

Why there should be no capital gains tax

Herbert Grubel

“Harvest the fruit but do not cut the tree.” “A buck is a buck.” These two slogans define the battleground on which the fight over the existence of a capital gains tax in Canada is taking place. The first slogan has long dominated the thinking of economists. Just as cutting the tree necessarily lowers future harvests of fruit, so does taxing capital diminish its stock and future returns. Taxes on capital interfere with the efficient, intertemporal allocation of capital.

The second slogan was introduced into the public domain by the Carter Commission, whose report provided the rationale for the introduction of Canada’s capital gains tax in 1972. The slogan’s appeal is based on equity considerations. Someone with a capital gain can increase consumption just as if the money was earned as income. Since income is taxed, capital gains should be taxed also.

The equity slogan dominates the culture of Canada’s Department of Finance also on the grounds that equal taxation of both sources of income eliminates incentives to shift financial resources between income and capital gains. As a result, the task of enforcing Canada’s tax code is made much easier.

It is obvious from this brief description of the battleground that both positions have merit and that the fight cannot be decided on the grounds of principle alone. There is, in fact, a trade-off between

efficiency and equity. Society as a whole needs to decide which point on this trade-off it chooses. In a free and democratic society like Canada's, this choice ultimately is made through the political process. However, voters' choices are influenced not only by value judgements—the kind of income distribution the people want—but also by empirical information about the trade-off.

The present paper provides available empirical information about the trade-off. In particular, it discusses the economic costs of the capital gains tax, the effects on the distribution of income and the implications for fiscal revenues.

Implications for efficiency

The implications of taxing the tree are best summarized by the following quotations.

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 thereby the strength and potential for growth in the economy. (President John F. Kennedy, 1963)

The capital gains tax is so economically inefficient—because of its punitive effect on entrepreneurship, thrift, and investment—that the optimal economic policy for the United States would be to abolish the tax entirely. (S. Moore and J. Silvia, *The ABCs of the Capital Gains Tax, Policy Analysis*, Washington, DC: CATO Institute, 1995)

The major impact (of the capital gains tax) 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. (Federal Reserve Chairman Alan Greenspan in testimony before the Senate Banking Committee, February 25, 1997)

The empirical judgements of these students of capital gains taxation are based on considerations discussed in the following three sections.

Lower capital stock

In today's integrated global capital market, investors equalize the risk-adjusted rates of return after taxes in all countries. Assume that the world is in equilibrium and that these returns are equal in all countries. If, under these conditions, a small country like Canada imposes a capital gains tax, investors reduce their investments in that country. The resultant lowering of the capital stock increases its marginal productivity in that country until the after-tax return is again equal to that in the rest of the world. Since productivity of labour is an increasing function of the capital stock, the smaller amount of capital in Canada is associated with lower output and living standards.

The impact of the imposition of the capital gains tax is slow since it takes time for the capital stock to fall. In fact, the effect may be swamped by the normal growth in the capital stock so that it is difficult to document that the stock would have been even higher if there had been no capital gains tax.

Knowledge capital and entrepreneurial innovation

Modern economic theory stresses that society's productive capital is made up not just of physical plant and equipment but also of human and knowledge capital. The latter is created by research and development and, most importantly, the efforts of entrepreneurs that turn the information into marketable products and services. The boom of the 1990s in the high-tech industries, as well as the increase in labour productivity in the rest of the economy, have been fuelled by entrepreneurship applying new knowledge. In many ways, entrepreneurs are the driving force behind all economic growth.

Entrepreneurs are people determined to make profits from an unproven innovation. They take risks by investing their own capital and time and borrowed capital in pursuing their dream. Unfortunately, a large proportion of entrepreneurial efforts fail. Only markets decide which innovative products, services and technologies are successful.

Entrepreneurs are like people buying lottery tickets. They hope to draw a winner but know that success comes only to a few. However, the expectation of drawing that lucky ticket or successful product is enough to keep people buying lottery tickets and becoming entrepreneurs.

The government of Canada does not tax lottery winnings because it knows that otherwise the net revenue from the lottery would be reduced because people would buy fewer tickets or the payoff ratio would have to be increased. However, the government imposes stiff capital gains taxes on entrepreneurs and the venture capitalists that finance them. Yet, there is little doubt that the reduced returns result in less innovative activity in Canada and it is curious that the same principles underlying the non-taxation of lottery gains are not applied to entrepreneurial gains. Because of this condition, economic growth and productivity gains in Canada are lower than they would be otherwise.

An argument can be made that the existence of venture capital firms deals with the problem that winners from innovation are taxed prohibitively. Such firms pool risks of investing in innovative activities and thus are able to offset wins against losses. Nevertheless, their total net profits are reduced by the capital gains tax and flows into venture capital activities are smaller than they would be in the absence of the tax. Moreover, many entrepreneurs are loners, perhaps because they necessarily fight established ways. These individuals cannot avail themselves of the risk-pooling benefits and the tax reduces their expected net returns. The lower the expected returns, the smaller will be the supply of entrepreneurs willing to take gambles on innovation.

Canada's record of innovative entrepreneurship is inferior to that of the United States. According to the preceding analysis, this result can be explained, at least in part, by the fact that Canada has a much higher capital gains tax than does the United States. To make up for lost ground and possibly pull ahead of the United States, Canada has to eliminate the capital gains tax.

The lock-in effect

The capital gains tax causes damage to the productivity of the existing capital stock by creating a so-called lock-in effect. This effect arises because the tax interferes with market incentives to move out of assets with low yields into assets with high yields. Consider an investor who owns an asset, the sale of which triggers a large capital gains tax obligation. As a result, the investor's cash available for a new investment is reduced by the amount of the tax. The yield

on the new investment must be higher than that on the old by an amount sufficiently large to compensate for the smaller amount of money invested.¹ The lock-in effect prevents the prompt reallocation of capital from low into high yielding uses. It thus reduces the dynamic efficiency of the economy and results in lower income and living standards in Canada.

The government has recognized the damage done by the lock-in effect. For some types of investment, therefore, it instituted roll-over provisions under which the capital gains tax is not payable if the reinvestment takes place under a strict set of rules. Assets held in tax-sheltered investments like RRSPs do not pay taxes on capital gains. However, these measures do not eliminate most of the lock-in effect, as many investors in stock markets have found out to their dismay during recent periods when stock markets boomed.

The marginal efficiency cost of taxes

The idea that taxes cause costly distortions and reduced supplies of the taxed factor of production have been formalized in the theory of the marginal efficiency cost of taxation. Essentially, the marginal efficiency cost of taxation is higher, the easier it is for the taxpayer to avoid the specific tax.

Thus, a consumption tax tends to have the lowest efficiency cost since every person needs to buy goods and services to maintain desired living standards and, as a result, they cannot avoid payment of the tax. The highest efficiency costs in turn arise from the taxation of capital because it induces people to move their capital abroad, keep it locked up in less than optimal investments, or to consume it. Estimates made by the Department of Finance in Canada and published by the OECD (1997) suggest that the marginal efficiency cost of taxes on capital is \$1.55. That is, if a private person has an investment yielding 10% and the government taxes it away, society will be poorer unless the government invests the money in a project yielding 25.5%.

The most important implication of the marginal efficiency cost models is that Canada's tax system could be improved greatly by the elimination of taxes on capital and their replacement by sales and personal taxes, which have efficiency costs of only \$.17 and \$.56, respectively.²

Quantitative estimates of the cost

Direct empirical estimates of the cost of capital gains taxes are very difficult because of the myriad of confounding changes in policies, technology, terms of trade, and demographics taking place at the same time changes in capital gains taxes are implemented. Moreover, there are few distinct, major changes in capital gains taxation levels and structure in Canada and other countries. And, as noted above, the effects of the tax on the capital stock and productivity take place over a prolonged period of time.

Nevertheless, there are two sets of empirical information that shed important light on the cost of the capital gains tax. The first set is based on the concept of the marginal efficiency cost of taxes and empirical studies made to estimate them in Canada and other countries. Dahlby (2002) in his contribution to this volume presents a careful review of such studies and concludes:

[R]ecent econometric studies indicate that switching the tax mix toward consumption taxes can significantly increase the growth rate of the economy. An increase in the annual economic growth rate on the order of a two-tenths of a percentage point ... would have a dramatic impact on Canadian living standards over time. The present value of the additional per-capita output from increasing the annual growth rate by two-tenths of a percentage point is 238% of current output, which represents an enormous gain.

... [E]ven if we have overstated the growth effect of switching to a consumption tax by a factor of 10 ... the present value of the increase in per-capita output would still be 22.3% of current output—a very significant gain. (Dahlby 2002: 96)

Dahlby's conclusion draws on the findings of studies that considered the entire range of indirect taxes, mainly taxes on labour and capital. For this reason, the empirical estimate quoted is not entirely relevant to the capital gains tax alone, which produces only a small fraction of the entire revenue from indirect taxes.³ On the other hand, the marginal efficiency of capital taxes generally is higher than that for other indirect taxes, which implies that its replacement with a direct tax would have a disproportionately large effect, albeit on a small base.

The second empirical study was produced by Kugler and Lenz (2001) for a Fraser Institute conference. This landmark study notes that the federal government of Switzerland does not have a capital gains tax but that, during the last 20 years, individual cantons have experimented with the tax. The authors show that the incomes of all cantons between 1978 and 1995 followed a very similar trend since the same external factors and federal policies affected the economies of all.

However, eight of the cantons during the period under study at some time eliminated the capital gains tax in their jurisdiction while the rest did not. Regression analysis showed that the cantons, which eliminated the tax, enjoyed a jump in cantonal income of 3.2% relative to the income of those that retained the tax. There also has been a beneficial effect on economic growth. The authors found that these gains were not achieved at the expense of cantons that did not eliminate their capital gains tax.

Finally, I made a very simple calculation of the rate of economic growth experienced in the period from 1990 to 1997 by OECD countries that do not have any capital gains tax imposed by their federal government. I found that Hong Kong, the Netherlands, New Zealand, Singapore and Switzerland, countries without the tax, had per-capita growth rates of 2.2% while the rest of the OECD countries grew at 1.2%.⁴

Summary and conclusions

Theoretical considerations suggest capital gains taxation imposes costs on society by lowering the stock of real and knowledge capital and by inducing its less efficient use through the lock-in effect and efforts to avoid the tax. All of these effects translate into lower productivity, per-capita incomes and living standards.

These theoretical considerations in turn have been used to make econometric estimates of the quantitative effect on income. The studies noted above are not specific enough to allow me to conclude that the elimination of the capital gains tax in Canada would result in a certain percentage increase in per-capita incomes. However, together, the empirical evidence implies strongly that the capital gains tax has reduced Canadian income by quantitatively significant amounts and that it will continue to do so in the future.

Effects upon equity

Many Canadians believe that a necessary part of a desirable, good society is a fair tax system and a fair distribution of income. The concept of fairness is value-laden and only the political process can decide on the merit of any given policy. In this spirit, the political establishment in the late 1960s decided to examine the effects of having no capital gains tax on the distribution of income. The examination and public mood resulted in the imposition of a capital gains tax in Canada in 1972.

Fairness of the system—“a buck is a buck”

The public mood at the time was influenced by the idea that people with the same level of income paid different amounts of taxes, depending on whether their income was derived through capital gains or from work. In economics jargon, the tax system did not meet the criterion of horizontal equity. The issue was popularized by the catchy slogan, “a buck is a buck,” and strengthened by reference to the work of two serious scholars, Robert Haig (1921) and Henry Simons (1938). The so-called “Haig-Simons conditions”—that income from all sources should be taxed equally—continues to this day to dominate the discussion of academics and policy makers about the merit of capital gains taxation.

The basic case for the taxation of capital gains on the grounds of horizontal equity is logically valid as far as it goes. However, for a number of reasons, it rests on an incomplete understanding of the nature of capital gains.

First, as Bruce Bartlett argues in a scholarly paper (2001), capital gains are not like income at all. He supports his detailed arguments by reference to the important fact that capital gains are not counted as income in national accounts, which record the total value of goods and services produced in a country. He quotes Simon Kuznets, one of the creators of these national income accounts: “Capital gains and losses are not increments to, or drafts upon, the heap of goods produced by the economic system for consumption or for stock destined for future use, and hence they should be excluded” (Kuznets 1941: 12). In other words, GDP designed to measure the value of national income do not reflect capital gains or losses. Since Kuznets’ principles for measuring national income are accept-

ed almost universally by economists, the question is why capital gains are excluded from the aggregate measures but included in the individual levels of income. Bartlett's answer to this question is:

In truth, their [Haig and Simons'] rationalization for taxation of capital gains rested more on ideological grounds than scientific analysis. As Haig once put it, "an income tax which would allow capital gains to escape unscathed would, in this country at least, be an ethical monstrosity." Simons too holds the same basic view. "The main and decisive case for inclusion of capital gains rests on the fact that equity among individuals is impossible under an income tax which disregards such items of gain and loss." (Bartlett 2001: 12-13; quoting Haig 1928: 120 and Simons 1938: 158).

Second, a large proportion of capital gains are illusory increases in spending power of their owners since they are caused by inflation. Thus, between 1972 and 1991 consumer prices rose 3.8 times while investments in the TSE increased only 2.9 times. Therefore, capital gains reported on such TSE investments were entirely nominal. Economic developments did not allow the owners of such capital gains to increase their spending as if the money had come from work. Their net worth was reduced.⁵

It is argued that the system of capital gains taxation in Canada takes account of inflation by requiring the inclusion in taxable income only one half of the realized capital gains. The preceding data on stock market investments over nearly 20 years show that this provision is not adequate. The exclusion from taxation of 50% of the nominal gains still meant that taxes were due on real losses. In addition, the inclusion rate introduces a bias in the rate at which investments are taxed depending on the length of time over which they have been held. Thus, when inflation is moderate, the 50% exemption is likely to more than compensate for capital gains held for a short period. On the other hand, for long-term investments, the exemption is not likely to equal the actual rate of inflation, as was the case in the stock-market example given in the preceding paragraph.⁶

The problem of assuring horizontal equity in a system without capital gains taxes is aggravated by the ability of people to engage

in tax arbitrage, which means that they shift taxable personal and investment income into non-taxable capital gains. For this reason many tax experts, especially those in Canada's Department of Finance believe that a capital gains tax equal to the tax on income is needed to prevent this type of tax evasion. This important subject will be discussed below in more detail.

Vertical equity—“the rich get richer ...”

Politicians, reflecting public opinion in Canada are very much concerned about the fairness of the distribution of income and wealth or what economists call vertical equity. The public demands that tax and spending policies of government reduce the disposable income and wealth of the rich and enhance those of the poor. There are special concerns that the policies address the problem that “the rich get richer and poor get poorer,” which is perceived to exist unless government intervenes.

Policies designed to create greater fairness in the distribution of income involve, among others, progressive income tax rates and the capital gains tax. In addition, there are expenditure programs like welfare, unemployment insurance, and pension benefits designed to help the poor.

Few people realize that the progressivity of the income tax has resulted in the fact that the top 10% of all income earners in Canada have traditionally paid around 45% of all income taxes⁷ while the bottom 40% of all income earners pay no income taxes at all. This outcome is the result of the progressivity of marginal income tax rates and, important for the present analysis, also to the payment of capital gains taxes by those who earn high incomes. This presumption is based on the appealing notion that only high-income earners hold assets and incur capital gains tax obligations.

What is the empirical evidence on the payment of capital gains taxes by Canadians at different levels of income? One set of calculations supports the view that most capital gains accrue to the rich. Thus, Joel Emes, using a data-base supplied by Revenue Canada found that in 1992 families with incomes of \$100,000 and more paid 78% of all capital gains taxes.⁸ Families with income of \$50,000 or less paid only 8% of the total. In looking at these numbers, it should be remembered that only 7.9% of all Canadian families in 1992 had incomes above \$100,000.

However, these results are quite misleading because the income used to classify families includes capital gains and these gains often are a rare event. In other words, capital gains push some into high income brackets when normally they have much lower incomes. For example, the owners of small retail stores or restaurants often have low incomes and plow earnings back into their business to build up a nest egg for retirement. In the year that such people sell their business and retire, they appear as high-income earners in the statistics. In fact, of course, they are not the “rich” that the capital gains tax was designed to affect.

Emes examined this issue employing the same 1992 data he had used to produce the conventional statistics reported above. In the new calculation he excluded the capital gains reported from total income and made a new distribution. He found that those Canadian families with incomes other than capital gains over \$100,000 in 1992 paid only 26.8% of all such taxes. Families with less than \$50,000 of such non-capital gain incomes paid 52.1%.⁹

One explanation of the large amount of capital gains taxes paid by those with lower incomes is that many of them have investments in mutual funds. Capital gains made by such funds have to be reported as individual income in the year they are realized.¹⁰

Incidence of the tax

Economists are fond of pointing out that taxes often are not paid ultimately by people who send money to the tax collector. For example, excise taxes on cars are paid by the manufacturer, the GST is paid by every firm in the chain of production and distribution, tariffs are paid by importers. Yet, in the end all of these taxes raise the prices paid by consumers through higher prices of their purchases.

Economists are divided over the issue whether business income taxes are paid by their owners or whether they too are shifted to consumers like tariffs and sales and value-added taxes. Some believe that all business income taxes fall on workers and consumers on the grounds that the lower after-tax rates of return drive capital abroad or into consumption until the resultant lower stock of capital restores the original pre-tax rate of return on capital. Others believe that most business owners have insufficient alternative uses for their capital and so are forced to accept the lower rate of return forced upon them by the tax.

While the issue of the incidence of excise and business income taxes has been analyzed widely, the incidence of the capital gains tax has not.¹¹ Yet, the capital gains tax is a tax on business and capital, much like the corporation and small business income taxes. Therefore, it is quite uncertain who pays the capital gains tax. It may in the end be paid by workers and consumers, most of whom are not the “rich” at whom the tax was aimed.

Summary and conclusions

The capital gains tax is designed to create a fair system of income taxation. In particular, it is designed to assure that “a buck is a buck,” that horizontal equity is achieved through the taxation of income whether it comes from ordinary income or capital gains.

The horizontal equity principle of taxation, however, is invalidated to the extent that capital gains in some important ways are not like other income. This fact is acknowledged in the official estimates of national income, which do not include capital gains. In addition, most capital gains are not real but due to inflation so that taxing them implies the confiscation of wealth.

The capital gains tax is also designed to equalize the distribution of after-tax income, to prevent “the rich from getting richer and the poor from getting poorer.” The rationale for this policy is based on the conventional wisdom that only high income earners own capital and enjoy capital gains. However, this wisdom is incorrect in the light of the fact that capital gains taxes are paid by people who enjoy one or a few capital gains in their life-times but otherwise have only low or average incomes. Calculations show that, in fact, over half of capital gains taxes are paid by families earning less than \$50,000 a year in other income.

The idea that capital gains taxes increase vertical equity suffers also from the neglect of hidden forces of market adjustment induced by the tax. Thus, it is likely that in a small country like Canada in a world of increasingly globalized capital markets, the incidence of capital gains taxes falls on workers and consumers, not the owners of capital.

In sum, we have found that the capital gains tax imposes significant cost on Canadians in terms of reduced living standards. We have also found that the benefits in terms of horizontal and vertical equity are much less than conventional wisdom suggests. This new

information combined suggests that the old calculations of the ratio between the costs and benefits of the capital gains tax are no longer valid. Canadians would be better off if the tax were abolished.

Tax arbitrage

When a business has to pay a tax on profits but not on capital, incentives are created to use creative bookkeeping and legal manoeuvres to turn profits into capital gains. Small businesses, like those of lawyers and physicians, can reduce the pay of their employees and invest the savings in the firm. The value of the firm increases correspondingly and employees can realize the gains as non-taxable capital gains. These processes designed to take advantage of the absence of capital gains taxes are known as tax arbitrage or “surplus stripping,” in the terminology used during the 1970s.¹²

A publication by the Canadian Department of Finance reviewed the history of tax arbitrage and reached the following conclusion: “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” (Department of Finance 1980). The Carter Commission Report recommended the adoption of the capital gains tax to prevent surplus stripping. The government accepted this recommendation and adopted a capital gains tax in 1972.

How big is the problem of tax arbitrage in Canada? At the 1999 symposium on capital gains taxation at the Fraser Institute, a number of participants, who had been working in the financial sector during the 1960s, disputed the proposition that surplus stripping was a major problem at that time. They noted that such stripping is not possible for large, publicly held companies except through the reinvestment of profits and the repurchase of outstanding stocks. These latter practices are employed for many reasons other than tax arbitrage and have continued after the capital gains tax was introduced and raised above the tax rate applicable to other income.

On the other hand, small, privately held companies were able to engage in this kind of legal and financial maneuver. But, it was also true that the Department of Finance could quite easily have prohibited such manoeuvres, which so obviously had no other purpose

than the avoidance of taxes. These observers suggested that surplus stripping was a red herring to divert public attention from an innovation in taxation that was motivated by a desire to equalize the distribution of income and expand the size of government.

The following view, attributed to one of the most respected American economists in public service in recent decades, supports the views of Canadian experts about the problem of tax arbitrage just discussed: “Alan Greenspan laboured in the Wall Street vineyards before he got his academic degrees in economics. He told me he had to spend decades trying to figure out how to convert ordinary income into capital gains and couldn’t figure out how to do it” (Wanniski 1999). To shed further light on this issue, the Fraser Institute’s 2000 symposium brought to Vancouver economists who were knowledgeable about the problems experienced in their countries as a result of having no capital gains taxation. The experience of Hong Kong is of special relevance to the present analysis. For evidence from other countries readers are directed to Grubel 2001.

Empirical evidence from Hong Kong

Berry Hsu and Chi-Wa Yuen (2000) discussed Hong Kong’s experience. They provided a list of methods that can be used to turn profits into capital gains. Some are quite simple, like buying real estate with the intention of reselling it but claiming that the resulting profits were capital gains. Others are more sophisticated, like the sale of the right to a future stream of income, claiming it to be a capital gain. These and other schemes have been tried and have been challenged successfully by the Hong Kong revenue authorities. These authorities are guided in their actions by two, relatively simple, anti-avoidance principles:

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 taxes 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. (Hsu and Yuen 2001: 43)

The decisions of the revenue authorities based on these principles are challenged regularly by the affected parties. A Board of Review adjudicates these appeals. Hsu and Yuen consider the rulings by the revenue authorities and of the review board to reflect the magnitude of the efforts of taxpayers to shift taxable income into non-taxable capital gains. They conclude: "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" (Hsu and Yuen 2001: 50). Hong Kong is, in so many ways, like no other "country" in the world and its experiences may have only limited relevance to others. Most important, the low income and profits taxes, which keep low the returns to be gained by turning taxable income into non-taxable capital gains.

On the other hand, Hong Kong's practices for dealing with such tax avoidance efforts show that it should be possible for Canada's revenue agency to set out some simple anti-avoidance principles against which it, and an appeals court, can evaluate any practices that appear to be designed to avoid taxes. Such a task would not be new since the present more favourable rate of taxation of capital gains relative to other income already contains some incentives to avoid taxes by dividend stripping or the methods used in Hong Kong. Existing rules and regulations may be expected to apply fully in a regime completely without capital gains taxes though, of course, under these conditions the incentives to get around these rules and regulations would be stronger for the private sector.

Conclusion

There is no doubt that the absence of a capital gains tax in the presence of business and personal income taxes opens opportunities for tax arbitrage. Such tax arbitrage wastes resources, induces the inefficient allocation of resources and causes the tax system to be unfair.

These facts give rise to two questions. First, how large would such arbitrage be and, second, how difficult is it for the Government of Canada to prevent it. Evidence relevant to the first question is mixed. Before Canada introduced a capital gains tax, government experts considered it to be a major problem. On the other hand, practitioners from the private sector deny this. Evidence relevant to the second question suggests that the cost of avoiding

arbitrage might be quite small, if the government armed itself with anti-avoidance principles as the base from which to evaluate and prevent the arbitrage.

Perhaps the views of capital market participants and the experience of Hong Kong are biased. But, it is also quite likely that the testimony of government experts is also biased. Their life has been made much easier by not having to prevent tax arbitrage.

On balance, the possibility of tax arbitrage and the cost of preventing it represent a cost of uncertain magnitude in eliminating the capital gains tax in Canada. It should, therefore, enter a rational calculation of the costs and benefits of such a policy discussed above. My own view is that the cost of arbitrage is unlikely to be greater than the benefits in terms of efficiency minus the net cost of reduced equity discussed above.

Implications for revenue

Any suggested changes in the tax system must be accompanied by consideration of their effect on overall fiscal revenues. In the context of the present discussion of the capital gains tax, the easiest way to handle this issue is to suggest that the government be required to raise other taxes to make up the lost revenue. Alternatively, at times when the government projects the development of fiscal surpluses, it may be assumed that the elimination of the capital gains tax is just one of the ways in which the surplus can be eliminated.

In either case, the size of the revenue losses from the elimination of the capital gains tax is important because it determines how significant are the required increases in other tax rates or how much of a surplus is required and, therefore, cannot be used for other purposes. Unfortunately, the Government of Canada does not publish how much revenue the capital gains tax generates. There are no relevant data in publications by the Department of Finance or Statistics Canada. In OECD publications, where estimates for other countries are presented, the entry for Canada is blank.

To make up for this lack of information, Joel Emes used a computerized model provided by Statistics Canada to examine a repre-

sentative sample of personal income tax returns. He estimated that in 1992 total revenue from the capital gains taxation was \$715.6 million, or less than .3% of the total tax revenue that year. This figure was disputed by the Department of Finance, which informed us that, according to their estimates, the revenue from the capital gains tax were about 3% of total revenue and that provincial governments collected additional amounts on their own accounts.¹³

Whatever the true size of the revenue from the capital gains tax, the available information suggests that it is relatively small. Therefore, it is almost certain that its elimination will have little impact on other taxes if revenue neutrality is desired or if it occurs at the cost of other uses of the fiscal surplus. As a practical matter, the increases in revenue generated by normal economic growth would quickly exceed the relatively small amount of revenue lost through the elimination of the tax and prevent it from causing, or adding to, any fiscal deficit.

Most important, however, is the fact that the elimination of the capital gains tax will almost certainly add to normal economic growth and, therefore, to revenues from all other tax sources. The prospect of such a favourable development follows directly from the analysis of the positive effects the policy would have on economic efficiency and incentives discussed above.

Unfortunately, the expected growth in income and other tax revenue is uncertain with respect to timing and magnitude. In addition, the link between increased growth and the elimination of the capital gains tax is not as transparent as one might wish. Therefore, the merit of the elimination of the capital gains tax is subject to much controversy among economists. If the government of Canada were to embrace the suggested elimination of the capital gains tax, politicians would encounter much opposition from organizations dedicated to the fostering of income equality, real and perceived. These politicians cannot expect support from the rest of Canadians since their gains in income will be relatively small and uncertain. They have only negligible incentives to lobby for their interests and threaten punishment at the ballot boxes. This asymmetry of pressures on politicians, formalized so ably by public-choice theory, haunts all efforts to create policies that improve overall economic performance but affect adversely small segments of society.

Summary and policy implications

At the risk of oversimplification, the battle over the retention or abolition of the capital gains tax is fought along lines characterized by two catchy slogans, “a buck is a buck” and “harvest the fruit but do not cut the tree.” The first slogan is about the distribution of income and the fairness of the taxation system. The second is about the efficiency implications of the tax and how much it reduces economic growth and per-capita incomes. Most people agree that both fairness and efficiency should be considered in the design and operation of Canada’s tax system. The crucial issue arises around the magnitudes of these two social objectives.

This paper discussed the growing evidence on the size of the efficiency losses due to the tax. The large number of studies using the concept of the marginal efficiency cost of taxes implies that the cost is substantial. The study of the Swiss experience is powerful and adds to the direct evidence on the effects of that tax on income.

A review of the issue of horizontal equity raises serious analytical questions about the relevance of the arguments suggesting the need to treat capital gains in the same way as other income. On the issue of vertical equity, recent calculations have shown that over half of the tax is paid by families with less than \$50,000 annual income from other sources.

Available empirical evidence suggests that tax arbitrage would be much less of a problem for the economy than the Department of Finance believes. A strong case can be made that the practices used in Hong Kong could effectively limit tax arbitrage at a reasonable administrative costs in Canada.

In sum, new empirical and analytical knowledge implies that Canada would be better off without the capital gains tax. The resultant increases in output and prosperity would almost certainly outweigh the relatively minor effects on the fair distribution of income and the small cost associated with limiting tax arbitrage.

Notes

- 1** Consider an investor who holds an asset worth \$100. The future rate of return is assessed to be 9% and thus brings \$9 annually. In the absence of the capital gains tax, the asset would be sold and reinvested in a comparable company assumed to exist and with a return of 10%, bringing an annual income of \$10. But, now consider that the sale of the asset gives rise to a \$20 capital gains tax obligation, leaving only \$80 for reinvestment in the higher yielding asset. If the investor holds on to the low yielding asset, the income is \$9, more than the \$8 earned by selling it, paying the capital gains tax and reinvesting in the higher yielding asset. The rational owner of the investment subject to the capital gains tax keeps his funds where they are and is privately better off than if the asset were sold. However, society is worse off because funds are prevented from flowing from the lower into the higher yielding investment—\$1 per \$100 in the preceding example.
- 2** In a study of the United States, Jorgensen and Yun (1989) estimated the capital income tax to have an efficiency cost of .924 while the sales and personal income tax costs were .256 and .598, respectively. The relatively small efficiency cost of capital taxation in the United States is not surprising since it is the one country in the world where the “small country assumption” does not hold. Capital inflows and outflows can be so large that they influence the “world” rate of return, in contrast with Canadian flows that are so small as to leave returns in the world unaffected.
- 3** According to one estimate, the capital gains tax revenue of the federal government in 1992 represented only .3% of all federal taxes collected (Grubel 2000: 14). Poddar and English estimated that federal capital gains taxes represented only 21.1% of the total federal tax on investment collected (Poddar and English 1999). For more on this subject, see the last section below.
- 4** The latter group excludes countries that index capital gains taxes to inflation (Australia, Ireland, Luxembourg, Mexico, and the United Kingdom). The per-capita growth rate of these countries from 1990 to 1997 was 2.3%.

- 5** See Grubel 2000: 40–42 for the sources of this information and a discussion of reasons why inflation indexing is used in only few countries. Eisner 1980: 343 shows that in the United States there were no real but only nominal capital gains during the period from 1946 to 1977.
- 6** These facts raise the question why capital gains taxes are not adjusted for inflation so that only real gains are taxed. I have not discovered any answers to this question. At the 2000 Fraser Institute symposium on capital gains taxation a number of economists reported on their countries' experiences with indexing. There are no theoretical objections and no practical pitfalls preventing the use of this system in Canada and other industrial countries. Unfortunately, its introduction in the presence of a 50% exemption rate, as prevails in Canada, would require the elimination of that exemption. Such a policy would be condemned widely as a tax increase, as it almost certainly would be during the relatively low rates of inflation that have prevailed in recent years and may be expected for some years to come.
- 7** A graph showing the share of all income taxes paid by the top 10% and 1% of all income earners between 1997 and 1995—regardless of the top marginal income tax rates—is found in Grubel 2000: 16.
- 8** See Grubel 2000 for more information about these calculations.
- 9** Jonathan Kesselman has indicated to me in private correspondence that the calculations made by Emes do not prove conclusively that lower-income and middle-income Canadians pay the bulk of the capital gains tax. He thinks that generally high-income earners can be expected to report their capital gains in years that their other incomes are below normal. I agree with him that this issue can be settled only by studies, which trace incomes and tax payments through time. Unfortunately, such panel data are not yet available in Canada.
- 10** As a result of this provision, many Canadians with low and modest incomes at income tax time face unanticipated tax obligations. Some are forced to sell part of their fund holdings to generate the

cash needed to pay the tax collector, which contributes to economically inefficient turnover of investments.

11 I owe the point on the shifting of the capital gains tax to Professor John Chant, who made it in an unpublished note presented at the first Fraser Institute conference on capital gains taxation held in Vancouver in September 1999.

12 Essentially the process requires that the owners of a working company establish a dummy corporation. This dummy borrows money from a bank to buy all of the shares of a working company. The dummy company becomes the owner of all of the real assets of the working company plus the profits it earned in the preceding period. These profits are referred to as surplus and are to be turned into capital gains.

The next step in the process of stripping this surplus is for the working company to use the money it received from the dummy corporation to buy back all of its shares. It thus becomes once more the owner of its real assets but, by agreement, it leaves the surplus with the dummy corporation. The dummy then uses the money it received for the shares to repay the bank loan. However, it has left over the surplus, or profits, of the working corporation. The dummy corporation is dissolved and in the process declares a capital gain equal to the working company's profits. The owners of the dummy corporation in effect have turned the taxable profits of their working company into a non-taxable capital gain.

An analogous process can be used to convert the income of professionals like physicians and lawyers into a surplus of a business owned by them. See Grubel 2001 for the way in which such practices can be used to turn taxable personal income into non-taxable capital gains.

13 For more details, see Grubel 2000. I remain puzzled by the fact that the Department of Finance has data on the amount of revenue collected but does not publish it and makes it available, after delays, only to persons making persistent requests for the information.

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