Capital Punishment

The importance and practicability of capital gains tax reform

The rationale for taxing capital gains as income, has never been generally accepted in the United Kingdom. The many changes to British capital gains tax over the years since 1965 bear witness to a tax that jibes uncomfortably with the rest of the tax system. We believe that capital gains tax should be levied only on predictable and predetermined gains, and that the tax on unpredictable gains does more harm than good and should be abolished. Short of abolition, there are a number of reforms which would reduce the damage done by the tax at present.

All jurisdictions that tax income have a problem with the boundary between income and capital gains — the fear that some people might try to evade income tax by taking their income as a "capital gain".

The British solution of assimilating capital gains to income taxation is characteristic of a few major Anglo-Saxon jurisdictions (Australia, Canada, United Kingdom, United States). The vast majority of others resolve the problem in other ways, as did the United Kingdom before 1965.

The purpose of this paper is to propose a series of reforms which:

- promote long term investment;
- improve the quality of investment;
- increase the entrepreneurial character of investment;
- simplify the present CGT;
- make the present CGT more equitable; and
- maintain the yield of the present CGT.

These aims are in conflict. For example, the simplest and most effective way to improve the quality and to increase the quantity of investment is to abolish CGT, which is an additional tax on saving, investment and enterprise. But this policy would still leave Treasury officials worried about

preserving their tax revenue. Our proposals therefore represent a compromise.

Structure of the report

As background to our proposals the paper considers the principal criticisms to which the present capital gains tax is vulnerable. Our proposals are designed to mitigate these disadvantages of the present tax.

A discussion of the financial magnitudes involved helps to quantify a series of proposals that satisfy the requirement of revenue-neutrality.

We then turn to the range of policy options which attempt to meet these conflicting aims.

Criticisms of the present CGT

Although predetermined capital gains are in many ways equivalent to income and their taxation as income is acceptable in terms of efficiency and equity, the taxation as income of *unpredictable* gains dependent on the vagaries of the market is inefficient and inequitable. The principal criticisms are:

(a) CGT *locks in gains* and *frustrates the efficient use of capital;*

(b) CGT *taxes gains more than it relieves losses,* so that it creates tax "nothings" on capital account;

(c) CGT falls most heavily on risk taking, so that it *depresses the quality of investment;*

(d) CGT at income tax rates on unpredictable gains is *far above the maximum revenue rate of the tax,* so that the Exchequer loses as well as the taxpayer;

(e) CGT *falls disproportionately on individuals and trustees* rather than companies and often on *savers of modest means* rather than the wealthy;

(f) CGT is often *inequitable* in the objective sense of imposing the heavier tax burden on the poorer taxpayer;

(g) CGT on long term gains *attacks the principle of self help and self provision,* on which increasing reliance will have to be placed as the welfare state comes under increasing strain;

(h) CGT is *so complex as to be unintelligible to the ordinary taxpayer* and often to require tax professionals to take advice from other professionals;

(i) the problem of the boundary between income and capital gains has been grossly exaggerated, since *most forms of unpredictable capital gains are nothing like income and most forms of income are nothing like capital gains;*

(j) away from the boundary between predictable capital gains and income, CGT has no useful function and suffers from a *permanent crisis of identity.*

(a) Lock-in

Except for a limited category of financial institutions and taxpayers involved in foreign currencies, it is

Thus choose lower rates of tax and shorter periods of taper.

Simplification

Under self assessment, the present CGT on individuals is likely to collapse under its own weight. Most taxpayers will not comply with the law or even know that they are not complying.

If the present annual exempt allowance were significantly reduced or abolished, compliance would become negligible:

CGT would become a voluntary tax in a sense that was never true of estate duty or inheritance tax; a tax which the authorities made no serious attempt to enforce (just as the police and the courts make no serious attempt to enforce a number of non-tax laws at present).

This development would be harmful in general and in particular it would corrode the respect for compliance with the tax system as a whole among the population in general. Such corrosion is especially undesirable under the new system of self-assessment.

Our proposals serve to guard against these dangers. CGT in any form is among the most difficult taxes to administer; but our proposals to *abolish major reliefs*, to *reduce the base of the tax and the rates at which it is charged* and to *reduce the number of individuals subject to the tax* (through the taper/cut-off and the annual exempt allowance) would help to prevent the breakdown of CGT and to maintain respect for the tax system as a whole.

not practicable or even possible to levy tax on accrued gains. Most individual taxpayers are unlikely to know the exact value of their assets at any moment, nor be able to estimate it easily and reliably.

If individuals and many other taxpayers cannot be taxed on accruals but only on realisations, important consequences follow. It is the taxpayer decides when to realise his gain and pay the tax which he could otherwise postpone, perhaps for ever. If he is realising in order to spend, he may accept the capital gains tax as the price of the additional spending power. But the argument is quite different if he is realising in order to reinvest, to rearrange his portfolio. It makes sense to do this only if the investor is confident of his ability to out-judge the market by enough to pay the tax charge. Few investors have or believe they have this ability to outperform the market. For most investors, *it seldom if ever makes sense to switch* and thus incur a charge to CGT. This is the origin of the lock-in problem.

All capital gains taxes have this lock-in effect, although the effect is less severe for short term capital gains taxes with exemption after a period of years, since after this period the lock in effect ceases.

The lock-in effect must be *a major cause of misallocation of resources and reduction in the quality of investment*. For example, a private investor might wish to move into tracker funds, which are far more important than they were ten years ago, in order simultaneously to reduce risk, reduce charges and improve performance; but such an economically rational move becomes irrational (and thus fiscally frustrated) if it incurs a tax charge of up to 40 per cent of the present value of his holding. To the suggestion that roll-over relief should be available for reinvestment in assets subject to CGT, the Inland Revenue and others have objected that this would destroy most of the yield of the tax. In so far as this is true, CGT cannot be a tax on (realisation for) spending — supposedly one of its principal functions — but has to be a tax on the quality of investment (additional to income tax and corporation tax, both of which are also taxes on the quality of investment). It is thus rational to expect that *CGT causes the quality of investment to fall.*

It is also significant that this fiscal discouragement of switching is largely confined to individuals, since corporations and investment funds often have means of mitigating the charge, even where they are not already exempt. CGT thus acts as an *obstacle to direct shareholding* and a fiscal incentive to the artificial interposition of intermediaries between the individual and his investment.

(b) Losses

The impossibility of imposing a general accruals basis of capital gains taxation gives taxpayers the possibility of running gains and realising losses, and thus removing much of the tax yield. It has been suggested that giving taxpayers a free hand to use losses as they pleased would destroy most of the tax base; if so, this is another

indication of the *fragility of the tax base* and thus another major disadvantage of a general tax on capital gains. Restrictions on the use of losses are therefore normal; and these restrictions were extended in 1993 by a prohibition on the use of indexation relief to create or increase a loss.

These restrictions on the use of capital losses have acted *as an additional tax on risk-taking by individual and corporate investors* by comparison with an economically neutral situation in which gains were taxed and losses relieved on the same terms. Investors have a fiscal incentive to play safe. But this is not what the economy requires. Downsizing and outsourcing by large established concerns mean that the economy is becoming more and more reliant on new and small concerns for innovation, growth and jobs. Many new and small concerns fail, and an additional tax on risk-taking is a fiscal obstacle to their activities.

(c) Entrepreneurial investment

Entrepreneurial investment, where the investor is working as owner or partner in the business in which he has invested, is likewise subject to additional taxation through CGT. Entrepreneurial investment is generally risky, like the more aggressive forms of passive portfolio investment; restrictions on the offset of losses against gains mean that *CGT is a tax on risk-taking*. The additional tax burden imposed by CGT on risk taking has been quantified in a series of representations by the British Venture Capital Association.

These tax burdens are cumulative. Income tax and corporation tax are taxes on the quality of investment: the higher the quality, the heavier the tax burden. CGT is an *additional* tax on investment quality which it catches in the share price or asset value as well as in the income flow. And CGT imposes a *further* additional tax on risk-taking, whether through a passive portfolio or entrepreneurial activity.

(d) Maximum revenue yield

Work done by the Institute for Fiscal Studies indicates that taxes on capital income have accounted for a falling proportion of total tax revenue in OECD countries during recent years. The IFS regard this development as a response to the increasing mobility of capital resulting from the abolition of exchange controls and better electronic communication. Firmer tax bases are provided by expenditure and earnings from labour.

In the United States, the Capital Gains Tax rate has been reduced from 39.6% in 1993 to 28% today, with some categories of gain being charged at well below that. On the experience of these (and previous) changes in CGT rates, US research suggests that the maximum revenue rate there is roughly 15 per cent. Thus a rate either above or below 15 per cent would reduce the yield. The argument for rate reduction is all the stronger if account is taken of the "second-round" effects on the yields of other

taxes: in other words, if CGT is reduced and transactions take place which were previously frustrated by taxation, these transactions generate further activity subject to PAYE, VAT, corporation tax and other charges.

We know of no research suggesting that the United Kingdom 40 per cent rate of CGT is other than *far in excess of the maximum-revenue rate of tax.* In other words, *the Inland Revenue would gain if the rate were reduced.* This was precisely what happened when United Kingdom income tax rates were reduced from 98 per cent to 40 per cent.

Another illustration of this general argument is provided by the yields of CGT and inheritance tax. CGT was raised from 30 per cent to 40 per cent for years after 1987-88. Inheritance tax was reduced from 60 per cent to 40 per cent for transfers after 14 March 1988. The following were the yields of inheritance tax/capital transfer tax and of capital and of capital gains tax on individuals and trustees during the years 1987-88 to 1996-7: (see table below)

Thus the yield of inheritance tax rose by some 50 per cent when the rate of tax was cut and the yield of CGT fell by some 50 per cent when the rate of tax was increased. Changes in capital values had similar significance for both taxes. Thus these figures support our argument that *the present 40 per cent rate of CGT is far above the maximum revenue rate of the tax.*

Yields of inheritance tax/capital transfer tax and capital gains tax on individuals and trustees 1987-88 to 1996-97

year	IHT/CTT yield (£m)	CGT yield (£m)
1987-88	1073.1	2175
1988-89	1066.7	1792
1989-90	1226.9	1658
1990-91	1259.3	976
1991-92	1295.1	894
1992-93	1200.9	625
1993-94	1328.3	937
1994-95	1399.9	799
1995-96	1516.5	1210
1996 -97	1555.5	1110

Sources: IHT: *Inland Revenue Statistics* *1992* Table 10.1
1997 Table 12.1
CGT: *Inland Revenue Statistics* *1997* Table 14.1
Financial Statement and Budget Report July 1997 page 113

(e) Incidence

The present CGT *bears more heavily on individuals and trustees than on companies and financial institutions*, which are exempt or have more opportunities for tax planning.

It is thus *an* encouragement and incentive to shareholding through intermediaries. The imbalance should be redressed by reducing CGT on individuals, not by increasing it on financial institutions, which represent the interests of individuals at one remove.

The present CGT *bears more heavily on risky, entrepreneurial and lumpy investments* than on fungible, passively held investments. This imbalance should be redressed by reducing CGT on risky, entrepreneurial and lumpy investments, not by increasing it on fungible, passively held investments.

Because the present CGT bears heavily on lumpy and once-in-a-lifetime gains, it *taxes people of modest means as though they were rich*. In terms of surtax and the higher rate of income tax, there is no top slicing (spreading the gain over a period of years). We do not recommend the introduction of top slicing but rather that CGT be made less oppressive in other ways.

The present CGT *bears disproportionately on taxpayers with low incomes (or even on non-taxpayers) who invest through insurance policies or companies.* They incur CGT at the level of these intermediaries that they would not incur if they invested direct. This anomaly is a consequence of levying CGT at each level of holding and is best put right by reducing the scope of the tax.

(f) Inequity

Although the present CGT is generally agreed to be (at best) sand in the working of an efficient economy and (at worst) a fiscal prohibition of economically self-sufficient activities, the worst characteristic of the tax is that it is unfair, inequitable. It is unfair in the most objective sense of that term: it taxes the poorer taxpayer more heavily than the richer.

Today's CGT adds to saving and investment a double or multiple taxation from which earnings are exempt. For example, the corporate manager (whether a "fat cat" or otherwise) is not taxed on the increase in the corporate financial base that provides an increase in his salary; but the individual shareholder, with an income a tenth or a hundredth as large, *is* taxable on the increase in his shareholding. Indeed, it is a normal characteristic of CGT that the taxpayer with the smaller income pays the higher tax.

Other examples of similar inequities include the following:

> **Accruals versus realisations.** Taxpayer A has accruals of £70,000, tax zero. Taxpayer B has

realisations of £7,000, tax £200 (=7000-6500 x 40%).

Active versus passive portfolio management. Taxpayer C manages his portfolio actively. He has a gain of £100 on stock X but would prefer to be invested in Y. He pays £40 in tax and invests the remaining £60 in Y. Alternatively, he would be willing to move if he could buy 80 of Y for £100 of X (stock market values being £1 for both), but not if he can buy only 60; so the transaction is fiscally frustrated. Taxpayer D, by contrast, manages his portfolio passively, if at all. His accrued gains of £100 are tax free.

Fungible and non fungible assets. Taxpayer E has a portfolio of shares which appreciates by £100,000 over a period of 20 years. He realises his gain at the rate of £5,000 a year and escapes all liability to capital gains tax. Taxpayer F has a property (not of course his principal residence) which appreciates by £50,000 over the same period. Tax at 40 per cent on this gain amounts to £20,000. Tax reduces the smaller gain from 50 per cent of the larger gain to 30 per cent: there is no top slicing for CGT. The only answer to the inequity of CGT is to reduce the rate of tax and phase the tax out after a number of years of holding. A low but permanent rate of tax would not remove this inequity.

(g) Self provision

It is widely agreed across political parties that the present welfare state is under strain: the rapidly increasing cost of universal provision free at the point of consumption is meeting an increasing resistance of taxpayers to pay for it. As a result both the last and the present government have explored various forms of self provision, that is, the replacement of welfare services funded by the taxpayer with services funded by the user or his family.

The replacement of government funding with self provision is a long term exercise in two senses: it will take a long time; and, once in place, it will require the new self providers to take a long term view, extending even from early working years to death and beyond (provision for dependants). A small proportion of the population has been doing this for years; this proportion will have to grow. The means of self provision are and should be various: the self provider should not be compelled to use a finance house (and incur the associated charges), and self funding should be an option for self provision.

A long term CGT is deeply hostile to self-provision through self-funding, since it imposes an additional 40 per cent charge on funds used to switch

the financing burden from the government to the self provider.

(h) Complexity

Under the present self-assessment regime, it seems unlikely that more than a small proportion of individuals potentially liable to CGT have satisfied all the requirements of the Inland Revenue returns, which are so daunting that they frequently lead professionals to seek advice from other professionals. The extension of self-assessment to CGT is already testing the compliance of taxpayers to the limit and beyond. Reducing the number of individuals liable to CGT, in particular by maintaining and increasing the present annual exemption and avoiding its reduction, is thus in itself an important simplification measure in the context of self-assessment.

If the present annual allowance for CGT were reduced or abolished, the proportion of compliant taxpayers would fall from small to negligible. This is a recipe for fiscal anarchy and rebellion.

(i) Exaggeration of the boundary problem

Income and capital gains are essentially different, as the difference of their names implies. Most forms of income and capital gains are far from the boundary between the two.

Capital gains which are not predetermined are in common sense capital gains and not income, not least because they can decline when the corresponding income increases and *vice versa*.

There are, in any case, a wide set of rules in place to make sure that the boundary cannot be crossed, with income disguised as capital gains. For example:

- The avoidance of income tax on *earnings from employment* is effectively prevented by section 775 ICTA 1988 on the sale by an individual of income derived from his personal activities.
- The badges of trade and case law serve to identify *trading income* as subject to income tax.
- *Profits from land taxable as income* are identified through the rules on premiums on short leases, on transactions in land (section 776 ICTA 1988) and on sales and lease backs (section 780 ICTA 1988).
- *Profits from financial assets taxable as income* are identified through the anti–avoidance rules in sections 703 728 ICTA 1988.
- The House of Lords decision in *CIR v McGuckian* affords protection against a range of attempts to convert income into capital.

Provisions of this kind were sufficient to protect the Revenue when income tax was 98 per cent and CGT was 30 per cent. The present more stringent provisions should be adequate to protect an income tax of 40 per cent from a CGT of 20 per cent or less.

(j) Identity crisis

All other taxes have an identifiable incidence either on spending or on saving or both; for example, inheritance tax and investment income tax on saving, excise duties and value added tax on spending. Even the tax on earned income contains an element of savings tax by comparison with value added tax and other taxes on spending, since it is equivalent to a tax at the same rates on both spending and new saving.

Capital gains tax is the only tax that is sometimes a tax on saving and sometimes a tax on spending. It is a *pure tax on saving* when it is levied on portfolio rearrangements. It is a *mixed tax on saving and spending* when money that could be spent immediately is invested for subsequent spending out of capital growth. It is a *pure tax on spending* if the gain is eventually realised for consumption.

This crisis of identity derives from the impossibility of taxing accruals; if accruals were taxed each year whether realised or not, capital gains tax would tax saving and spending at the same rates. But since in practice accruals cannot be taxed, capital gains tax is a *capricious* tax, sometimes taxing saving more heavily than spending and sometimes taxing spending more heavily than saving, and acting mainly to impede the efficient management of the country's capital.

Magnitudes

CGT is an *unstable and unreliable source of revenue* for the Exchequer. Figures cited above show that the yield of CGT on individuals and trustees in 1992 93 was 30 per cent of the yield in 1987-88. Figures show that the yield of corporation tax on corporate capital gains in 1991-92 was 25 per cent of the yield in 1989.

No other significant source of revenue has anything like this degree of instability. The total yield of CGT on companies, individuals and trustees in 1992-93 was some £875 million. This was about one-third of one per cent of general government expenditure (excluding privatisation proceeds) in 1992-93 and 5 per cent of the increase in GGE between 1992-93 and 1993-94. For all the damage it does, CGT is merely the small change of the tax system. *Its yield is dwarfed by the yields of other taxes and by changes in taxation and expenditure from year to year.* If the real purpose of CGT is to protect the yields of income tax and corporation tax, it would be better to have a tax targeted to that end instead of the present general tax, most of whose base is irrelevant to the protection of the yield from taxes on income.

Yield of corporation tax on corporate capital gains

year	£ million
1989	1000
1990	550
1991	250
1992	250
1993	600
1994	650
1995	1050
1996	1350

Source: *Inland Revenue Statistics 1997* Table 11.1

The Adam Smith Institute publication *False Economy: The Losses from High Capital Gains Tax Rates* (1993) gives theoretical and empirical reasons for believing that the revenue maximising rate of CGT in the United Kingdom is 15 per cent or less. The revenue maximising rate has probably been *reduced* rather than increased by developments over the last five years.

Inland Revenue Statistics 1997 Table 14.5 indicates that gains on tangible assets held for more than ten years were about the same as gains on tangible assets held for up to ten years; for financial assets, over-ten-year gains were a little over 60 per cent of under-ten-year gains. We believe that *this long term pattern of holding results from the lock in effect:* taxpayers are unwilling to incur a heavy tax charge in order to make economically justifiable rearrangements in their portfolio. *If the present system were replaced with a taper and cut-off, taxpayers would have more incentive to realise their gains earlier than at present.*

The revenue yield from CGT could increase or decrease; but the yield from other taxes should increase as capital was deployed more efficiently. There is no reason to believe that the replacement of the present system with a taper and cut-off is more likely to reduce than to increase tax revenue in total.

The range of policy options

The most radical option

Although the abolition of CGT is unlikely to appeal to the present government, it is still fair to note that there is a wide area of overlap between that policy and the present government's aims. Abolition

would promote long termism, improve the quality and entrepreneurial character of investment, and simplify and improve the equity of capital gains taxation.

There are other positive aspects too. For example:

- the cost of abolition is incurred a year later than its enactment;
- the cost is a (very) small proportion of the growth in a single year of other relevant magnitudes such as GDP and total tax revenue;
- income and capital gains can be distinguished by the test of pre-determination (thus, if a gain is pre-determined, it is taxable as income; but if it is subject to the vagaries of the market, it is not taxable at all);
- on the basis of pre-determination, boundary problems between income and CG are resoluble, and CGT could be replaced by boundary protection.

Revenue maximisation

Higher rates, lower revenue

The yield of CGT on individuals and trustees is forecast at £1.95 billion in 1998-99, and the maintenance of this yield is an important argument against abolition. Furthermore, the Treasury is concerned that any reform should be structured to protect these revenues. Today's high rates of CGT are not necessary to achieve this protection and are indeed inimical to this purpose. We have discussed this question under "Magnitudes", above. To recapitulate:

- US research suggests that the maximum revenue rate there is roughly 15 per cent. Thus a rate either above or below 15 per cent would reduce the yield. *The argument for rate reduction is all the stronger if account is taken of the "second round" effects on the yields of other taxes.*
- The maximum revenue rate of tax (where the interest of the Internal Revenue Service/ Inland Revenue is considered to the exclusion of all other interests) is not the economically optimum rate: *the economically optimum rate is lower. The Inland Revenue is not the only stakeholder in the economy and society.*
- *We know of no research suggesting that the United Kingdom 40 per cent rate of CGT is other than far in excess of the maximum revenue rate of tax.* In other words, the Inland Revenue would gain if the rate were reduced. This was what happened when United Kingdom income tax rates were reduced from 98 per cent to 40 per cent. The ASI report *False Economy* suggests that the revenue maximising rate of CGT in the United Kingdom is 15 per cent or less.

Thus, the best evidence known to us indicates that, far from costing the Exchequer money, *a cut in the*

rate of CGT from 40 per cent to 20 per cent or below would increase the yield and serve to finance other reforms and reliefs.

A reduction in the rate of tax on long term gains is a prerequisite for improving the quality of investment and should be at the centre of any reform of CGT. In addition to its being self financing, a cut in the rate of CGT could be paid for through the withdrawal of one or more of the present reliefs against the basic structure of the tax: the more this structure is reduced and mitigated, the less the need for reliefs. It is regrettable that the information available in *Inland Revenue Statistics* does not make it possible to cost most of these trade-offs, including the two most important — indexation relief and loss relief. We emphasise that *if either or both of these major reliefs is to go, the reduction in the basic structure of the tax must be correspondingly drastic*: and the most suitable area for this reform of the structure of CGT is to taper and phase out the tax after a limited holding period.

Trading reliefs for tax cuts

If the general burden of CGT were made less oppressive, indexation relief could go. This is not costed in *Inland Revenue Statistics 1997* (page 15); but indexation relief must be a large proportion of the present yield and could be more than the whole. The present indexation relief is *very complicated and largely inoperable under self assessment*. The Inland Revenue opposed its introduction; and taxpayers have accepted it only as a means of making an oppressive tax more tolerable. There could be gains on both sides if indexation were removed for price rises from a future date. The obvious replacement is tapering down to exemption, which preserves the equity of adjusting for inflation in a simpler form. Tapering would release large amounts of money from investment funds, and the tax paid at the lower rates of taper would bring in tax revenue from assets at present locked in at 40 per cent. *But if indexation relief is to go, the period of taper must be short and the eventual rate of CGT zero.* We would not wish to rely on ministerial statements that the battle against inflation is now won, even if governments could bind their successors.

Loss relief is at present an indefensible muddle. As an alternative to reinstating a coherent system of loss relief, *loss relief could be abolished in tandem with a drastic reduction in the rate of CGT and the exemption of assets held for more than a certain period.* Again, we emphasise that the removal of loss relief would not be acceptable unless the period of taper were short and the rate of CGT at the end of the taper were zero.

Similarly,*retirement relief* and *reinvestment relief* could be *traded in for a radical reduction in the rate and an exemption after a given period of years.* Retirement relief is inherently equitable and may well serve to defray costs in old age that would otherwise impact on the state. Reinvestment relief serves to reduce the lock-in effect which is the most economically damaging consequence of CGT. The cost of these reliefs is not large (£180

million for retirement relief and 75 million for reinvestment relief in 1997-98); it would be unjustifiable to reduce or remove these reliefs unless the basic structure of CGT was being reduced dramatically.

Modifications short of abolition

Tapers and cut-off

A more long termist outlook can be promoted by recognising that long-term gains differ in degree or in kind from short term gains and thus that the former should be taxed less heavily or not at all. There are ample foreign precedents for this policy — indeed, *we know of no country in continental Europe that taxes capital gains without the alleviation of some form of taper and cut-off.*

With the exception of the former Chancellor of the Exchequer, Kenneth Clarke, there is also widespread agreement on the idea in the UK. For example:

- a taper down to zero after eight years was proposed by Chris Smith, then Opposition Spokesman on Treasury and economic affairs, on 23 June 1992. (Hansard Finance Bill 225ff);
- the CBI's proposal for exemption after seven years attracted support from Gordon Brown when in opposition;
- the Institute of Directors has proposed exemption after three years combined with abolition of most present reliefs.

Some in the Inland Revenue have argued that tapering and cut offs are impracticable or logistically impossible. Nevertheless, *every continental country that taxes capital gains has some form of taper or cut-off.* Moreover, the Inland Revenue said that the indexation of capital gains was impracticable or logistically impossible — until it was introduced: then they found a way.

If the *gain* were tapered, rather than the rate of tax, it would be possible to economise on computations. Clearly, large numbers of tapered gains would fall within the annual exemption.

A taper over four years (40, 30, 20, 10 per cent, fifth year zero) combined with a withdrawal of most present reliefs might maintain the present yield: the reliefs probably cost a multiple of the present yield; the replacement of lock-in with a low rate of tax during the later years of the taper would generate additional tax revenue during those years; and the reduction or removal of fiscal obstacles to economic activity would increase the yields of other taxes in the second round.

Rate of tax

A taper and cut-off, especially if compensating for the withdrawal of indexation relief, loss relief and other reliefs (retirement relief and reinvestment relief), implies the phased reduction of CGT to zero after the satisfaction of limited holding requirements. As a less satisfactory alternative to a taper and cut-off, a straightforward reduction in the rate of tax from 40

per cent to 20 per cent or below, should have the advantages of:

- increasing the yield of tax;
- reducing the economic distortions and inhibitions of the present CGT; and
- reducing the inequities of the present CGT (whereby the taxpayer with the smaller income often pays the higher tax bill).

Rolling rebasing

This would follow the 1988 rebasing to March 1982 but (unlike that rebasing) would keep up to date.

Because of the practical difficulties and expense of having to value every asset several years before the date of disposal, rolling rebasing might have to be confined to quoted shares.

More modest reforms

Indefinite carry-forward

Introducing *an indefinite carry-forward of the annual exemption* would help the taxpayer with "lumpy" gains relatively to the taxpayer with modest gains each year. Thus, for example, it would help people on modest incomes who were cashing in their lifetime savings at retirement or because of family bereavement. Equally it would do nothing for those lucky few who (so the Treasury fears) might be able to disguise part of their income as capital gains (though, as we have seen, there are detailed rules in place to prevent this anyway). Indefinite carry-forward would also serve to reduce the number of individuals subject to CGT (see under "Simplification", below).

Exempt proceeds and gains

Exemption on the basis of proceeds as well as gains would reduce the number of computations required.

Mistakes to avoid

Reducing or ending the annual allowance

Bringing larger numbers of ordinary taxpayers into the grip of a tax they do not understand is a *prescription for fiscal breakdown and rebellion.*

A lifetime CGT allowance or threshold

Not only are all lifetime allowances complex; they all introduce their own additional dimensions of inequity, such that the poorer taxpayer pays the higher tax charge. (See "Lifetime cumulation of transfers", *British Tax Review* 6/1979, which was studied by Sir Geoffrey Howe, Chancellor of the Exchequer, shortly before he abolished the lifetime cumulation of transfers).

Further demands on computation capacity

This is never welcome, and is particularly burdensome as the millennium approaches. Large numbers of taxpayers have other difficult figures to work out too, especially with self assessment.

"The proprietor of stock is properly a citizen of the world. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed to a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune at his ease. By removing his stock he would put an end to all the industry which it had maintained in the country which he left."

Adam Smith
The Wealth of Nations

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