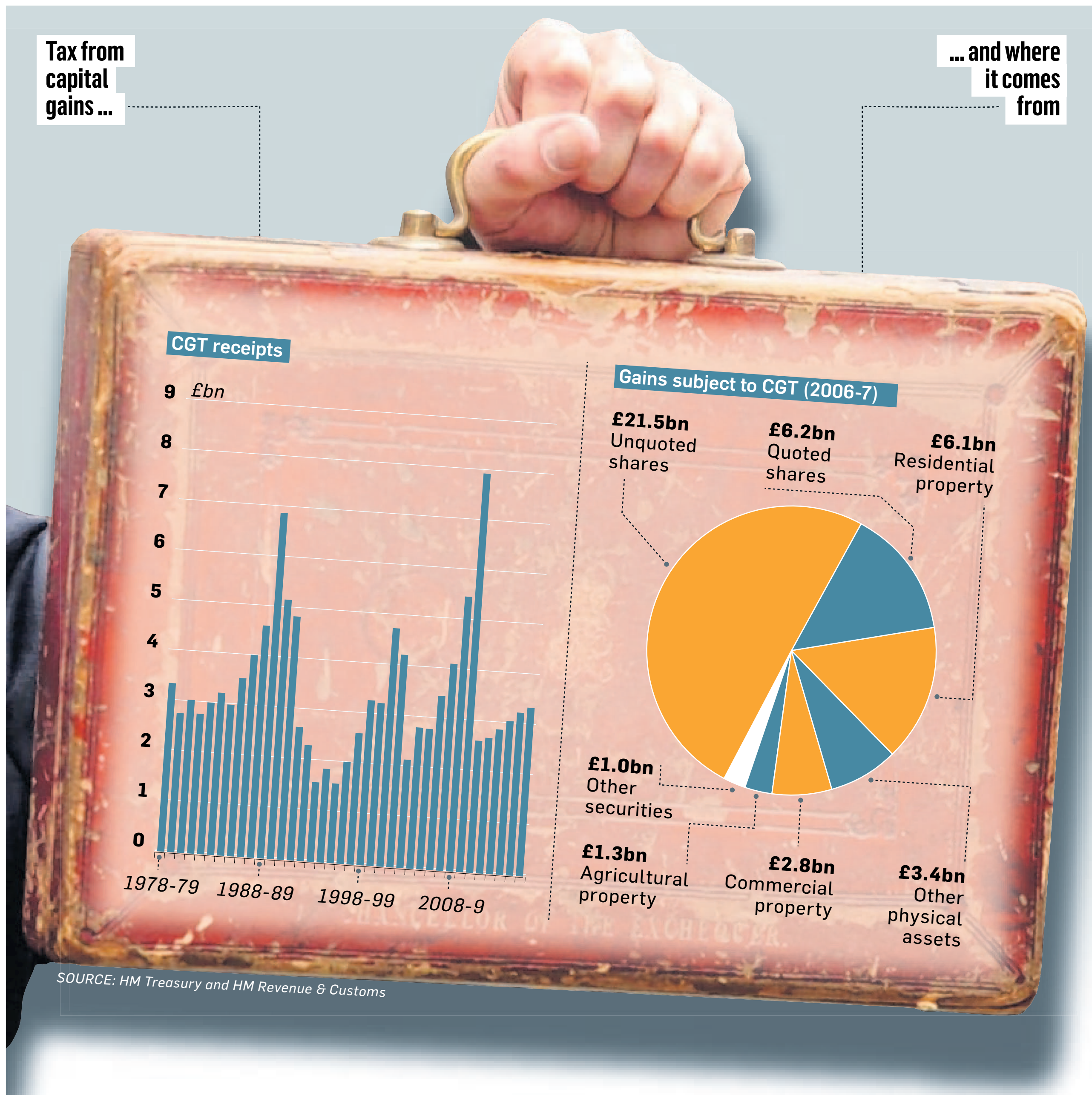
Solutions to the taxing issue of capital gains

ROBERT CHOTE
ECONOMIC OUTLOOK



The Institute for Fiscal Studies was founded in the late 1960s largely out of frustration with the way capital gains tax (CGT) was designed and implemented in Britain. Over the subsequent four decades CGT has been attacked, substantially reformed and attacked again roughly every 10 years. Our new government is only the latest to try its luck.

The coalition has promised to "seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities". This suggests the tax rate on assets such as shares, second homes and works of art could rise significantly.

The Liberal Democrats see this as a good way to raise money for income-tax cuts, but also as a move back towards the rational CGT regime put in place by Nigel Lawson in 1988. However, some backbench Tories see it as an attack on the middle classes and a betrayal of Conservative values. David Cameron has told critics to "calm down" until they see the details.

At first glance, CGT looks unimportant. It is forecast to raise £2.7 billion this year — just 0.5% of the Treasury's total revenue. Some critics argue from American and British experience that increasing CGT rates would actually cost the government revenue, but swings in CGT revenues from year to year often reflect the pre-announcement of rate changes and expectations of where they might go next. And we should not look at CGT revenues in isolation: perhaps the key role of the tax is to underpin the much bigger revenues we get from income tax and National Insurance.

CGT is applied to the increase in the value of an asset between its acquisition and disposal. This sounds simple, but the devil lies in the many attendant details. For example, to which assets should it apply? Which part of the gain should you tax? And should the tax rate be uniform or vary with the type of asset, the length of time it has been held or the income of its owner?

Different chancellors have answered these questions in different ways. When James Callaghan introduced CGT in 1965, it was a flat rate of 30%. Geoffrey Howe introduced indexation allowances in 1982, ensuring that only gains in excess of inflation were taxed. In 1988 Lawson began taxing gains at the taxpayer's marginal income-tax rate. This was probably as good as it got.

Gordon Brown abolished indexation allowances for gains after April 1998 and introduced "taper relief". This gave taxpayers an increasingly generous discount on their CGT bills the longer they held the assets (with a bigger discount for business assets than non-business ones). He made taper relief more generous in 2000 and 2002, before Alistair Darling announced in 2007 that he would abolish the relief and impose a flat rate of 18% — returning to the pre-1982 system. Business lobby groups complained that this would increase the rate paid on long-held business assets, forcing him to create "entrepreneurs' relief", which cuts the rate to 10% on the first £1m of lifetime gains for some business assets.

Looking back, most of these changes have been attempts to balance two competing objectives: the desire to minimise the scope for tax avoidance created when capital gains are taxed more lightly than income, and, second, the desire to keep capital taxes as low as possible to avoid discouraging saving and investment. The now Lord Lawson and the Liberal Democrats put more emphasis on the former, while the last Labour government and the current Conservative critics of the coalition put more on the latter. These critics also argue that many small investors have been saving in non-business assets in the expectation of generous tax treatment and that it would be unfair to withdraw it now.

The Liberal/Lawson view has much to recommend it. The tax system should not distort people's behaviour in a costly way without good reason. From this several lessons follow.

First, the tax rate on capital gains should be aligned with the rates on earned and dividend income, ideally with a single tax-free allowance. Different tax rates encourage people to be paid in more lightly taxed forms and to move into occupations where this is easier. Using anti-avoidance rules to restrict how people are paid in particular circumstances is much less attractive.

Second, CGT should not discriminate between business and non-business assets. People should be left to decide unbribed whether to put their money into a bank account, housing, shares, or into their own businesses, based on their own judgment of the risks and returns involved. There is an argument for taxing shares more lightly, however, because company profits that give rise to capital gains have already been subject to corporation tax. We should be wary of the argument that investing in one's own business is a virtuous act deserving of subsidy in a way that investing in somebody else's business is not. People should decide whether and how to build an enterprise on the basis of its commercial fundamentals, not its tax treatment.

Third, we should not try to bribe people into holding assets for longer than they would otherwise wish to do — economic welfare is best served by having assets owned by the people who value them most. The previous government justified taper relief as a way to discourage short-termism, but encouraging people to hold assets for longer than they want is not the same as encouraging companies to undertake productive investments that may take a long time to pay off.

Fourth, we should tax real gains rather than the illusory gains from inflation, so there is a strong case for reintroducing indexation allowances.

But what of the twin objections that all this would discourage future investment and penalise past saving?

High CGT rates certainly discourage investment, but reducing them is not necessarily the best way to encourage it. Capital allowances, including schemes such as the Annual Investment Allowance aimed at small firms, are more effective ways because they specifically reduce the tax rate on capital investment rather than on the other factors that generate capital gains. But the Conservatives want to shrink capital allowances to help pay for cuts in the main rate of corporation tax.

An alternative approach would be to reintroduce indexation allowances, not just for inflation but also for the minimum return that someone would require to invest a pound today rather than spend it. This would move us closer to an "expenditure tax" system that would not distort levels of saving and investment, especially if accompanied by similar changes to income tax and corporation tax.

Aligning CGT and income-tax rates more closely would, of course, anger people who have been saving in assets that currently attract generous tax treatment. But there was never any guarantee that this preferential treatment would remain in perpetuity, especially given the regularity of CGT changes in the past. Various possible transitional arrangements could ease the pain, but all would be costly, complicated and of questionable fairness.

The uncomfortable truth is that the coalition partners will have to inflict a lot of pain and disappoint quite a few expectations over the next few years as they clear up the fiscal mess they have inherited from Labour. Hopefully they will have the courage to move towards a more rational tax system as they do so, rather than simply scrambling from one short-term fix to the next.

Robert Chote is director of the Institute for Fiscal Studies

David Smith is away