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Centre for Policy Studies, 52 Rochester Row, London SW1P 1JU Tel:(071) 828 1176 Fax:(071) 828 7746

WHAT'S WRONG WITH CAPITAL GAINS TAX

Thomas Griffin

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Contents

The author

Thomas Griffin was formerly Chairman of GT Management PLC of which he was joint founder in 1969. He has spent over thirty years in investment management and is a director of a number of Investment Trusts and other financial companies including GT Venture Investment Company PLC. He is a Chartered Accountant.

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Introduction

IN THE POLITICAL WORLD THE GENERAL VIEW OF CGT (Capital Gains tax) is one of indifference; it is a subject little discussed. On the left wing it is regarded as 'a good thing' in that it takes money from people who can afford to part with it, to the benefit of the poorer members of the community. On the right it is seen as a necessary evil, a political sop worth paying to still criticism that too much has been done to benefit the rich. Even among business people, most of whom receive the bulk of their rewards in the form of salaries, pension rights and benefits in kind, rather than in capital gains, the impact of CGT is little appreciated. And yet it has far reaching consequences, not only for individuals but for the economy as a whole.

CGT was first introduced in its present form in 1965, and at the rate of 30% which was maintained until 1988. In that year Mr Lawson, then Chancellor of the Exchequer, altered it to bring it into line with Income Taxes, with a lower rate of 25% and an upper one of 40%. In so doing he saddled Britain with one of the highest rates in the free world, an action in sharp contrast with the Government's declared intention to make British tax rates competitive with those of her trading partners.

The reduction in income tax rates during the eighties, coupled with the raising of CGT, totally altered the balance of taxation in this country. For most of the post-war period rates of income tax, particularly the higher rates, were so punitive that there was great compulsion on the individual to opt for capital gains rather than for income, and where possible to order his or her affairs to turn income into capital. The devices used in this process were a running sore for the Inland Revenue, who have long been strong advocates of taxing capital gains and income at the same rates. This certainly has a superficial attraction and makes the task of the tax-gatherer simpler. However, it leaves out of account the factor of double taxation and, by removing one apparent distortion in the tax system, it exacerbates a number of others.

Advocates of CGT, including the Inland Revenue, express great concern that much income tax revenue might be lost through tax avoidance if CGT was abolished, because taxpayers would contrive to convert income into capital. This certainly was true when income tax rates were very high and it cannot be denied that the risk of some loss does exist. It seems probable, however, that such fears are exaggerated. The increase in income tax revenue derived from the top five percent of taxpayers since high rates were cut shows how taxpayers behave when rates appear reasonable to them.

Furthermore, proprietors of companies are now encouraged to take money out in the form of dividends, which they can do at an additional tax cost of only 15%, rather than wait for a deferred and more heavily taxed capital gain. It may well be, therefore, that the Inland Revenue is fighting yesterday's battle. They also ignore the large element of double taxation in CGT; the main engine of corporate growth is retained earnings, from profits which have already sustained tax. In any case, the possibility of squeezing extra revenue out of a few thousand people has to be set against that of creating a much more favourable environment for the entrepreneur, and thereby helping to make the economy very much more dynamic.

The changes have in effect moved the balance between income and capital gains to the opposite extreme, and given encouragement to the citizen to spend capital as if it were income. Income and capital gains are not the same, and should not be treated as such. Income is a necessity, and the tax base for raising income taxes is very broad. Capital gains are not a necessity, and the method of taxing them is arbitrary and narrowly based. Capital gains may happen fortuitously, but more often they are the product of deferring expenditure and of risk-taking. To ignore this is to assume that people do not understand their own best interests. If the rewards of endeavour, initiative and risk-taking are reduced, so will be the numbers of entrepreneurs.

The purpose of this paper is to restate the major objections to CGT, particularly at punitive levels, and to demonstrate some of its unintended results. It also seeks to examine the effects that these rates have on the behaviour of two main groups of people; those who have already built up substantial CGT liabilities and those who take entrepreneurial risks.

1.

The objections

The main counts against CGT at its present levels, in rising order of importance, are:-

1. The tax is complex and costly to collect, both for the state and for the individual; a lower rate could be expected to generate a higher yield.

2. It is a tax on transactions rather than on capital gains; it is optional except in a few hard cases and the largest proportion of it is paid by a tiny number of people.

3. It acts as a clog on markets and thereby causes distortions in the flow of capital. The 'lock-in' effect on those with big CGT liabilities which they wish to defer leads to misdirection of capital and a shortage for new enterprises.

4. It handicaps initiative and risk-taking, and thus discourages both the setting up and the development of new businesses. CGT contains a major element of double taxation; the main source of growth, particularly in small companies, is retained profits which have already been taxed. CGT thus in effect raises the cost of equity capital and promotes over-dependence on borrowings.

All taxes create some measure of distortion in markets. Wise governments, however, ensure that the distortions are not greater than is needed to produce the desired revenue. As Adam Smith stated:-

> Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. ......A tax....may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes.

Adam Smith also stated:-

> All taxes upon the transference of property of every kind, so far as they diminish the capital value of that property, tend to diminish the funds destined for the maintenance of productive labour.

By these criteria, CGT at 40% must be seen as destructive. Adam Smith's references to employment and productive labour are significant. The rôle of small companies in job creation is very important, and probably dominant.

2.

Foreign experience

Before looking in greater detail at the British scene, it is worth while to note the experience of some of our main competitors. It seems that little attention can have been given to the effects of CGT, or its absence, on the affairs of these countries.

Several of the most successful economies of the Far East (Hong Kong, Singapore, South Korea and Taiwan, for example) are subject to no CGT at all. Japan has a 20% rate on both short and long term gains but taxpayers have the option of paying 1% of the proceeds of sales of an investment. Among European countries, Belgium, The Netherlands and Italy have no CGT; France operates at a rate of 16% and Germany has a heavy short-term (six months) gains tax but no long term one. The USA, when State and City taxes are added in, comes close to Britain's rate. Only Australia and Spain, on present evidence, have higher rates than ours.

Overall, the countries with little or no CGT have turned in a much better economic performance than those with heavy rates. Although many other factors are involved, the rôle of CGT, which substantially alters the ultimate return to the investor, plays a more important part than is generally understood.

The USA

The record of CGT in the USA provides a remarkable case history of the effects of raising and lowering rates, as emerges clearly from Tables 1 to 4. Before studying these, it is important to be aware of one major difference between Britain and the USA, namely that in the latter capital gains are not indexed for tax purposes. This vexes taxpayers -- and adds an extra distortion to the American system.

As will be seen from Table 1 overleaf, in the 1970s rates were raised in steps from 27% to 49%. In 1978 a proposal was put before Congress to equate CGT with income taxes, thereby taking it to a maximum of 70%. This, however, was defeated and sentiment turned so sharply that Congress accepted a recommendation to reduce the rate of CGT by nearly half (the Steiger Amendment). The success of this move led to a further reduction to 20%, a rate maintained for five years until the passing of the Tax Reform Act of 1986, which brought CGT into line with income taxes. This latter, controversial step was included in the Act as a political compromise against the wishes of the Reagan Administration. Subsequent attempts by the Bush Administration to lower CGT rates have been frustrated by manoeuvring in the Senate despite commanding majority support in both Houses of Congress. The issue, however, is by no means dead.

These changes have led to much academic analysis, from many different angles. The most important factors studied have been the impact on government revenues and the effects on tax-payer behaviour, with particular reference to willingness to pay CGT and the propensity to invest.

Until recently academic opinion has been divided on the merits of a CGT cut, particularly with regard to its revenue effects, but lately some consensus has been achieved in support of a reduction in rates. Of fourteen studies listed by the Department of the Treasury's Office of Tax Analysis, most of those published in the last three years predict a modest to a very positive long-run revenue gain.

TABLE 1

The Inverse Relationship Between Capital Gains Revenues
and Capital Gains Tax Rates (Billions of Dollars)

Year	Capital Gains Realisations	Capital Gains Tax Revenues	Capital Gains Top Marginal Rate
1969	$32	$5	27%
1970	21	3	32
1971	28	4	39
1972	36	6	45
1973	36	5	45
1974	30	4	45
1975	31	5	45
1976	39	7	49
1977	45	8	49
1978	51	9	48
1979	73	12	28
1980	74	13	28
1981	81	13	24
1982	90	13	20
1983	122	19	20
1984	139	22	20
1985	169	25	20
1986	333	46	20
1987	134	-	28
1988	...	..	33
1989	...	..	33

Source: Office of Tax Analysis, US Department of the Treasury, and Richard Rahn, US Chamber of Commerce, Testimony before the House Committee on Small Business, on Capital Gains Taxation, November 1, 1989.

The figures in Table 1, while not conclusive, both show the wide range of CGT rates charged over the last twenty years and suggest the implicit response of taxpayers to these changes. This is demonstrated by the remarkable increase in realisations from 1979 onwards after the reduction in rates, and the later decline following the 1986 Tax Reform Act. Figures for the last three years are not yet available.

One additional effect of the increase in the federal rate of CGT has been observed. A number of states, including New York, California, Florida and Texas, charge their citizens an additional rate of CGT. In all four states the amount of capital gains reported in 1988 was less than half the amount reported in 1986 -- and this despite a nationwide increase of more than 22% in personal income during the same period.[1] No other cause which could have produced this outcome can be identified. It is a striking demonstration of how confiscatory rates can reduce tax revenue.

In the last few years there has been much greater willingness to accept that high rates of taxation on income are actually counter-productive, even in terms of raising revenue for the government. People contrive to order their affairs in such a way as to avoid payment of taxes which they regard as punitive. The work done on the subject in the USA, most notably by Professor Lawrence Lindsey, has demonstrated beyond reasonable doubt that since the lowering of the higher income tax rates, the highest earners have actually contributed a greater percentage of the total revenue derived from income taxes. Table 2 opposite, while not directly relevant to a study of CGT, demonstrates the contrast between the predictions by the Senate Finance Committee and the actual outcome of the lowering of tax rates. Similarly, after the 1978 cut in CGT both the Congress's Joint Committee on Taxation and the Office of Tax Analysis underestimated the benefit to revenues by a huge margin, the latter by a factor of 50%. Despite the evidence, however, forecasts regularly and grossly underestimate the effects of tax changes.

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1. Source: Alan Reynolds, Hudson Institute, Indianapolis.

TABLE 2

SHARE OF INCOME TAX BURDEN

Income Group	1984 as Predicted	1984 Actual	1986 Actual	1987 Actual*
$0 - 15,000	7.8%	5.8%	4.0%	2.8%
$15,000 - 30,000	28.5	21.1	16.8	14.7
$30,000 - 50,000	29.4	29.0	25.9	23.0
$50,000 - 100,000	17.9	22.0	24.3	27.7
$100,000 - 200,000	8.7	8.6	10.2	11.9
$200,000+	7.8	13.4	18.9	19.8
TOTAL	100.0%	100.0%	100.0%	100.0%

Note: Figures may not equal 100% because of rounding.
* Preliminary estimates
Sources: For predictions: Senate Finance Committee, 1981;
For results: IRS (Published in the *Wall Street Journal*, 14 March 1990)

The effect on government revenues, however, is in the long run far less important than that on capital formation and business development. Again there has been a wealth of analysis on the subject, all pointing to a significant benefit in terms of growth of Gross National Product and of employment. In testimony given before the Senate Finance Committee, Michael Boskin, Chairman of the Council of Economic Advisers, stated:-

> There have been a variety of estimates of the effect of reducing capital gains tax rates on national output. Put on a basis consistent with the administration's proposal, a survey of these suggests that GNP will ultimately rise between 0.2% and 1.2% per year. The Council of Economic Advisers believes that the effect lies roughly in the middle of this range, with GNP rising by about 0.6%, or $60 billion per year in the year 2000 and $280 billion over the next ten years.

The most striking demonstration of the effects on the behaviour of investors is contained in Table 3 opposite. Both measures of new business formation dropped sharply during the period of peak CGT rates and recovered with great vigour as rates were lowered. Since the 1986 Tax Reform Act they have once again declined.

TABLE 3

<u>Relationship Between Capital Gains Tax Rate and Elements of New Business Formation</u>

Year	Venture Capital Disbursements to Portfolio Companies US$Mn	Initial Public Offerings US$Mn	Capital Gains Top Marginal Rate %
1969	N/A	9,743	27
1970	297	2,761	32
1971	458	5,610	39
1972	420	8,935	45
1973	621	1,020	45
1974	278	142	45
1975	235	673	45
1976	258	571	49
1977	359	341	49
1978	605	519	48
1979	866	811	28
1980	1,015	2,345	28
1981	1,750	4,832	24
1982	2,063	1,894	20
1983	3,566	18,172	20
1984	3,638	5,190	20
1985	3,424	13,376	20
1986	4,033	24,075	20
1987	4,767	19,820	28
1988	4,238	6,584	33
1989	3,620	7,224	33
1990	2,100	6,014	33

Sources: *Venture Capital Journal* and American Council for Capital Formation.

The reasons are not hard to find. CGT, being a tax on the return on capital, raises the relative cost of capital and thus alters the relationship between risk and reward. The impact on private investors, who provide a surprisingly high proportion of the finance for new companies, is particularly severe as almost all of them fall into the top tax-rate category. Table 4 gives a good indication of the importance of private capital in the creation and development of new technology firms. Although high technology has been an area of exceptional demand for and supply of private capital, the principle is true of small businesses in general. They cannot depend on pension funds and other large accumulations of capital for their 'seed' money.

TABLE 4

Sources of Investment in New Technology Firms

	Private Individuals	Venture Capital Funds	All Other Sources
By Investment Financing Stage			
Seed Capital	48%	46%	6%
Start-up Capital	20	45	35
First Stage	8	69	23
Second Stage	8	58	34
By Size of Financing			
Less than $250,000	84	6	10
$250,000 - $499,000	58	19	23
$500,000 - $999,000	26	55	19
Greater than $1m	9	63	28

Source: John Frear and William E. Wetzel, *Equity Financing for New Technology Based Firms*, paper prepared for the Babson Entrepreneurship Research Conference, Calgary, Alberta, May 1988.

These effects are not confined to start-up companies. They permeate all the most entrepreneurial sectors of the market, that is to say small listed companies, new issues and venture capital formation, and they have a significant influence on the creation of new jobs. A recent study in the USA deals with the growth characteristics of newly listed companies (Initial Public Offerings). It shows that IPO firms increased their employment during the period studied (1983-87) at a rate of almost 30% per annum, while employment in industry by public companies dropped at an average annual rate of 6.5%. The revenue growth and capital investment of IPO firms in relationship to industry in general are even more striking. Tax decisions affecting these sectors thus appear crucial to the health of an economy.

During the whole twenty year period represented in the Tables, there have been, of course, many other factors at work, but an examination of the figures makes it difficult to ignore the very large part which the changes in CGT rates have played in the phases both of contraction and expansion.

3.

British experience

There are some significant differences between the British and American systems. The first, already mentioned, is that taxpayers are allowed the benefit of indexing the base cost for inflation. Second, taxpayers were permitted to 'rebase' their assets at 31 March 1982 to the values then obtaining. Third, in a recent modification, taxpayers have been allowed in certain circumstances to set off trading losses against capital gains. And fourth, retirement relief, available from the age of 55 to anyone selling a family company or business, exempts the first £150,000 of capital gain of all tax liability, plus 50% of the excess of gains up to £600,000. These concessions have at least ameliorated some of the harsher elements of the tax.

In contrast with the USA, statistical information about the impact of tax changes is scanty. Furthermore, since the original setting of the CGT top rate at 30% in 1965, there has only been a single move, the Lawson leap to 40% in 1988. The evidence of harm is therefore more confirmatory than conclusive. However, all the critical measures of entrepreneurial behaviour have shown deterioration since the rate was raised (though not solely for that reason) and there are many indications that CGT in Britain exerts a malign influence, especially on small companies and risk-taking.

Let us first turn to government revenues and to those who do pay CGT. Table 5 opposite is an extract from the Inland Revenue Statistics 1990, containing figures for the tax year 1987/88, the latest available. CGT paid by trustees in that year amounted to a further £214.6 million, the total coming to just under 6.5% of the revenue derived from Income Tax. In the previous four years this percentage was much smaller, and of course no figures are yet available for the years in which the 40% rate has obtained.

TABLE 5

Capital Gains Tax Assessments

Made to 31 October 1989 on Individuals

Range of net chargeable gain (lower limit) £million	Number '000s	Amount of Gains £million	Amount of Tax £million
Disposals in 1987-88			
1	0.22	2.0	0.1
5,000	27.9	232.5	13.3
10,000	44.4	713.3	119.7
25,000	20.7	697.3	168.9
50,000	12.4	810.7	215.3
100,000	8.7	1,265.7	355.7
250,000	3.1	1,017.4	303.6
500,000	1.6	1,064.1	321.6
1,000,000	1.2	3,148.5	947.4
TOTAL	120.3	8,951.4	2,445.6

Source: *Inland Revenue Statistics* 1990

This Table draws attention to a number of other aspects of the impact of the tax. First, the 120,300 who were subject to assessment formed a tiny proportion of the number who in the same year paid the higher rate of income tax, namely over two million. Second, it will be seen that, of these people, 72,300 (60% of the total) contributed £133.1 million in taxation paid an average of £1,841 per head. Over the previous four years an average of just under 100,000 people a year had been assessed; three quarters of them had contributed an average of less than £1,500 per head. The complexities of CGT and the costs of record keeping and analysis must make this one of the most unwarrantably expensive elements of government revenue to collect.

Third, for all practical purposes CGT is a tax levied at the higher rate of 40%; under one eighth of the revenue is derived from those whose range of net chargeable gain is below £25,000. And fourth, over 38% of the amount paid by individuals came from a mere 1,200 people. It is, of course, impossible to find out who these people are and why they have paid such large sums in taxation. One may, however, make one or two educated guesses. It seems likely that for many of them this will be their sole experience of being taxed as 'super rich'. It is probable also that many will be people who have built up businesses and, for divers reasons, have sold out; in fact just the sort of people whom the Government claims to encourage. Their predicament is in sharp contrast to those who invest in the largest house they can afford, or those whose prime asset is a personal pension fund; in neither case is there a CGT liability.

For most people -- except for a few unfortunates -- CGT is essentially an optional tax which can be indefinitely deferred. Among the 1,200 there will have been many for whom the option of deferring was outweighed by greater pressures, and from whom has been taken a substantial part of the reward of a lifetime's enterprise and endeavour.

The problems of the rich are not a likely subject for sympathy. However, it is seldom the very rich who are most vulnerable to the arbitrary effects of CGT, but rather those who have achieved what our forebears would have called a 'competency' -- modest wealth without affluence.

More important, however, is the 'locking-in' impact of CGT, which can place such an extraordinarily high transaction cost on a switch between investments. This leads to the immobilisation of capital, and is against the public interest.

4.

Some taxpayers' behaviour

The narrowness of the base for CGT, and the heavy costs of collecting it, give some clue to the damage and distortions which it causes, but these do not affect only those who actually pay. CGT forces a far larger number of people to make allowances for its impact in the ordering of their affairs. This impact is felt both by those with established capital and by those who seek to create it from personal savings. It drives them away from managing their own portfolios and into the arms of the institutions. A few examples may help to illustrate the points.

1. Mr H is a professional man, recently retired, who in 1982 invested in a Far Eastern fund. Over the years his holding has multiplied over eleven times in value and now forms a disproportionate part of his portfolio. However, despite his wish to increase his income he is reluctant to sell and incur a CGT liability which would amount to nearly 35% of the total value of his current holding, even allowing for indexation.

2. Mr T was a long-term holder of the Globe Investment Trust and has now retired. As a result of the actions of the Coal Board Pension fund, an agent of the State, which in 1990 bid for Globe, he was faced with the alternatives of either paying a CGT bill amounting to over 25% of the total value of his stock, or accepting a holding in a new fund which he neither chose nor wanted. With great reluctance, he opted to pay the tax. (It is worthy of comment that of the thirty thousand private shareholders of Globe, some twelve thousand communicated with the company to express their resentment at what was being done to them.)

3. Mr K is an entrepreneur who built up a successful company and sold it out to a major corporation. But for CGT he would redeploy his assets in a new venture which he wishes to start, but the removal of some 36% of the proceeds of his sale renders the venture unviable.

4. The brothers G built up over a twenty-five year period a business manufacturing consumer goods, which they sold to a major company for stock worth several £millions. Although the stock they have received is of impeccable quality and stability, they would like to diversify their investments. The base cost of their investment for CGT purposes is less than 4% of the current value, with the result

that any substantial sale incurs a CGT liability of approximately 38% of the value of stock sold.

5. Mr R has returned to this country after a career working abroad. He has decided that he should invest in a manner which allows him to defer any potential CGT liability indefinitely. He has therefore invested his very considerable wealth in investment trusts and other managed funds which he regards as 'permanent' holdings, and is taking no direct interest in either listed or unlisted companies.

These cases illustrate a feature of private portfolios which will be familiar to all those responsible for their management. In most sizable private portfolios one sees, on the one hand, a massive build up of CGT liability, and, on the other, a tendency to move assets where possible into investment trusts, unit trusts and other managed funds which pay no CGT. Private ownership of listed securities has been declining for decades and is now estimated to be less than 20% of the total capitalisation of the British market. The extent to which private people are 'locked in' to their portfolios has also aided the process whereby trading in the stock market has become totally dominated by the institutions. This has had a particularly damaging effect on the market in smaller companies.

One other important fact emerges from the Inland Revenue Statistics, namely that a substantial part of the burden of CGT falls on the elderly. Nearly 35% by number of those assessed are over 65, although in 1987/88 they were only responsible for some 16% of the tax levied on individuals. For these people, and for the much greater number who opt not to pay CGT, the decisions they take can have a crucial impact on matters of deep concern to them: provision for ill health in old age, the wish not to be a burden to their children and the desire to pass on a reasonable inheritance to their heirs. In making these decisions, they have to take account of the fact that CGT liabilities cease at death, leaving the heirs to contend only with Inheritance Tax. A combination of payment of CGT and an untimely death may have a devastating effect on the heirs: a 40% rate paid twice leaves 36% of the value of the original asset.

Both the figures from the Inland Revenue and the individual examples of taxpayer behaviour demonstrate that people go to inordinate lengths to avoid paying CGT. Some no doubt emigrate, some take unconscionable risks, and the majority defer the decision for as long as they can.

5.

Effects on smaller companies

It has already been pointed out that high CGT rates reduced the rate at which new stocks came to market in the USA. In Britain the 30% rate was already a sufficient deterrent, and the decline since 1988 (see Table 6) may be attributable to harsher economic conditions. Nevertheless it still compares very unfavourably with the stock market behaviour of larger companies. Indeed, the underperformance by small companies vis-a-vis larger ones over the last two years has been extreme. In 1989 the Hoare Govett Smaller Companies Index trailed the FT All Share Index by approximately 25%, in 1990 it lost ground by a further 13%, and in the first six months of 1991 it continued to under-perform, though by a mere two percent.

TABLE 6

New Companies Admitted to UK Stock Markets

Year	Listed UK & Irish	Unlisted Securities Market	Third Market
1980	35	23	-
1981	63	63	-
1982	59	62	-
1983	79	88	-
1984	87	101	-
1985	80	98	-
1986	136	94	-
1987	155	75	35
1988	129	103	27
1989	110	77	23
1990	120	51	7
1991 (Qr 1)	15	7	-

Source: *Quality of Markets Quarterly Review*, 1991

Overall, the number of entrants to stock markets has remained disappointingly low and the recent market performance of smaller companies gives little hope for improvement in the near future. Indeed the severe monetary squeeze of the last two years has destabilised large numbers of small over-indebted businesses, resulting in the biggest crop of failures since the mid-seventies and the weakening of many more.

The downgrading of smaller companies adds significantly to their costs of financing, making it hard for them to compete for capital with their larger brethren. For a dynamic economy plenty of small companies must grow and prosper; and for this to happen these companies must have access to equity capital on favourable terms, rather than rely excessively on borrowings. Of course, CGT is only one of the factors that has afflicted this sector of the economy. The rôle of the institutions and the shrinkage in the capacity of the stock market are two other important influences, but these were already present before the deterioration of the last two years -- it is therefore reasonable to suppose that CGT has played its part.

The behaviour of the owners and managers of small companies in their calculations of risk and reward is also affected. Another example will illustrate the point. Company Y is a successful small manufacturing company, built up by its two founders who own the majority of the capital. The company has substantial cash flow, well in excess of the immediate needs of the business. The founders have been considering a major expansion of the business, involving a significant increase in risk, but have dropped the plan on account of the meagre potential reward after payment of CGT. Instead they have taken heed of the fact that the company can use its surplus cash flow to pay out greatly increased dividends at the marginal extra cost to themselves of the 15% differential between the lower and upper rates of income tax. In reaching this decision they have also been influenced by the possibility of much more adverse tax treatment under a Labour government.

6.

Impact on new companies

It is on the prospects for new companies and on venture capital, however, that CGT bears most harshly. All new businesses have to offer their investors a potential reward which compensates for the deferment of income and for the substantial extra risk taken. They are competing in the market place for capital, and since the possibility of high reward is their major attraction, a high rate of CGT can be death.

Small companies are much more dependent than large ones on private investors for their capital. The public market is entirely dominated by the institutions, to a point where private investors are believed to own less than 20% of the total value of stocks listed on the International Stock Exchange. In the case of small and unlisted companies, however, the institutions are constrained by considerations of marketability and the proliferation of their lists of investments, and they therefore limit their commitments and leave the field to private investors. The effect is to increase the disparity of the returns needed to attract capital. Thus, large institutions, such as pension funds which pay no CGT, supply the bulk of equity capital for listed companies, while the private investor plays a much larger part in supplying seed capital and the needs of corporate saplings.

Variables such as inflation rates, swings in monetary policy, changes in tax law, business cycles etc make it impossible to quantify how great is the impact on equities. Only in the gilt-edged market is it made plain. There still remain a few very low coupon stocks which stand at a good discount from their redemption values. No CGT is payable on redemption of Gilts and these stocks are therefore attractive to high CGT payers. At the time of writing Exchequer 3% Gas 1990-95 and Funding 3 1/2% 1999-2004 yield 6.74% and 8.69% to redemption respectively. All the higher coupon stocks of comparable dates have redemption yields of over 9.5%.

The 25% compound gross return which venture capitalists strive to achieve becomes a much more modest rate when nearly 40% of the net gain, even after indexation, is knocked off at the end. It is questionable whether the risk premium is big enough compared with, say, the inflation-adjusted returns of Index-Linked Gilts.

The message is that it is the *net* return after all taxes that governs the market and dictates the willingness of the investor to invest. This factor has even more impact on the potential entrepreneur, whose ratio of risk to reward was significantly altered by the 1988 tax changes.

Let us take as an example a high flyer in a major manufacturing company, who wishes to break away and start his own company. He will expect both to give up a substantial amount of current income and to subscribe equity money to his new venture. Let us assume that he will give up an average of £25,000 per annum for ten years and that he will put up £50,000 on which he will suffer a notional loss of income. Crude calculations indicate that under the tax rules prevailing before 1988 he would have needed to multiply his stake money just under 3.5 times to break even: under the current rules, he needs to multiply his money just under 6 times to achieve the same result. If the calculations are time-weighted, the change becomes even more adverse, and of course it takes no account of the loss of valuable pension rights which would be clocking up totally tax free if the entrepreneur had remained in his salaried employment. Even for the courageous and enterprising, the prospects are daunting and for a 40 year old with the responsibilities of a wife, two children and a mortgage, they may well be too much. It seems likely, therefore, that there will be a diminished supply of people willing to take the risk of starting new enterprises, to the considerable detriment of the economy. Indeed, recent experience of venture capitalists indicated that the supply of entrepreneurs had declined even before the current wave of bankruptcies.

There are compelling reasons why this should be true. Except in times of economic stress, people tend to look at new and young companies in the light of the successes. What is less readily recognised is the number of cases which, even in more clement conditions, either totally fail or produce an inadequate rate of return on capital. It should also be remembered that the state is a major partner in every successful enterprise, but not in the failures; it is the entrepreneur's capital that is lost.

Statistical evidence about the British market is scarce, but the experience of American venture capitalists gives a good indication of success and failure rates. These would indicate that in nearly a quarter of cases there is either a total or partial loss and that a further 30% break even, or give a poor rate of return. In fact over 60% of the profit of venture capital funds has come from under 7% of their investments, and only about 15% of their investments would provide the return of 20% per annum which, but for CGT, would justify the extra risk taken. Overall statistics on a number of fully realised funds which matured during the 1980s indicated an average compound growth rate of 25%. It may be, though informed opinion suggests the contrary, that higher rates have been achieved in this country, but if the American experience is anything to go by, then the post-CGT reward in relationship to risk is totally inadequate, since CGT effectively reduces a gross 25% rate to a 15% rate net of tax. Of course, there are always heroes who fancy their chances of beating the odds, and a sufficient number will succeed to give the illusion that we have a thriving small companies sector. The figures, however, give cause for doubt.

Lastly, the effects on creation of jobs must be considered. In a year in which it is estimated that over 20,000 companies will go into liquidation, the vulnerability of small firms is clear. And yet their rôle in supplying new jobs is of huge importance. Lack of statistical evidence in Britain means we must look at the USA, where studies carried out in the early '80s by David Birch (then of the Massachusetts Institute of Technology) indicated that companies at that time with fewer than twenty employees were creating 88% of net new jobs. Even though these figures are open to challenge as being on the high side, it is certain that the rôle of mass manufacturers as employers has been much reduced -- and the health of small companies becomes of correspondingly greater importance. In Britain, though the proportion of total employment in the hands of major corporations may be rather greater, the principle applies just as much as in the USA.

7.

Business Expansion Schemes

The Government, while discouraging enterprise with CGT, has attempted to redress the balance with Business Expansion Schemes. The BES tax concessions have indeed helped new businesses to raise capital on favourable terms, although the exclusion of employees, partners or paid directors of BES companies eliminates from benefit those who are taking the greatest risk and on whose efforts and skills success depends. Presumably the Inland Revenue intended to frustrate various techniques of tax avoidance, but it seems perverse that owner-run businesses should be so handicapped.

In practice all too many BES companies have been launched by promoters seeking an outlet for clients' monies, rather than being soundly-based businesses which need further funding. These promoters have neither the financial nor the management depth to fulfil the venture capitalists' rôle of close monitoring and guidance, coupled with the ability to supply development capital to the successful. Furthermore, BES companies are complex and expensive to set up and manage and, because of earlier abuses, they have been hedged about with restrictions. Some have been set up primarily in order to take advantage of the tax concessions, and consequently have been based on ill-thought out business plans. It is not surprising, therefore, that they have had a high casualty rate. To take the case of one well-supported manager of BES Funds, their 1984/85 Fund has had eight total write-offs out of thirteen investments and their 1985/6 Fund six out of twelve. Other such funds have fared even worse, and in very many cases the only profit made has accrued to the promoters.

The counter-palliative to CGT of BES schemes has been modest. Table 7 opposite sets out the number of companies formed and the amount of money raised. Figures concerning failures are not available.

Note that the 1988/89 figures contain an exceptionally high proportion under the heading 'Private Rented Property'. Evidently this trend has continued, or become even more extreme; of the money raised in the first half of this year by one of the leading firms in the BES business, over 98% has been for companies buying property for rent. It is also notable that the amounts raised for manufacturing industry and the number of companies involved have gone into sharp decline. It seems, therefore, that BES schemes will do little to strengthen the industrial base of the country. All in all, they provide less than adequate compensation for the unnecessary rigours of CGT.

TABLE 7

Business Expansion Scheme
Companies and amount of investment by industry

Numbers: actual; Amounts: £million

Industry	1983-84		1984-85		1985-86		1986-87		1987-88		1988-89	
	No	£	No	£	No	£	No	£	No	£	No	£
Private rented housing											1,934	362
Agriculture, fishing and horticulture	23	20	13	1	15	4	21	2	41	15	23	2
Construction	32	7	49	7	26	10	34	12	38	17	16	1
Manufacturing	300	35	311	35	266	35	277	37	287	28	154	14
Wholesale & retail	134	14	120	14	126	31	149	35	152	38	101	7
Service Industries	214	25	310	90	238	69	280	83	294	102	208	26
Others	12	4	-	31	8	2	-	3	-	6	-	-
Total	715	105	807	148	702	157	763	169	815	200	2,442	412

Source: *Inland Revenue Statistics* 1990

Conclusion

It is axiomatic that taxation should collect the optimum revenue with the minimum damage. On this count CGT is a lamentable failure. Professor Lindsey's work in the USA indicates that the optimum rate of CGT for tax gathering is approximately 18%, and he has recommended a rate of this order to the Bush Administration. While an analysis in this country might produce slightly different figures, the effects demonstrated in this paper suggest that a much lower rate than the present one would both gather more tax and do less harm.

Britain has already derived benefit from the cuts in the higher rates of Income Tax, even in terms of tax revenues. In 1978/79 the top five per cent of taxpayers contributed 24% of the Income Tax revenue, whereas in 1987/88 the top five per cent contributed 30.5%. The major increase in this percentage occurred from 1983/84 onwards as the more substantial tax cuts began to have their effect, although the cut of the top rate to 40% has yet to make its mark in the published figures.

The arguments based on the analysis of tax receipts have been influential in so far as they affect income taxes. Indeed, Mr Lawson in his 1988 Budget speech specifically referred to the work of Professor Lindsey in recommending the reduction of the top rate of income tax from 60% to 40%. It is true that Professor Lindsey indicated that a rate nearer 30% than 40% would be desirable but the substance of his argument was accepted by the Conservative Government.

In the case of CGT, however, the dispute has not been won in the USA and the debate has scarcely been joined in Britain. In both countries suggestions for the reduction or elimination of CGT are still presented as a 'gift to the rich'. This is, I believe, a singularly misguided attitude. If changes in top rates of income tax can be demonstrated to affect taxpayers' behaviour, it seems inherently probable that high rates of CGT do likewise. By ignoring this, we risk damaging both individual interests and those of the economy as a whole.

What then should be done?

The choice lies between abolition and amelioration. The former would:-

1. Free up much capital at present 'locked-in'.

2. Reduce the distortions in the flow of capital and the consequent mis-direction of investment.

3. Eliminate the double taxation element of CGT.

4. Lower the costs of equity capital, particularly to small businesses.

5. Remove a major handicap to British companies in competition with those from countries with no CGT.

Amelioration could take a number of forms, none of them ideal but any one of them better than the present state. It might:-

1. Reduce the rate to 15%, equal to the difference between the upper and lower bands of income tax, which would have the combined merits of bringing in more revenue and effectively removing the element of double taxation.

2. Extend to shares in companies the rollover relief already granted to certain other classes of assets, when the proceeds of sales are reinvested within a given period.

3. Make CGT a short-term gains tax with a six months, or one year, cut-off period.

4. Calculate the rate of CGT on a sliding scale of, say, 40% in the first year, 30% in the second, and so on down to nil.

5. Take a leaf out of the Japanese book, and allow the taxpayer an option of paying a percentage of the total proceeds (1% in Japan).

Each of these suggestions has its flaws, but each would nevertheless have the effect of removing some of the more damaging effects of the present level of CGT.

As it stands, CGT must be regarded as almost wholly a political tax, levied for appearances rather than for substance. All in all, few taxes can have done so much mischief for so little revenue gain. Against it are arrayed objections of real and practical concern, having implications for the dynamism of the entire economy, including its ability to provide employment.

This country is no longer so rich in capital that it can afford to neglect its proper deployment: as Francis Bacon had it: 'Money is like muck, not good except it be spread'. Those who possess capital should have every inducement to invest it profitably and productively, and not to keep it buried. Those who have talents should not be deprived of the rewards of their endeavours.