The effect of a capital gains tax cut on revenue

Revenue neutrality places a special responsibility on your shoulders to ensure the estimates of losses and gains to revenue from particular changes to the taxation system are fair and reasonable in light of all the information available.

If they are fair and reasonable, you will release a tremendous dynamic that will allow you to make changes to our taxation system that will drive economic growth in this country.

If they are unfair and unreasonable, i.e. revenue gains are underestimated and revenue losses are wildly overestimated, your review will never have a fair chance. It will have to fight with one hand tied behind its back. Your review will be a failure that simply tinkers at the edges.

You owe it to the community to get these revenue estimates right. Subject them to intellectual rigor. Perform your due diligence. Check them for overall reasonableness. Expose the assumptions that underlie them to public scrutiny.

Your current estimates are unfair

I recently attended a conference organized by the Innovations Section of the Department of Industry, Science and Resources in Sydney where the person in charge of the CGT segment of your review spoke.

The information provided to the conference showed beyond a doubt that the direction your number crunchers are taking is to under estimate revenue gains and overestimate revenue losses. That is right, they are tying one hand behind your back and dooming your review to failure.

The revenue implications of a cut in the capital gains tax rate

I lived in the USA during the period they fought the battle to have the way the revenue effects of changes to CGT rates are calculated. The need for the change was because up to that point no account was taken of the fact that cutting CGT rates grew the pie bigger.

Up until then, if they were collecting $100 from CGT and they cut the CGT rates by 10%, the forward estimates would assume a reduction in the number of dollars collects by 10% or $10.

However there was substantial evidence to suggest that if you cut the CGT rate, the pie actually grew bigger. In fact it grew more than enough to compensate for the revenue lost as a result of the CGT rate cut. So the actual situation was closer to this – if they were collecting $100 from CGT and they cut the CGT rates by 10%, the total number of dollars collected actually increased, to say $103.

This error in calculation made it very difficult to implement CGT rate cuts because of the erroneous effect on revenue collections. So the calculation methodology had to be changed to reflect reality.

Comprehensive study on the effect of a cut in CGT rates

In 1998 the Joint Economic Committee of the United State Congress (JCT) released the results of probably the most comprehensive study into the revenue effects of a cut in CGT rates ever performed anywhere in the world. The study was based on US experience and showed that if you cut CGT rates, the total number of dollars collected from CGT actually increased. If you raise the CGT rates, the total number of dollars collected from CGT actually decreased. A copy of this study can be found at http://www.house.gov/jec/fiscal/tx-grwth/capgain/capgain.htm

Surely, if your review is to claim that a cut in CGT rates in Australia will cut the total number of dollars collected from CGT, then your committee must clearly show why the Australian outcome will be the exact opposite of the USA experience.

The JCT study has been rejected out of hand by your number crunchers

There are clear indications that your number crunchers have rejected the JCT study out of hand and are intent on ignoring it. To show you why I believe this I will outline the course of conversation at the Sydney conference. Please note these are not exact quotes and are compiled from the presentation, questions and answers, and breakout discussions. Nor am I trying to pick on the representative you sent to the conference, but since he heads the CGT segment of your review, I can only believe his statements provide a window into the current thinking of your committee.

RBT Rep Presentation:	Capping the CGT rate at 30% will cost revenue $600 million. Basically each 1% reduction cuts revenue by about $100 million.
Question from the Audience:	What about this JCT study that shows that the total number of dollars collected actually increases.
RBT Answer:	The problem with the study is that it relates to a period of time in the 1980s and you need to take into account the behavior shift that results in people converting income to capital gains to take advantage of the lower rate.
Breakout session question:	Why is it that the whole JCT study dedicates one line to the income to capital gain shift, but you are ignoring all the other positives in the report and using that one line to discard the report.
RBT Rep Answer:	The thing you need to take into account in Australia is that behavior will change. Companies will accumulate earnings rather than paying out dividends so their shareholders can realize lower taxed capital gains rather than income etc. etc. So while more CGT taxes will be collected less income taxes will be collected.

These answers showed clearly that the findings of the JCT study had been rejected out of hand without being thoroughly checked out and the reasons for the difference in behavior in Australia producing enormous revenue losses have not being justified. Here are a couple of facts to show why.

Fact 1

The JCT study was not some 1980's aberration, but included data from the 1970s, 1980s, and 1990s.

Fact 2

The RBT Rep said the Australian situation would result in a revenue loss rather than a revenue gain due to a lower CGT rate causing companies to prefer to accumulate income rather than pay dividends. The assertion this would result in a loss in income tax collected was poorly thought through. **When properly analyzed, this specific situation will cause the revenue gain from a CGT rate cut to be greater in Australia than it was in the USA.** Here is why.

In Australia we have a dividend imputation system, which means shareholders get a tax credit for any company tax paid when they receive a dividend. It was designed to stop the double taxation of company earnings. The end result is that there is a strong incentive to pay dividends under the dividend imputation system because many shareholders will not have to pay any tax on the dividend income and even those on the top marginal rate only have to pay about 14% tax on the dividend income once franking credit is taken into account. Whereas if the income was accumulated shareholders would have to pay up to 50% tax on the resulting capital gain. I am sure you will agree this produces a strong incentive to pay out earnings as dividends rather than accumulate for capital gains.

In the USA, right through the period of the JCT study they had a system that double taxes companies' earnings. Once in the hands of the companies and once again in the hands of the shareholders when dividends are paid. The way to avoid that double taxation is to accumulate earnings rather than paying them as dividends. Indeed share buybacks are a preferred method of returning value to shareholders in the USA because they avoid that double taxation. This means American companies have always had a much stronger incentive to accumulate earnings and allow shareholders to take a capital gain then Australian companies do under our dividend imputation system.

Now lets introduce a capital gains tax rate cut and assume it brings about the behavior change predicted by the RBT Rep. Since companies in the USA already have strong incentives to accumulate earnings and Australian companies have strong incentives to pay out earnings as dividends, the behavior shift will be much greater in Australia then the USA.

But what is the effect of that behavior change. Because the purported behavior shift is much greater in Australia than the USA, it would result in a greater increase in CGT revenue in Australia than the USA.

In fact many may argue the behavior effect in the USA would be relatively miniscule because they already had such strong incentives to accumulate earnings and return value to the shareholders through capital gains. That the CGT revenue effect of this behavior change in the USA was negligible. If the behavior change was negligible (maybe this is why it only rated on line in the study), the cost to income tax revenue would also be negligible.

And still the CGT revenue collected after the CGT rate cut increased.

This clearly disproves the RBT Reps reason for discarding the JCT study. Not only does it disporve it, but it shows if the behavior shift actually took place in Australia when CGT rates were cut, then the increase in CGT revenue would be greater in Australia then the USA.

Fact 3

One of the major reasons, apart from the increased economic growth flowing from a CGT rate cut, for the increased CGT revenue was what they called an "unlocking effect". Basically the unlocking effect is the increased willingness of people to realize capital gains when the CGT rate is lower. These increased realizations means more transactions subject to CGT, therefore more CGT is collected.

Given the quantum of the CGT rate reduction (50% to 30%) is much greater in Australia then it was in the USA **the additional CGT revenue generated by the unlocking effect in Australia will be much greater than it was in USA**.

To test this theory, how many people do you know who own Commonwealth Bank Shares or National Australia Bank Shares. With the market so high they are wondering if they should take a profit. But they do their sums. Lets say their marginal rate is 50%, they bought their National Australia Bank NAB shares for $6.50 and the current value is $28. Lets further assume their cost base has been increased by the CPI index to $8. If they were to sell, they would crystallize an immediate CGT bill of $10 {($28-$8)*50%}. So for them to be worse off by holding their NAB shares, the share price would need to drop by $10. Not surprisingly they do not sell, that CGT revenue is locked up. (This also causes resources to be inefficiently allocated).

I can already hear your number crunchers saying "hang on, that is just a timing difference" and in theory they may be right. But in the real world if you are relying on dividend income to live off, it is much more than a timing difference – after all you can defer CGT indefinitely by not selling and if the share price does fall in the future you would not have to pay CGT anyway.

Lets say NAB shares are yielding 5% and investments of similar quality and risk are also yielding 5%. Currently for each NAB share you receive a dividend of $1.40 ($28*5%). If that NAB share is sold, the CGT is paid, and the balance reinvested, that income drops to $0.90 {($28-$10)*5%}. That is a 30% drop in income/cashflow not a timing difference. Many successful business people say cash flow is everything – shareholders that need cash to buy their cornflakes tomorrow agree. So the shares are not sold and the CGT revenue remains locked up.

Fact 4

The other reason the JCT attributed to the increase in CGT revenue was the overall increase in the value of assets as a result of a lower CGT rate being applied to them. These higher values produced higher capital gains and therefore more CGT revenue

As explained in Fact 3 above, the quantum the proposed CGT rate reduction in Australia is much greater than that in the USA, so the overall increase in value of assets will be much greater. Therefore the increase in CGT revenue should be greater.

Fact 5

Obviously there is a crossover point where a reduction in CGT rates will reduce the CGT revenue collected. We do not know exactly where that is, but the JCT study shows we can safely reduce our CGT rates to those of the USA without hitting it.

One final point

The world doesn't stand still. I was in the USA last month and on TV they were talking about reducing the CGT rate again.

Why?

Because they will collect more revenue that way.

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