International Evidence on the Effects of Having No Capital Gains Taxes

Edited by Herbert G. Grubel

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Table of contents

3 Capital gains tax regimes abroad—countries with inflation indexing

About the authors

Barry Bracewell-Milnes is an author and consultant on economic and tax policy. He has degrees from Oxford and Cambridge and was advisor to Erasmus University, Rotterdam (1973–1980) and to the Institute of Directors, London (1973–1996). He has written 25 books.

Francisco Gil-Díaz was CEO and President of Avantel (a joint venture between Banamex, a Mexican banking group, and WorldCom). Before that, he held numerous, high-ranking executive positions in the public sector. Since early 2001, he has been the Financial Secretary (Minister of Finance) of Mexico. He holds a B.A. in Economics from ITAM, the Technological Institute of Mexico and an M.A. and a Ph.D. from the University of Chicago. He has taught Economics part-time at various institutions and, between 1970 and 1978, was Chairman of the Economics Department at ITAM. Gil-Díaz has published extensively on topics such as public finance, exchange-rate policy, macroeconomic management and deregulation of economic activity.

John Freebairn is a Professor and Head of the Department of Economics, University of Melbourne, Australia. He is a graduate of the University of New England and the University of California, Davis. His research interests are taxation reform, unemployment, and the pricing of infrastructure.

Herbert Grubel is a Senior Fellow and holds the David Somerville Chair at The Fraser Institute. He is a Professor of Economics (Emeritus) at Simon Fraser University, where he has taught since 1971. He received a B.A. from Rutgers University, and a Ph.D. in

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Where a chapter has more than one author, biographical information is given only for the co-author who attended the symposium in Vancouver.

economics from Yale University. He has taught full-time at Stanford University, the University of Chicago, and the University of Pennsylvania and has had temporary appointments at universities in Berlin, Singapore, Cape Town, Nairobi, Oxford, and Canberra. He was the elected Reform Party Member of Parliament for Capilano-Howe Sound from 1993 to 1997 and served as the Finance Critic from 1995 to 1997. He has published 16 books and 180 professional articles in economics dealing with international trade and finance and a wide range of economic policy issues.

Peter Kugler has been a Professor of Economics at the University of Basel in Switzerland since 1997. Formerly, he was professor of Statistics at the University of Basel (1984–1986), Professor of Econometrics at the University of Bern (Switzerland, 1987–1993) and Professor of Economics at the University of Vienna (Austria). He has published, in refereed journals, over 50 articles on macroeconomics and (international) monetary economics as well as applied econometrics.

Moore McDowell is a Senior Lecturer in Political Economy at University College Dublin. He has degrees from University College Dublin (National University of Ireland at Dublin) and Oxford. He has been a senior Lecturer in Political Economy at University College Dublin since 1990 and has taught at San Francisco State University (1977/1978) University of California at Davis (1978, 1983, 1984/1985), and the University of Delaware (1988, 1990, 1993). His areas of teaching and research are industrial organization, public sector, and competition policy. He has written numerous papers, provided expert testimony in competition law, done advisory work in mergers, and some industry studies.

Robin M. Oliver has been General Manager, Policy, Inland Revenue Department, Government of New Zealand since June 1995. In this position, he is responsible to the Commissioner of Inland Revenue for the Department's Policy Advice Division, one of the four business units into which Inland Revenue is divided. The Policy Advice Division is responsible for providing all aspects of the Department's policy advice to the Government. It also includes the international tax section, which handles the negotiation, administration, and interpretation of New Zealand's Double Tax Agreements with other countries. Prior to joining the Inland Revenue Department, Mr Oliver was a taxation partner in the international accounting firm of Arthur Andersen. A well-known adviser and commentator on taxation matters, Robin is a co-author of a text on the taxation of financial arrangements in New Zealand.

CHI-WA YUEN is an Associate Professor at the School of Economics and Finance, University of Hong Kong, Hong Kong. He obtained his Ph.D. in economics from the University of Chicago in 1991. His doctoral thesis is about the design of dynamic optimal taxation in a human-capital-based growth environment. He is the author of many articles in academic journals and a co-author in the latest edition of a popular graduate text in open economy macroeconomics, *Fiscal Policies and Growth in the World Economy* (MIT Press, 1996), originally written by Jacob Frenkel and Assaf Razin in 1987 and 1992.

Preface

International Evidence on the Effects of Having No Capital Gains Taxes represents the second part of my ongoing effort to study the costs and benefits of capital gains taxation in Canada. The first part of this effort involved a colloquium among 25 economists and entrepreneurs from Canada and the United States who met in June 1999 for the Fraser Institute 1999 Symposium on Capital Gains Taxation. We discussed the question: "Resolved that Canada's capital gains tax rate should be equal to that of the United States." Drawing on this discussion, I wrote a monograph entitled *Unlocking Canadian Capital: The Case for Capital Gains Tax Reform* (Vancouver, BC: The Fraser Institute, 2000). The main conclusion of my study was that the capital gains tax rate in Canada was too high and that lowering it would increase revenues, have little effect on the distribution of personal income, and bring large economic benefits.

During 1999 and early 2000, the Senate of Canada held a series of hearings about the merit of the capital gains tax. *Unlocking Canadian Capital* included the proceedings of five of these Senate hearings, all of which supported and expanded on the arguments I had presented in the first half of the volume. During the same period, the *Financial Post* published a number of articles by economists, including myself, who argued the case for lower capital gains tax rates in Canada.

The Liberal government in Ottawa did not respond officially to the arguments made in these studies. However, it acted as if it had been persuaded by them. It lowered the effective rate of capital gains taxation by about one-third in two distinct steps. The first, announced in the February 2000 Federal Budget, lowered the percentage of realized capital gains that had to be included in personal income tax returns from 75% to 66.66% for gains realized after February 28. The second was announced in the mini-budget leading up to the election in November 2000. It reduced the inclusion rate further to 50% for gains realized after October 17, 2000.

In effect, these policies reduced the maximum rate of personal capital gains taxation to between 23% and 25% from about 40% at the highest marginal tax rate on Canadian federal and provincial taxes combined. As a result, the Canadian rates came close to those of the United States, though comparisons are complicated. Canada applies the same rate to all gains regardless of the holding period of the assets while the United States rates for short-term gains are higher than those for long-term gains.

The first of the rate reductions was welcomed immediately by the investment community in Canada. The criticism normally expected from the political left did not materialize. The positive public reaction to the first cut undoubtedly encouraged the government to make the further reductions later in the year. It is somewhat surprising that these policies also failed to elicit any negative response from the political left or the general public.

It is not clear why Canadians were so ready to accept these lower capital gains tax rates passed in 2000. It is possible that the cuts were acceptable because they were part of a broader range of tax reductions made while the fiscal surplus was high and forecast to grow rapidly. A further cause for the lack of public protest may have been the fact that the cuts merely reduced the capital gains tax rates to the level that had prevailed until the 1994 Budget. These rates presumably had been arrived at after much debate and consultation and had become accepted as a necessary part of a fair and efficient tax system.

In addition, it is almost certain that the barrage of studies of the harmful effects of capital gains taxation noted above has played an important role in the government's decision to lower rates. In my view, most of the arguments presented in these publications made a persuasive case not only for lower rates of capital gains taxation but for the complete elimination of the tax. Almost everyone present at the symposium agreed that such a policy would increase the rate of capital formation, foreign investment, and growth in productivity and, therefore, raise the living standards of all Canadians. However, these benefits are seen by many to bring some important costs in terms of lower overall government revenue, requiring higher taxes on other forms of income. The elimination of the capital gains tax is also considered to make the income distribution less equal and, most important, cause strong incentives for tax avoidance.

The question for public policy therefore is: Do the benefits from the elimination of the tax in terms of higher income outweigh the costs of lower revenues, greater inequality of income, and incentives for tax avoidance? Unfortunately, the answer to this question must be based to a large extent on judgements rather than solid empirical evidence, in part because the history of capital gains taxation in Canada is too short and involves too few changes in rates and coverage to allow the kinds of econometric studies needed to measure the important changes objectively.

This state of affairs did not prevent the Senate Committee Report to reach the following conclusion, after it had listened to a number of expert witnesses:

> For all of the above reasons, the Committee believes that a further, substantial reduction in the capital gains tax rate is warranted. Indeed, as markets for goods and services become increasingly globalized, and because international competition for capital rests ultimately on after tax rates of return, Canada cannot ignore developments elsewhere in the world. Therefore, at a minimum, we recommend that the Canadian capital gains tax rate should quickly be lowered to match the rate in the United States. However, this is probably insufficient. A tax rate even lower than the American rate is more appropriate, as other nations have concluded ... Thus, the Committee also recommends that international competitiveness be the criterion guiding the choice of a capital gains tax regime, and that the federal government be prepared to lower the tax until that criterion is met. (*Senate Banking Committee Report on Capital Gains Taxation* 2000: 22)

Table 1 provides information about the capital gains tax regime of major foreign countries. This information is not easy to obtain and has been compiled by Arthur Andersen through a special survey and from information from Deloite Touche and KPMG. The table has been adapted by me by drawing on Appendix A of the *Senate Banking Committee Report on Capital Gains Taxation* (2000).

This table not only is important in understanding the need for Canada to consider international competitiveness in setting policy on capital gains taxation. It also shows that there are a number of

Table 1: Capital gains tax provisions in selected countries (rates on individuals, maximum rates on gains from equities)

	Short-term	Long-term	Holding period
Argentina	Exempt	Exempt	No
Australia	24.5	24.5; inflation indexing	No
Belgium	Exempt	Exempt	No
Brazil	15.0	15.0	No
Canada	23–25	23–25	No
Chile	45.0; exclusion $6,600/yr	45.0; exclusion $6,600/yr	No
China	20.0; specific shares	20.0; specific shares	No
Denmark	40.0	40.0; some exemptions	3 years
France	26.0; exclusion $8,315/yr	26.0; exclusion $8,315/yr	No
Germany	55.9	Exempt	6 month
Hong Kong	Exempt	Exempt	No
India	30.0	20.0	1 year
Indonesia	0.1	0.1	No
Ireland	20.0	20.0	No
Italy	12.5	12.5	No
Japan	1.25% of sales price or 20% of net gain	1.25% of sales price or 20% of net gain	No
Korea	20.0; share traded on major exchange exempt	20.0; share traded on major exchange exempt	No
Mexico	Exempt	Exempt	No
Netherlands	Exempt	Exempt	No
Poland	Exempt	Exempt	No
Singapore	Exempt	Exempt	No
Sweden	30.0	30.0	No
Taiwan	Exempt	Exempt	No
United Kingdom	40.0; some exemptions	10.0 to 40%; Rate dependent on holding period	Sliding scale
United States	39.6	20.0	1 year

Source: Adapted from Senate Banking Committee (2000), Appendix A. See source for more details and source of data.

countries in the world that have considerable experience in running a tax system without capital gains taxation. Because this experience is useful in shedding light on the likely consequences of adopting a capital gains tax rate of zero in Canada, in September 2000 The Fraser Institute held the 2000 Symposium on Capital Gains Taxation (September 15, 2000) at which economists from nine countries addressed a number of issues that I consider important in assessing the consequences of having no capital gains tax. Some of the papers discussed countries' experiences with the use of indexing of capital gains due to inflation.

Part 1 of the present study presents my views on the merit of eliminating Canada's capital gains tax and is based on the existing, traditional literature. It also summarizes the main findings of the papers presented at the gathering. Part 2 contains seven papers written by the participants at the symposium.

Herbert G. Grubel

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