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The Case for Full Taxation of Captial Gains

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The Case for Full Taxation of Capital Gains

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The business community has mounted a concerted lobby to have capital gains exempted from tax. In both speeches and financial publications, business leaders and many financial journalists are calling for the end of the tax on capital gains. This movement coincides with similar developments in the United States which have culminated in a reduction of taxes on capital gains in the recently passed Revenue Act of 1978. Canadian business interests often appear to borrow their ideas for reform from measures that special interest groups in the United States succeed in getting passed through Congress. Therefore, it is worth noting that of the over $2 billion of capital gains relief this recently enacted American provision will provide, 75 per cent will be received by the wealthiest 2 per cent of taxpayers.

The movement in Canada has also derived considerable impetus from the recent report of the Royal Commission on Corporate Concentration which recommended the abolition of the tax. The Commission's recommendation coincided well with the lobbyists' activities. It also went beyond the Commission's terms of reference and was unsupported by any background study. It was explained by George Radwanski of the Financial Times in these terms: "once you're putting in a good word for your friends, why not go all the way?"

The lobby effort has now reached the stage where stockbrokers and investment dealers are circulating thousands of petitions to customers and other sympathetic signatories calling for the abolition of the tax. The petition circulated by Yorkton Securities of Toronto describes the tax as a "significant deterrent to investment," and adds that "abolition would probably lead to a higher level of personal investment and risk capital formation."

The suggestion that the capital gains tax should be abolished and the arguments supporting such a suggestion are so tenous that it is hard to take them seriously. But they must be taken seriously. The tax reform process in Canada clearly reveals that even the most ludicrous of ideas, if supported by business interests, are often acted upon by the government.

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A capital gain is the profit an investor receives from the sale of property, usually corporate shares or real estate. The present tax law gives such income privileged treatment in two ways. First, only one-half of the profit has to be included in the investor's income for tax purposes. Second, the tax is only payable on such income when the property is disposed of, rather than when the gain accrues. Under an equitable tax system, an investor who held property that appreciated in a year would be taxed on that appreciated value whether or not it was realized in cash. A $100 appreciation in the value of stock increases a person's command over goods and services to the same extent as $100 in earned income.

Instead of exempting gains from investment property from tax, the sensible thing for the government to do would be to stop giving such income the enormously generous preferential treatment it receives under the present law and to tax it in the same fashion as income from labour.

The Case for Taxing Capital Gains

The case for taxing capital gains at the normal rates is straightforward and compelling. The following are some of the obvious reasons:

A dollar of profit resulting from the sale of a capital asset increases a person's capacity to consume or ability to pay by as much as a dollar earned through personal effort. Therefore, a tax system premised upon ability to pay and upon the most fundamental axiom of justice - that people similarly situated should be treated equally - should tax capital gains in full.

To the extent that income from capital is not taxed, it means that other income, income from labour for example, must be taxed at higher rates. Thus, not taxing capital gains at full rates causes a redistribution of the tax burden from investors to wage and salary earners.

The benefits of taxing capital gains at preferential rates accrue almost exclusively to a small minority of high-income individuals. In 1975, over 30 per cent of the capital gains were reported by people with income over $50,000, people who represented only .6 per cent of all tax return filers. The average person in the $5,000 - $10,000 income group received a benefit of about $4 because of the preferential tax rate. But the average person with income over $100,000 received a benefit of $4,222 - over a thousand times greater!

The argument for repeal of the tax on capital gains was buttressed by the Royal Commission on Corporate Concentration when it noted that repealing the tax would simplify the Income Tax Act. However, an appeal to tax simplification more compellingly supports the abolition of the distinction between ordinary and capital gains. Such a move would render the majority of the most complicated provisions in the Act unnecessary.

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A capital gain has no economic reality; it is merely a legal construct. Therefore, high income taxpayers are sometimes able, with the assistance of expert advice, to recast transactions so that, without changing their economic reality, they attract preferential capital gains treatment. This "tax game" results in an enormous waste of resources in legal planning and litigation and in the compliance and administrative costs the Government must expend to police the game. It also has a debilitating effect on the tax morality of those taxpayers unable to escape tax by "playing the game." Thus, the integrity of the self-assessment system is threatened.

Capital losses, except to a limited extent, can only be deducted from capital gains. This is unfair to many taxpayers who have large capital losses but no capital gains against which to offset them. But because capital gains are taxed only when realized, this limitation on the deduction of losses is necessary to prevent taxpayers from timing their capital losses to their best advantage. If it were not for this rule, taxpayers could avoid tax by realizing losses as they accrue in high-income years while allowing large capital gains to accrue tax-free and realizing them in low-income years. However, if capital gains were fully taxed on accrual, the unfairness of not permitting taxpayers to deduct their capital losses from ordinary income could be eliminated.

Not taxing capital gains at full rates leads to economic ineffiencies. First, to the extent that capital gains are accorded preferential treatment the price relationship between assets of equal economic value is upset: capital is diverted from its optimum use into investments that promise a return in the form of capital appreciation. As a result, there is an over-investment in such activities as real estate speculation. Second, the present system results in a tax advantage in favor of corporate accumulations. Because shareholders are anxious to realize the return on their investment in the form of equity appreciation, corporations are under no pressure to pay out dividends. Consequently, corporations become less dependent on new stock issues to finance growth. The securities marketplace is thus not able to perform its allocative function and corporate managers have one less reason to maximize profits.

Removing the tax on capital gains would provide an enormous and unjustifiable windfall to all those investors who already have money invested in capital assets. And once the tax advantage was reflected in the price of the assets to which it attaches, new investors would receive very little advantage by investing in capital assets. Since the purpose of the incentive is to encourage people to invest, it should only apply to new investments; it should not be given to those who are willing to invest in the absence of the subsidy. In no other subsidy program would the government tolerate such a windfall.

Not only is the concept of capital gains inequitable and inefficient, but also it is replete with inconsistencies and cannot be administered with a reasonable degree of certainty. The borderline between a capital and an income gain is the most litigated issue in tax law.

Finally, the ultimate irony of a commission on corporate concentration recommending the abolition of the tax on capital gains is that such a change would result in increased corporate concentration. The only way that an entrepreneur can receive this subsidy is by selling a successful enterprise and realizing a capital gain. Naturally, it will be large corporations that provide the market for the sale of small on-going businesses.

In the face of these reasons for taxing capital gains at full rates, the arguments for providing them preferential treatment, much less their total exemption from tax, pale in significance. Indeed, their feebleness would be laughable were it not for the political strength of the lobbyists advancing them. The proponents of the abolition of the tax on capital gains make appeals to fairness, economic efficiency and the need for the government to foster sustained economic growth. Each of these appeals will be examined in turn.

Fairness

It is sometimes argued that a preferential rate for capital gains is necessary in order to make the taxation of this type of income equivalent to the taxation of income from labour. The preferential rate is said to compensate for the problems of bunching and inflation, both of which cause capital gains to be taxed unfairly.

(a) Bunching - Preferential treatment of capital gains is said to serve as a remedy for the inequity of taxing in one year, at progressive rates, a gain that has accrued over a number of years. If the gain were taxed annually as it accrued, it would be taxed at the taxpayer's normal marginal rates. However, because it is all added to the taxpayer's income in the year that it is realized, the taxpayer's income will be abnormally high in that year and the gain will be taxed at unfairly high marginal rates. This argument for preferential treatment is without validity.

First, the Income Tax Act provides a means by which large capital gains realized in one year can, in effect, be received and taxed in equal amounts over a fifteen-year period. As well as this liberal averaging provision, the Act provides that if the proceeds of sale are received on an installment basis, the gain is not taxed until the cash is received.

A second flaw in the argument that the "bunching" effect justifies preferential capital gains treatment is that for most people who realize capital gains, bunching is not a problem. Over 40 per cent of the capital gains are received by taxpayers with income of over $50,000. These taxpayers are likely to be in or close to the highest income tax bracket every year; thus bunching will not push them into higher marginal tax brackets. Moreover, to the extent that capital gains are small they are not likely to move taxpayers into higher tax brackets. And to the extent that a taxpayer realizes capital gains on a fairly regular basis - and the evidence suggests that to most taxpayers realizing capital gains they are a regular source of income - no income distortion occurs even if gains are bunched on individual assets.

Finally, bunching would be entirely avoided in the most equitable system, namely, one in which capital gains are taxed as they accrue. Indeed, the argument for preferential treatment overlooks the value of tax deferral. To the extent that capital gains are not taxed as they accrue each year, the taxpayer has received an interest-free loan from the government equal to the amount of tax that would be owed if the gain were taxed as it accrued. The value of this loan will in practically all cases vastly exceed the additional tax payable because of the bunching of the gain.

(b) Inflation The current preferential treatment of capital gains is sometimes justified as a correction for the effects of inflation. To the extent that an increase in the price of property simply reflects a general rise in prices there is no increase in the owner's economic power. Ideally, since only increases in economic power are the proper subject of taxation, all inflationary gains ought to be ignored for tax purposes. However, this argument for the present preferential treatment of capital gains, and even more so for their total exemption from tax, also fails on a number of counts.

The exclusion of one-half of all capital gains is an extremely crude instrument with which to compensate for inflation; rarely will it accurately isolate and eliminate the inflationary element of capital gains. The historical evidence reveals that for practically all holding periods the exemption from tax of one-half of capital gains would have resulted in the investor being vastly over-compensated for inflation. This would be all the more true if capital gains were totally exempted from tax.

This method of compensating for inflation unfairly favours those who realize quick gains. For example, if an asset doubles in value in two years, excluding half the gain from tax to compensate for declining purchasing power is, even under the most severe inflation, overly generous. It also unfairly favours those in the highest marginal tax brackets. Inflation reduces the purchasing power of all capital gains recipients. And yet the present system saves a person in a 50 per cent bracket a great deal more money than a person in a 25 per cent bracket who realizes the same amount of capital gains.

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Furthermore, in an inflationary economy, debt, as well as all types of income from capital must be adjusted for inflation. Adjusting only capital gains creates additional inequities. For example, it seems unfair to compensate holders of stock for inflation but not savings account depositors, particularly because the latter are not as heavily concentrated in upper-income brackets as holders of capital property. Also in an inflationary period debtors enjoy a gain in real terms. Adjusting only capital gains for inflation leads to the incongruous result that holders of debt-financed capital properties have their gains reduced in recognition of inflation, while the fact that they were able to repay the debt with cheaper dollars is ignored.

Finally, if gains are taxed only when realized no special treatment is justified for inflation because, again as a matter of historical record, the value of tax deferral will, in most cases, at least equal the tax imposed on the inflationary gain. Perhaps the fairest and most administratively feasible system would be one in which, when an asset is sold, the value of deferral and the inflation factor are reckoned in computing the taxable gain. However, in the absence of such a system the fairest results will be achieved by taxing the full amount of the gain on the assumption these two factors balance one another out.

Economic Efficiency

As well as appeals to fairness, proponents of preferential treatment for capital gains argue that taxing capital gains leads to economic inefficiency in that such a tax impairs the mobility of capital. In a tax-free world investors will continually seek to place their capital in those investments which, in their view, will yield the highest rate of return. Thus, resources will be allocated with maximum market efficiency. A tax on capital gains, however, imposes a cost on the sale of an asset that has appreciated in value. When such an asset is sold, the investor, after paying the tax, will have less to invest in another enterprise. This makes it necessary for taxpayers to earn a substantially higher return on a new investment in order to maintain their previous income position. Consequently, investors tend to hold appreciated investments instead of reallocating their capital to uses which generate the highest rate of return. This inefficiency in the market reduces the cost of capital to established firms, and hurts new ventures which find it more difficult to dislodge funds from established enterprises which may be declining or stagnating.

But the extent to which a tax on capital gains locks in appreciated capital and the economic effect of any such capital immobility are greatly exaggerated. Innumerable variables affect a person's decision to buy or sell stock, and it seems unlikely that an investor will hold an investment of dubious return, if a more attractive one is available, simply because of the tax cost of selling. Only if the difference in the expected rate of return were trivial, would a rational investor retain his or her present investment. A study done for the Carter Report found that in the early sixties there was less investment mobility in Canada than in the United States even though Canada at that time did not tax capital gains and the United States did. Thus, there was no evidence to suggest that a lack of capital gain taxation in Canada improved security mobility.

Some recent studies in the United States tend to show (although their findings have been disputed) that high-income individuals are less likely to sell capital assets because of the tax on sale. However, these studies have no bearing on the situation in Canada. Canada's averaging provisions for capital gains are far more liberal and, more importantly, in the United States the factor that aggravates the locked-in problem does not pertain to the Canadian situation. In the United States, if an investor holds on to a capital asset until death the tax on its appreciated value can to some extent be avoided. However in Canada, of course, an investor would have no such incentive for retaining a capital asset that had appreciated in value; there is a deemed disposition of all capital property on death and tax is imposed on its appreciated value.

But even assuming that some investors are reluctant to unlock their investments because of the tax on capital gains, it is still not clear that this has any serious effects on economic efficiency. Two arguments are frequently made: that the locked-in effect restricts the flow of capital to new enterprises and that it causes instability in the securities market. It is difficult to see how capital formation can suffer much because some investors have capital locked into particular investments. While one investor's funds might be tied up, the person who otherwise might have purchased those investments now has funds available to use elsewhere. And while individuals have varying investment aspirations

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and abilities, generally it is likely that potential buyers of a locked-in investment would use their available funds for much the same uses as would the locked-in investors.

The locked-in effect is also said to aggravate fluctuations in the stock market. The contention is that a rising market locks in gains, and the investors' reluctance to sell and incur the tax reduces the available supply of securities. This artificially reduced supply of securities will result in price increases. A number of points might be made about this argument. First, there is no compelling relationship between the stock market and instability in the economy. Second, in the absence of a capital gains tax more money would be coaxed into the market. It is conceivable that this increased demand would exceed the increased supply that would result from the elimination of lock-in. If so, prices would rise even more. Third, the fluctuations attributable to the locked-in effect are minimal because, in most cases, the same investors are on both sides of the market. That is to say, if people selling certain stocks are simply re-purchasing others, aggregate demand remains the same whether or not the tax is imposed. If a person is both a buyer and seller his net influence on the market will be nil. The argument that the locked-in effect aggravates market instability assumes that people who might unlock their investments would withdraw their funds from the market altogether. For most investors this seems unlikely.

Two final points about the locked-in effect should be noted. First, when we consider the effect of capital gains taxation on the mobility of capital, we must also consider the effect of the full deductibility of capital losses. During a period of economic decline, full deduction of losses would tend to make capital more mobile since there would be a tax incentive to realize losses. This would facilitate the transfer of assets into more efficient uses. Second, the locked-in problem arises only because capital gains are presently given preferential treatment in that they are only taxed when realized. If they were taxed in the most equitable fashion - on an accrual basis - there would be no locked-in problem. Tax considerations would have absolutely no effect on an investor's decision to buy or sell, and capital would freely seek its most efficient economic use.

Subsidy for Sustained Economic Growth

The Royal Commission on Corporate Concentration argued that the capital gains tax should be abolished in order to increase aggregate savings in the economy and the availability of financial capital, particularly equity capital and capital to finance risk ventures. Thus, although it was not explicitly stated in this fashion in its report, the benefit of not taxing capital gains was viewed by the Commission as equivalent to a subsidy that the government gives to sellers of capital property in pursuit of the goal of economic growth. Viewed as a subsidy for this purpose, the non-taxation of capital gains has a number of defects.

(a) Encourage Savings - Over the last few years various economists and business interests have been warning of an impending capital gap. They argue that unless drastic steps are taken the amount of aggregate savings in the economy will not be sufficient to finance the necessary capital investment. The abolition of the capital gains tax was presumably perceived by the Commission as one way of encouraging savings in order to provide for future capital needs.

The capital scarcity theory has become the rallying cry for all high-income taxpayers seeking a tax break. This is so in spite of the facts that the evidence of any impending shortage of financial capital is meagre; a capital shortage in Canada will only be serious if it reflects an international capital gap; aggregate studies of capital needs are inappropriate in a complex economy; it is not clear that the growth of capital stock has a significant impact on economic growth; and, at present, physical capital is underutilized (thus it is possible to increase the level of investment simply by increasing the willingness of businesses or individuals to expand the use of plant, equipment, and other types of capital). However, even accepting the capital scarcity theory, exempting capital gains from tax is an inefficient and inequitable way of meeting it.

A number of arguments are often made in support of

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the notion that abolishing the tax on capital gains will increase savings. The premise of each of these arguments is open to question. First, it is said that since capital gains are often irregular increments to income, people are more likely to save than consume the amount of the gain. Taxing part of the gain will, therefore, directly reduce aggregate savings. However, the more plausible assumption is that to most people capital gains are a recurring form of income. In terms of whether they save or consume a capital gain, most people probably do not distinguish it from other forms of income. Indeed, we know very little about the relationship between income and consumption, except that the propensity to consume appears to decrease as income rises. If an additional income tax were allocated among income classes in the same way capital gains are now distributed, it is unclear that the effect on savings and consumption would be any different.

Second, it is argued that taxing capital gains reduces the after-tax rate of return to savers. This, in turn, causes some substitution away from saving and in favour of consumption. However, a multitude of factors affect the amount that an individual saves and it has been shown that personal savings are not very sensitive to the rate of return; indeed the consensus among economists is that aggregate personal saving is unresponsive to changes in the after-tax rate of return.

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Third, some say that savings will be increased if capital gains are not taxed because the non-taxation of capital gains provides a tax incentive for corporations to retain their earnings and thereby increase the value of their shares, rather than pay out profits to shareholders in the form of dividends. But, while the non-taxation of capital gains might lead corporations to increase savings, to the extent that increased share values increase the wealth of individuals, there is likely to be a corresponding decrease in personal savings.

Fourth, it is argued that since a tax on capital gains falls most heavily upon high-income taxpayers, it reduces the disposable income of those people with the highest propensity to save. While this argument is undoubtedly true, it points up the fact that exempting capital gains from tax is the most inequitable way of encouraging savings. Capital gains is a form of income available to only a small number of, in the main, high-income taxpayers. Surely if a tax incentive for savings is required, it should be available to all taxpayers, wage earners as well as property owners. And, if the government is intent on increasing savings by reducing the tax burden on high-income taxpayers, the most economically efficient way of doing it is by simply reducing their tax rates. Indeed, the fact that this is a politically unattractive alternative probably explains the appeals to idealogy surrounding the capital gains tax: high-income taxpayers can camouflage their real goal - lower taxes on themselves - with the ideologies of economic growth.

Two further points might be made about this general argument. First, full taxation of capital gains will undoubtedly result in increased savings for some people. Full taxation will cause a decline in the price of capital property. People will resond to this decline in their wealth by increasing their savings in an effort to rebuild it. Second, like all subsidies provided through the Income Tax Act, this subsidy to encourage savings has an upside-down effect. If a taxpayer in the sixty per cent tax bracket sells an asset and capital gains are not taxed, the government subsidizes this person to the tune of sixty cents per dollar. A taxpayer in the thirty per cent tax bracket receives a subsidy for an equivalent gain only to the extent of thirty cents per dollar. It is intolerable that a low-income taxpayer who engages in the identical economic activity as a high-income taxpayer, and who supposedly contributes as much to the economy, receives only one-half as great a subsidy.

(b) Encourage Equity Investment - There has been increasing concern in Canada about the thinness of the equity securities market. Indeed the Commission on Corporate Concentration expressed grave concern about the lack of equity capital in Canada. It noted that in the last few years the number of new equity issues, particularly those of medium-sized and small firms, has been steadily declining. Corporate stock is, of course, one ot the principal types of assets to which capital gains accrue. Exemption of capital gains is thus seen as a method of increasing the after-tax rate of return on corporate stock, and of encouraging investors to purchase it. This will increase the price of stock and reduce the cost of new equity issues. However, there are a number of problems with this assessment.

First, it is doubtful whether a tax subsidy to individual Canadian investors can in any serious way affect the price of Canadian securities. A large majority of securities are held by institutional investors who are indifferent as to whether capital gains are taxed at preferential rates. Furthermore, because non-residents of Canada hold investments in Canadian securities, the price of Canadian securities must move in the same general direction as foreign securities. An increased demand by Canadian investors for Canadian securities will drive up their price, but this increased demand will be offset to some extent by the consequent selling by non-residents.

Second, it is uncertain what effect an increase in the price of corporate stock will have on business investment expenditures. If there is a lack of profitable investment opportunities, reducing the price of equity financing will have no impact on economic growth. Indeed, most economists have asserted that Canadian businessmen are failing to invest in productive resources not because of a lack of equity financing but because the rate of return on new investments does not justify the undertaking.

At any rate, as we mentioned earlier, exempting capital gains makes companies less dependent on the new issue market.

(c) Encourage Risk Capital - Another matter that concerned the Commission was the "deficiency in the availability of risk capital in Canada." The abolition of the tax on capital gains was presumably seen as a means of encouraging investors to increase risk-taking. Abolishing the tax on capital gains should increase risk-taking by permitting the owners of successful ventures to sell their enterprise and realize a gain that would not be taxed; thus increasing the potential after-tax rate of return on such enterprises. Also, to the extent that exempting capital gains from tax reduces the cost of equity capital, it should permit firms to finance by equity capital and thus engage in more risky undertakings.

High-income taxpayers can camouflage their real goal– lower taxes on themselves–with the idealogies of economic growth.

This argument is subject to the reservations that the encouragement of risk investment is not necessarily a good thing; the non-taxation of capital gains is likely only a trivial incentive to risk-taking; and as a subsidy for risk-taking the non-taxation of capital gains is ridiculously target-inefficient.

The reason that the non-taxation of capital gains is not likely to have an important impact on risk-taking is that if capital gains are not taxed, capital losses cannot be used to reduce tax liability. The full taxation of capital gains would permit the full deductibility of losses. Therefore, when the chances of gain or loss are regarded as equal, a tax on capital gains does not affect the preference for risk-taking. Indeed, since losses are more frequently the result of risky investment, the full taxation of gains coupled with the full offset of capital losses would reduce the downside risk and might actually increase risk-taking.

A subsidy for risk-taking provided by means of the exemption of capital gains from tax is target-inefficient. Indeed, it is both over- and under-inclusive. On the one hand, it benefits all sorts of investments which do not involve the taking of risks, for example, blue chip securities and real estate. In fact, the majority of capital gains are realized on these types of investments. On the other hand, many entrepreneurs who undertake risky investments are unable to turn their profits into capital gains in order to take advantage of the subsidy.

Conclusion

The economic gains, if any, of not taxing capital gains are utterly trivial when compared to the economic distortions, administrative costs and inequity of not taxing them at full rates. Unfortunately, the political constituency that might support full taxation is diffuse. No group in particular is hurt by the exemption of capital gains from tax. Consequently, the assertions that capital gains should not be taxed go largely unopposed, and eventually acquire an undeserved legitimacy. #

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