and equitable goal is not a favored treatment for capital gains, but rather to strive for a symmetrical treatment of distributed profits and of capital gains. If the first are taxed twice so should the other and, if the first are not adjusted for inflation, it is not clear why the other should.
>
> On the other hand there are no efficiency or equity grounds to double tax corporate profits, if dividend and corporate profit taxation were integrated, that is, if only the individual shareholder were considered the unit of taxation, capital gains taxation would virtually disappear.
>
> Under such a scheme a corporate income tax is solely an individual income tax withheld at the source, just as it is frequently done with wage or interest income. In this vein, individuals add-up their various sources of income, including dividends, albeit grossed-up to determine the before corporate income tax profit, but then the corporate income tax would be creditable as a withheld tax in order to arrive at the individual income tax.
>
> The end result of this procedure is that corporate profits would be taxed only once at the individual's level. Such a design requires parallel corrections in the way capital gains are taxed. The seller of a share would be allowed to modify its purchase price when calculating the difference between the sale and purchase prices to arrive at the taxable capital gain. The required adjustment would be to allow for taxed reinvested profits to be added to the purchase price of the share and to deduct corporate losses.
>
> However transparent and non-distorting, the integration solution has serious drawbacks. The accounting requirements are complex and many years of information and documentation are needed.

Diaz expands on these problems of information and documentation and refers to several issues arising from the policy of taxing personal and business incomes at different rates, which was introduced recently under President Zedillo's regime. However, it appears

that Diaz strongly supports eliminating double taxation of business income and, implicitly, the elimination of capital gains taxation.

New Zealand, like Mexico, has a fully integrated system of taxation for personal and business income. It also does not have a capital gains tax. The reasoning of Mexico's Minister of Finance and the experience of New Zealand should be studied carefully. In my view, such a study will increase the support in Canada for the elimination of the capital gains tax and the double taxation of business income.

Inflation indexing

The preceding analysis implies that Canadians would gain large benefits from the elimination of the capital gains tax. However, if such a policy is not adopted, the following analysis suggests ways in which the present system can be made more efficient, transparent, and equitable.

Logical consistency is not the hallmark of the Canadian or any other country's system of taxation. Thus, the argument that a buck is a buck implies that capital gains should fully enter taxable income. There is no reason why capital gains should be treated the way they are in 2001—taxable at only one half of their value. After all, there is no analogous adjustment to wage income or dividends and interest and they give rise to a buck just as capital gains do.

So why are 50% of all capital gains in Canada excluded from taxable income? The official reason is that this practice eliminates the unfairness and inefficiencies resulting from inflation. To see the importance of these considerations consider someone who owns stocks bought at 100. Assume that the general inflation over the following 10 years has doubled the price level and wages so that the real income of the investor and of every other worker remained constant in inflation-adjusted real terms. Now assume that the value of the stocks also doubled to 200 and that they are sold for a realized and taxable gain of 100.

The taxation of these purely nominal gains in that year results in a decrease in the investor's real income. This outcome is not the intention of the capital gains tax legislation but is due to the taxation of phantom capital gains caused by general inflation. In the context of the analogy used above, the holding of the stocks has not

produced a taxable fruit and the tax on the nominal gains falls entirely on the tree. In terms of the populist slogan, a buck really is not a buck unless the capital gains are adjusted for inflation.

The logical method for handling problems of inflation is to adjust nominal values correspondingly. However, for reasons that are not clear to me, to adjust for inflation the government of Canada has decided instead to use a blanket approach. All capital gains presently are subject to a 50% inclusion rate. The remaining capital gains then become part of total taxable income and are subject to the investor's personal marginal income tax rate.

It is easy to see that, by the standards of the buck-is-a-buck principle, the 50% inclusion rate results in a fair and efficient adjustment only when over the investors' holding periods the cumulative inflation is exactly 50%. For any given level of inflation, this rule clearly favours capital gains made in the short run. Consider an annual, average inflation rate of 3%. An asset sold after one year is over-compensated for the inflation. On the other hand, at that inflation rate, nominal asset values increasing at the same rate double in 24 years. Assets held over 24 years bring nominal capital gains greater than is compensated for by the 50% inclusion rate.

It is interesting to note that the Canadian system of adjusting for inflation encourages the realization of capital gains in the short run. The United States and many other countries have systems designed to tax short-term more heavily than long-term gains. This approach is used to reduce the magnitude of short-term speculative bubbles in stock and real estate markets.

The injustice created by the broad approach to inflation adjustment for capital gains may be illustrated by an example from recent Canadian history. Between 1972 and 1991, consumer prices in Canada rose 3.8 times while the Toronto Stock Exchange Index of 300 Companies rose 2.9 times. As a result, consider what happened to the financial conditions of a person who bought a representative sample of stocks in the TSI worth $100,000 in 1972. This investment in 1991 was worth $290,000. Its sale that year brought a capital gain of $190,000 and, at the 50% inclusion rate, resulted in taxable income of $95,000. Assume that the gain was taxable at the investor's 50% marginal tax rate on personal income and resulted in a tax payment of $47,500. The investor was left with $242,500 from the sale of the stocks. However, because of the inflation, the real

goods and services worth $100,000 in 1972 cost $380,000 in 1991. Our investor suffered a loss of 36.2% of the initial wealth in 1972.

This loss in real wealth has two components. First, there is a decline of 24% due to the excess of the rate of inflation over the growth in the asset value experienced during the years from 1971 to 1992. The second component of 12.2% was due to the tax paid on the fictitious capital gains during the period. Whereas the government cannot control the real decline in asset values directly, it could eliminate the unfair taxation of phantom gains.

To achieve this objective, the Government of Canada needs to index all gains to the actual rate of inflation. This can be done very simply by sending to all taxpayers a table that allows them to read off the cumulative inflation in the consumer price index experienced during the time they bought and sold their assets. Taxpayers can easily adjust their capital losses correspondingly. Under such a system of indexation, the present 50% inclusion rate should rationally be raised to 100%. The outcome of these policy changes would be a fair, efficient, and transparent system of capital gains taxation fully consistent with the principle underlying the slogan that a buck is a buck.

It is possible that such a policy would raise effective rates of capital gains taxation in the future and that it might have meant higher rates in the past compared with what they were under existing 50% inclusion rates and actual inflation. Unfortunately, the estimation of such revenue effects is complicated by the need to make assumptions about the length of holding periods as well as by the assumed rates of future inflation. I have not seen any estimates of this sort made by private scholars though the task should not be beyond the capability of the Canadian government.

The indexing and the full inclusion of capital gains may result in politically undesirable changes in revenues and tax burdens. Under these conditions, revenues can be kept unchanged through the adoption of the American system, which has a special rate for capital gains completely separate from the personal income tax and has generally lower rates for long-term than it has for short-term capital gains. Under this approach, the progressivity of the present Canadian capital gains tax would be eliminated. However, because of the close integration of the two countries' financial markets, the adoption of the same rate in the two countries would provide desirable incentives for the efficient allocation of capital.

Capital gains taxes in the United States are not adjusted for inflation. This has led Alan Greenspan, the Chairman of Board of Governors of the Federal Reserve in Washington to make the following statement:

> Actually I'd go to indexing. And the reason I would is that it's really wrong to tax a part of a gain in assets which are attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So, for the government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate. (quoted in Joint Economic Committee 1999: 35)

If Canada taxed capital gains tax at the same rate as the United States and if they were indexed, investors would be induced to place more of their capital in Canada. From a narrow Canadian point of view, this would be a desirable development because it would raise the country's capital stock and productivity of labour. The Canadian policy might also give more urgency and weight to Greenspan's recommendation and cause the United States to adopt inflation indexing.

What is the evidence from abroad? Countries with inflation indexing

The indexing of capital gains to inflation is seen by many to cause costly administrative complexities. Three chapters in this volume consider indexing in Britain, Ireland, and Australia.

All three authors conclude that, at the level of individual tax payers, the indexing of capital gains is not a very complex process. As already noted, taxpayers face the simple task of using a table, which the government provides, together with general tax forms and instructions. The table allows taxpayers to read off the amount of inflation in the country in the years elapsed between the initial purchase of the asset and the realization of the gains. The actual calculation of the real taxable gain is very simple and involves the multiplication of two numbers.

However, as in most seemingly simple forms of taxation, there are many devils in the details. These devils often stem from the need to translate a principle into operational instructions for taxpayers. More often they originate with revenue authorities and politicians. Some of the details are introduced in response to the need to counter avoidance techniques used by taxpayers. Some are due to changes in the environment like high levels of inflation, which led to indexation in Britain in the early 1980s. Others are introduced by politicians dissatisfied with the economic and social effects of existing legislation.

United Kingdom

In ***Capital Gains Taxation in Britain: The Merit of Indexing and Tapering*** (p. 107), Barry Bracewell-Milnes notes that the indexation of capital gains was introduced in 1982 largely in reponse to the economic distortions and inequities caused by the inflation of the late 1970s, which peaked at over 25%. The system of indexation was gradually made more comprehensive. In 1985, it was extended to cover losses. One important operational problem involved the calculation of gains on assets in a portfolio, which were acquired at different prices and times. Until 1982 investors could use the FIFO (first in, first out) principle. Thereafter, they were required to use LIFO (last in, first out) accounting. There was also a rule for averaging prices, which lasted until 1998.

In 1998, indexation was replaced by a system of tapering under which the taxable percentage of a nominal capital gain was made a decreasing function of the time over which the asset was held. Under this rule, only 25% of any gain was taxable if a business asset was held for 10 or more years. This means that a person with a high marginal tax rate effectively pays only a 10% capital gains tax rate. For non-business assets, the maximum effect of tapering is much less generous and makes taxable 60% of gains after 10 years. The 10-year period was reduced to 4 years for business assets in 2000.

The author's view on indexation in his own words is:

> Income and capital gains are as distinct as day and night, even though there are short periods of ambiguity at dawn and dusk. If it were right to tax capital gains as income, indexation would merely remove the additional burden imposed by price

> rises. But I believe that it is not right to tax capital gains as income. In my view, therefore, indexation is a means of lightening the burden of an excessive and damaging tax. As such, it reduces public demands for the elimination of the unjust tax and it prevents the adoption of superior alternative methods like tapering for reducing the burden.

The following is the author's final, summary conclusion:

> The main thesis of the present paper is that capital gains taxation is an economically damaging tax. Short of the ideal of its abolition, the damage done by the tax can be mitigated by measures to reduce its burden and inefficiencies, like indexation or tapering.
>
> However, these two measures do not have equal merit. Those who view capital gains tax as necessary for reasons of equity and efficiency consider indexation desirable. Indexation makes the tax fairer and less distorting. Tapering generally appeals to those who believe it desirable to have low rates of taxation to minimize the efficiency cost, especially the lock-in effect. Tapering, which ultimately lowers the tax to zero appeals most to those who oppose the Simons definition of income. These analysts, including myself, believe that capital gains are distinctly different from other sources of income and in particular that all certain gains should be taxed and uncertain gains should not.

Australia (Freebairn)

John Freebairn is an economist at the University of Melbourne, specializing in public finance and taxation. In his chapter, ***Indexation and Australian Capital Gains Taxation*** (p. 123), he notes that Australia adopted a capital gains tax in 1985 mostly to broaden the tax base and eliminate the tax avoidance maneuvers used to avoid paying income and profits taxes. The 1985 law allowed realized capital gains to be adjusted for inflation during the holding period of the asset. Real gains were taxable fully at the payer's personal income-tax rate.

In 1999, indexation was abandoned and Australia adopted a system equivalent to that used in Canada—only one-half of realized gains was taxed at the personal income-tax rate of the owner. Why

was indexing abandoned? According to Freebairn, it was not because of any problems inherent in the system:

> The indexing of capital gains for inflation to determine real capital gains is a trivial and low cost exercise once the data on acquisition costs and sales values are known. The Australian Taxation Office provides taxpayers with a table of the general consumer price index along with instructions on how it has to be used. For this reason, high compliance costs associated with the measurement of real capital gains, as opposed to nominal capital gains, has not been a part of any discussions about changes to the Australian system of capital gains taxation.

The reason for the change from indexation to the lower inclusion rate is found in *The Review of Business Taxation,* quoted by Freebairn:

> Though indexation provides a significant reduction in effective rate for many taxpayers, this is probably not well recognized, especially among foreign investors. Indeed the perception has been that the Australian tax system imposes tax at full income tax rates. Such perceptions are not easily corrected and a change in the form of concession or something more akin to the types of concessions available abroad would, in the Review's judgement, be more effective in attracting investors to Australian assets.

The concluding section of Freebairn's paper provides the following assessment of the effects of the 1999 tax reforms:

> The stated objectives of these reforms of the capital gains tax were to encourage innovation, promote domestic and overseas investment in Australian business and achieve greater equity. It is not clear that these objectives of the reform will be achieved. Their attainment depends on questionable assumptions about the rationality of investors, especially that they do not understand the benefits of indexing and put great weight on the fact that only one half of their nominal capital gains are taxable.

The shift from indexing to the halving of the inclusion rate affects the effective tax burden and government revenues in ways discussed above and elaborated on by Freebairn. If, over any given holding period, cumulative inflation exceeds 50% of the nominal capital gain, effective tax rates and revenues are increased. If inflation is below 50%, they are reduced. Since future inflation is not known, it is impossible to know whether the 1999 capital gains tax reforms have increased or lowered effective rates.

Ireland

Capital Gains Taxation in Ireland (p. 141) by Moore McDowell contains a long and detailed history of capital gains taxation in Ireland. Readers will find it interesting how the details of the tax code changed frequently in response to external developments, changes in economic theory, and new political trends. Of greatest interest to the present analysis is the country's experience with inflation indexing:

> The high inflation rates of the 1970s resulted in high capital gains taxes on assets held for long periods. In response to protest over this unfair tax, some major changes in the original capital gains tax regime were introduced. The first of these was in 1978 an inflation adjustment mechanism designed to limit the tax liability to changes in the real rather than the monetary value of assets. This adjustment took the form of what was termed an "inflation multiplier," which was simply the percentage change in the Consumer Price Index in the year up to the beginning of the current financial year beginning on April 6. In practice, the procedure requires an increase in the purchase value of assets by the rate of inflation. The resultant adjusted purchase value is subtracted from the disposal value to arrive at the taxable capital gain.
>
> The 1978 Finance Act also introduced differential tax treatments depending on the length of time an asset had been held. This arrangement can be seen as a form of inflation relief, which already had been granted through the inflation multiplier provision just discussed. So, why was it considered necessary to add this new provision? The authorities offered the argument that the capital gains tax was a disincentive to long term "genuine" investment. Such investment was needed

> to encourage capital formation, which would relieve Ireland's chronic problem of underemployment and foster structural change needed in the wake of accession to membership in the European Economic Community. On the other hand, accruals of wealth based on mere "speculation" were considered to be a legitimate target of taxation on the grounds of equity. Since assets held for longer time periods were already subject to inflation indexing, the lower rate of taxation for them means that were over-compensated for inflation.

McDowell explains some fundamental and sophisticated theoretical issues raised by the practice of indexation. Readers must judge for themselves the extent to which these criticisms imply that inflation indexing is economically undesirable.

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