

# Tax: the need for change

Response to Financial System Inquiry, National  
Commission of Audit and Tax Discussion Paper 2015

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## Overview

Prior to the 2014 Budget the Government asked the Shepherd Commission of Audit to report on public spending. They did not include in its remit the cost of tax expenditures – money which could be collected but, because of concessions, is not. Tax expenditures cost the Budget \$130 billion per annum – or a quarter of all revenue. The issue of superannuation tax expenditures, costing almost \$35b, is the subject of a companion paper to this report. Other large tax expenditures are in the area of housing.

The 2014 Financial System Inquiry, headed by David Murray and the 2015 Tax Discussion Paper have concerns about the disparate effective tax rates on various forms of savings – a concern which echoes the 2010 Henry Tax Review. For example, bank accounts are very heavily taxed, with no account taken of inflation, while assets yielding capital gains or utilising gearing are very lightly taxed. We concur with Murray's suggestions that the tax advantages on capital gains and negative gearing be reduced, although Murray ultimately suggested these be matters for the Tax Review. The Tax Discussion Paper argues that negative gearing is not inherently concessional, but that geared property investment is encouraged by the capital gains discount. The Paper implicitly targets the latter concession. Our view is that both should be addressed.

Neither Henry nor Murray addressed the tax rate on owner-occupied housing, which is zero despite the huge advantages home ownership has historically conferred. Shepherd would trim the concessionality of welfare means tests with respect to housing but does not address the tax system's overall concessions for housing. The Tax Discussion Paper notes that Australian households hold 43 per cent of total assets in the family home, but then claims that:

*Given the central importance of the family home for Australian families, there is strong consensus that it would not be appropriate to tax either the imputed rent on owner-occupied housing or capital gains derived from it.<sup>1</sup>*

Shepherd would trim the concessionality of welfare means tests insofar as they are very generous to housing but leaves the tax system's overall concessions for housing alone. We argue that concerns about the disparity in tax treatment of various assets are justified, but we need a consistent policy approach to this area. In the arena of owner-occupied housing the exclusion of capital gains and imputed rent are large holes in the tax net – at \$36b per annum, as large as the superannuation hole.<sup>2</sup> We suggest a way to plug these gaps, starting with those who are better-off.

One way to tax all assets consistently might be some form of Annual Wealth Tax (AWT). Currently we apply an AWT to welfare recipients, in the form of the assets test, and the Government is raising the implicit AWT rate.<sup>3</sup> These recent Inquiries seek to widen its scope by extending the use of deeming and including some part of housing wealth.<sup>4</sup> Why restrict wealth taxation to the poorer part of the population?

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<sup>1</sup> Treasury 2015b p67

<sup>2</sup> Their total cost is \$46-50b but cost offsets reduce the net cost to some \$36b – see Johnson and Baker 2015

<sup>3</sup> See <http://scottmorrison.dss.gov.au/media-releases/fairer-access-to-a-more-sustainable-pension> and the critique of this policy in the companion (superannuation) paper.

<sup>4</sup> ACOSS has recently argued for tightening the pension asset test as an alternative to scaling back pension indexation – see ACOSS 2015 [http://acoss.org.au/media/release/acoss\\_outlines\\_fair\\_proposals\\_to\\_reform\\_pensions\\_and\\_superannuation](http://acoss.org.au/media/release/acoss_outlines_fair_proposals_to_reform_pensions_and_superannuation)

An AWT has been seen, in the past, as exacerbating the distortions caused by the income tax's disparate treatment of savings. However it can be integrated with the personal income tax either by using it as a form of *alternative minimum tax* (AMT) on capital income, or by the use of deemed (potential) income as a tax base, with actual asset income to be disregarded. The AMT is the approach currently used in the pension asset test; deeming is the approach favoured by both Henry and Shepherd for the welfare system.

A transformation of the tax system along these lines is preferable to partial approaches focussing on the wealth and/or housing wealth of pensioners and provides a means of increasing the overall equity and efficiency of the tax system. In particular an AWT would be a serious alternative to the 'Buffet rule' we have advocated elsewhere as a means of making the rich pay at least some tax, and could obviate the need for changes to negative gearing and capital gains tax. Indeed in its most comprehensive form such a tax could entirely remove the need to tax capital income at the level of the income tax.

## **Recommendations of Financial System Inquiry (FSI - Murray)**

The FSI reported in October 2014 and made 44 recommendations relating to 5 specific themes. In addition the inquiry nominated a number of issues of concern in the tax system, which it felt should be more fully examined in the upcoming tax inquiry.

The theme this paper relates to the tax matters raised in Appendix 2 *Tax Summary*. We also comment on the 2014 Report of the Commission of Audit and the 2015 Tax Discussion Paper.

The Australia Institute has written extensively on tax matters over the past 6 years. We review these official reports in the light of those writings.

## **Summary of FSI Tax Appendix 2**

We here include only a few of these comments that are relevant to our main interest of tax reform.

*The Inquiry has identified a number of taxes that distort the allocation of funding and risk in the economy... Unless they are already under active Government consideration, the tax issues listed below should be considered as part of the Tax White Paper process.*

### Differentiated tax treatment of savings

*The tax system treats returns from some forms of saving more favourably than others. For example, interest income from bank deposits and fixed-income securities are taxed relatively heavily...*

*The relatively unfavourable tax treatment of deposits and fixed-income securities makes them less attractive as forms of saving and increases the cost of this type of funding.*

### Negative gearing and capital gains tax

*Capital gains tax concessions for assets held longer than a year provide incentives to invest in assets for which anticipated capital gains are a larger component of returns. Reducing these concessions would lead to a more efficient allocation of funding in the economy.*

*For leveraged investments, the asymmetric tax treatment of borrowing costs incurred in purchasing assets (and other expenses) and capital gains, can result in a tax subsidy by raising the after-tax return above the pre-tax return. Investors can deduct expenses against total income at the individual's full marginal tax rate. However, for assets held longer than a year, nominal capital gains, when realised, are effectively taxed at half the marginal rate. All else being equal, the increase in the after-tax return is larger for individuals on higher marginal tax rates.*

*The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment.*

Tax treatment of superannuation: Tax concessions

*"Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes" – see companion paper on superannuation for details.*

## **National Commission of Audit (NCOA - T Shepherd, Chair)**

The NCOA was not asked to report on tax expenditures, a rather glaring omission as such expenditures now cost the budget \$127b<sup>5</sup> and some of these are growing faster than many direct expenditures. However Mr Shepherd has questioned the incidence and value of superannuation tax concessions, noting that they fail to reduce pension spending.

### **Tax Discussion Paper**

The Tax Discussion Paper in general is not prescriptive, but rather highlights areas of concern where the tax system is not working well and where public discussion is sought. Reading between the lines, however, it is possible to discern Treasury's preferred positions. The general view is that the economic costs of revenue-raising in Australia are higher than they need to be, and there are opportunities to simplify the tax system by concentrating on taxes which are efficient and have large revenue potential. Further, "Tax concessions need to be well justified to ensure the fairness of the tax system" (p2). In general, however, the Paper concedes that "Australia's overall tax burden is relatively low compared to other developed countries" (p13), although we do rely heavily on income taxes (including company tax). Taxes with particularly high economic costs are company tax and stamp duties.

In 2012 the Institute argued that the case for cutting the corporate tax rate is not clear-cut.<sup>6</sup> In reality, budget considerations rule out rate cuts unless they are financed by roll-back of dividend imputation. This would reduce benefits for domestic shareholders while reducing tax payable by foreign investors. The politics of doing this however are unattractive for any government and the economic arguments are not unambiguous.

Stamp duty rollback can be financed by increases in land taxes, as advocated by the Henry Report, although there really needs to be base broadening in this area to make the land tax more fully tax economic rent from any land. The ACT government is moving in this direction in a staged manner. However other state governments have not initiated reform, although South Australia is looking at the possibility.

<sup>5</sup> Budget Paper No 1 2013-14 Appendix E: Tax Expenditures has estimates for total TEs from 2009-10 to 2016-17. These totals are not provided in Budget Paper 2014-15 although there are estimates of large measured tax expenditures (Appendix B to Statement 5 and Attachment C to Part 3). See also Budget Paper No1 2015-16 Statement No 4 Appendix A for similar estimates.

<sup>6</sup> Richardson 2012 The case against cutting the corporate tax rate TAI Technical brief No.20, December. See also the discussion in Stewart et al 2015 Ch5.

The Tax Discussion Paper is also concerned with compliance costs (in the order of \$40b a year), and bracket creep. Compliance costs are partly a result of tax law complexity which in turn reflects numerous carve-outs and concessions. The Paper is also concerned about high effective tax rates (ETRs) for some groups, especially those on the border between work and welfare. In the companion paper on retirement incomes we discuss options for reducing ETRs in the pension system.

Not much can be done about bracket creep, given the budget situation, unless alternative sources of revenue are found.

The Tax Discussion Paper argues that taxes should be “lower, simpler, fairer”. Base broadening and tax mix change are seen as the vehicles for achieving such objectives. The Treasury is clearly attracted to increasing the GST and/or cutting out exemptions such as fresh food, medical and education. Such exemptions reduce the GST base by over half, compared to total consumption in the economy. Moreover that is the slower-growing half.

TAI has previously suggested that there are opportunities to broaden the base in education and medical expenses, and this would be progressive as higher income groups spend more in these categories.<sup>7</sup> In theory low income earners could be compensated for base broadening in areas such as food; the risk is that compensation measures would be unwound in the future under the budget pressures of e.g., an ageing population.

Differences in the taxation of alternative savings vehicles were also a focus of the Henry Report, although the Treasury now seem less attracted to the idea of an expenditure tax treatment of, e.g., superannuation savings since “Empirical evidence suggests the behavioural response of taxing savings is uncertain and may not be significant”<sup>8</sup>. However they do not rule out some concession involving taxing savings more lightly than labour income. However this should logically be limited to lower income groups as they respond more to savings incentives. Other options canvassed include a flat tax on capital income as using in some Nordic countries; this approach seems to be inconsistent with the Treasury view that tax incentives don’t impact high income earners.

These arguments point to taxing bank account earnings less heavily (Henry suggested a 40% discount) and taxing superannuation more heavily. The logic of the capital gains discount is also questioned, as is the continuing relevance of the dividend imputation system when the global economy is becoming much more integrated.

In the Tax Discussion Paper, owner-occupied housing tax breaks worth \$30-40b<sup>9</sup> are sacrosanct. This of course is a political judgement, and one we disagree with.

As an aside, although the Tax Discussion Paper is meant to be a holistic examination of tax options, nowhere is there any discussion of carbon or mining taxes, despite these both being important themes in the Henry Report, and despite most tax experts regarding taxing of environmental externalities and economic rents as desirable. The Paper is very much a political document.

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<sup>7</sup> Grudnoff M 2014 How to extend the GST without hurting the poor TAI, December

<sup>8</sup> Treasury 2015b p59. An expenditure tax treatment implies that the normal return to saving is not taxed. In the superannuation arena that can be achieved by taxing only contributions, or taxing only end benefits.

<sup>9</sup> Johnson M and Baker D 2015 The great Australian lockout – inequality in the housing market” TAI March, p14. See also the Grattan Institute report on housing, Kelly 2013 <http://grattan.edu.au/report/renovating-housing-policy/>

## General comment on these Reports

The Murray report takes aim at the 50% discount for capital gains tax for assets held longer than 12 months and at negative gearing for property investments. These are also long-held concerns of The Australia Institute. In Ingles 2009c it was proposed that the capital gains concession be abolished with revenue saving of up to \$10b pa.<sup>10</sup> The current Tax Expenditure Statement (TES) estimate is \$5.8b<sup>11</sup> but this excludes super fund gains for which a 33% discount applies (cost=\$0 .5b) so the current total would be closer to \$6.5b. This figure is volatile and depends on the state of the housing and stock markets.

The 50% discount was originally a trade-off for the abolition of indexation in the capital gains tax. However we do not currently index other forms of capital income so arguably it is unfair to single out capital gains for this concession. Further, tax is deferred on capital gains compared to the ideal of accrual taxation (taxing gains annually) and under reasonable assumptions the deferral gains compensate for the non-indexation of the base.<sup>12</sup>

A further reason for the capital gains discount was to encourage more frequent realisation, with their being some suggestion that revenue is actually enhanced by a lower tax rate.

While this may be true in the short term, the underlying tax base continues to rise over time so that the net present value of revenue is not reduced. However there is scope for tax to be indefinitely deferred by the current provisions allowing assets embodying capital gains to be passed to heirs tax-free at death. The inheritors then are allowed an uplifted cost base using value at the time of death. This provision is anomalous and should be corrected irrespective of decisions about the discount.<sup>13</sup> This is the policy in Canada.<sup>14</sup>

As regards geared property investments, Ingles 2009b noted that negative gearing would not be concessional so long as capital gains were fully taxed annually on an accrual basis. That is, the property would be revalued each year and the increment to value would be included in taxable income. Absent a full accruals tax – surely an unlikely prospect - negative gearing should be disallowed.<sup>15</sup> Instead, losses would be carried forward and be utilised against future income or capital gains tax liability on the property. Grudnoff suggests that negative gearing be restricted to new housing, but with existing access to negative gearing to be phased out gradually.<sup>16</sup>

The Treasury regard negative gearing as not concessional if capital gains are fully taxed. Their analysis fails to take account of tax deferral which is inherent in a realisation-based gains tax; this factor suggests that both reforms could be pursued jointly.

The Grattan Institute has commented:

*Through negative gearing rules, and the capital gains discount introduced in 1999, the Commonwealth provides residential property investors with ... \$4,500 on average for each property investor. Private renters, by contrast, receive very little support through the tax and welfare system, even though they make up nearly one in four*

<sup>10</sup> The extent of the likely revenue gain is hard to calculate because of the likely impact a higher CGT would have in reducing the rate of realisations. In a recent paper Evans et al 2015 suggest that revenue gain might be around half of the tax expenditure.

<sup>11</sup> See Treasury 2015a p7 and p64

<sup>12</sup> Ingles 2009 p18

<sup>13</sup> Ingles 2009

<sup>14</sup> Stewart et al 2015

<sup>15</sup> Ingles 2009 p 18

<sup>16</sup> Grudnoff 2015b *Top Gears*, TAI

households. By increasing demand for residential property, these policies help to push up property prices and lock many homebuyers out of the market.<sup>17</sup>

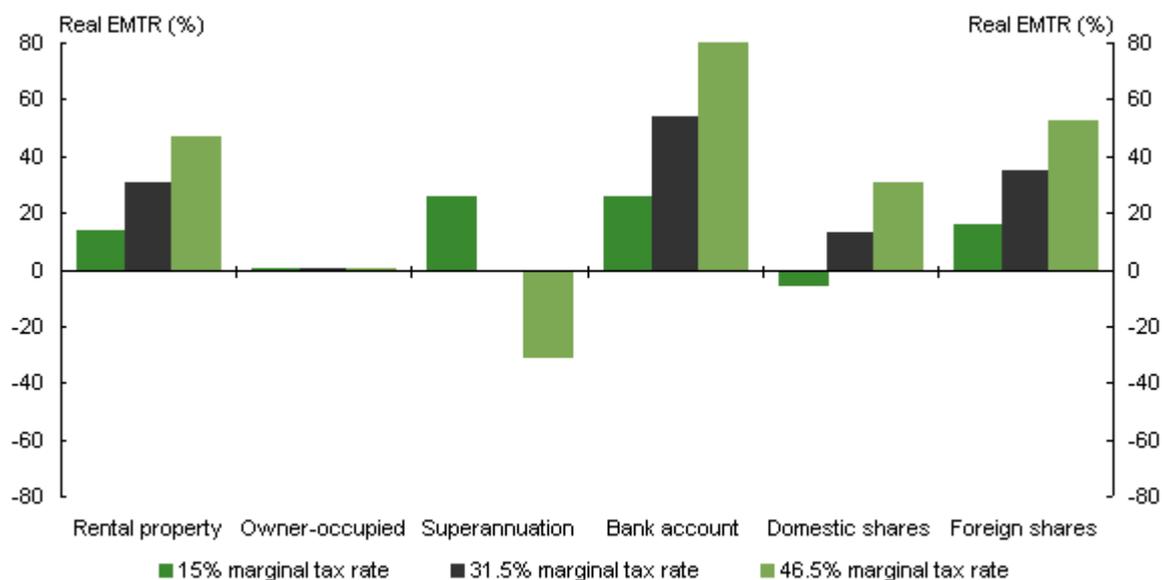
The Grattan Institute, consistent with Murray, recommended winding back negative gearing and the capital gains discount. They also suggest, consistent with the Henry report, repealing stamp duty on land transactions in favour of an annual land tax.<sup>18</sup>

This idea that negative gearing helps owners and hurts renters is perhaps too simplistic. Orthodox tax incidence analysis (used to calculate the distribution of effective tax burdens) suggests that some of the benefits of negative gearing and capital gains discounts flow through to tenants, although such a subsidy is woefully targeted as it benefits wealthy tenants the most. On the other hand it is analogous to the tax subsidies for owner-occupied housing, which benefit wealthy owners the most. If negative gearing is abolished rents may tend to rise over time if investors refrain from new investment until gross rental yields rise.<sup>19</sup> In this policy context steps should be taken to improve rent assistance schemes for low income earners, as these are already inadequate.

## Effective Tax Rates On Saving

Because the taxation of capital is so partial and incomplete the effective tax rates on various forms of capital varies widely. The various effective tax rates on savings were illustrated in the Henry Report as follows (Figure 1).

**Figure 1: Real effective marginal tax rates on savings depend on asset class**



Source Treasury 2010b Chart A1-19<sup>20</sup>

<sup>17</sup> *Renovating housing policy* Jane-Frances Kelly 2013, Grattan Institute

<sup>18</sup> Kelly 2013 p1

<sup>19</sup> For example, investors have a choice of investing in property or equities. Net real yields in these 2 sectors should tend towards equality and have done, historically.

<sup>20</sup> Notes: Real effective marginal tax rates show the tax levied on the normal real return to saving, and reflect the tax treatment of the income from which savings are made (where it deviates from tax payable if that income had been immediately consumed), earnings on those savings, and the final use of the accumulated savings. A zero effective tax rate corresponds to an expenditure tax benchmark, with the investment funded out of post-tax wages, and earnings and the subsequent realisation of the

Henry notes that a zero effective tax rate represents an expenditure or consumption tax treatment (ET); a rate equal to the statutory tax rate represents a real (i.e. indexed) income tax (IT) outcome. In only a few cases is this achieved; e.g. for some ungeared investors in rental property.

Bank accounts are very heavily taxed due to the effect of inflation; if the accounts yield 3 per cent and inflation is 2.5 per cent then the real yield is only 0.5 per cent but tax is paid on the whole of the nominal yield which, at a 30 per cent rate, reduces it below zero and the effective tax rate is 200 per cent (the figure above shows an effective tax rate as high as 80 per cent but this is under different (higher) assumptions about interest rates). This is an important point because it is mainly unsophisticated savers who are drawn to bank deposits; the smart money is all into gearing, capital gains and superannuation. Henry's concerns align with those of Murray.

## **The Henry Report recommendations on tax and superannuation**

Henry would have partially addressed some of the matters raised in Murray.

Henry was attracted to the ideal that long term savings should attract an expenditure tax (ET) treatment, since the income tax produces a 'wedge' between present and future consumption and this wedge increases with time. An expenditure tax produces no such wedge; that is, it achieves intertemporal neutrality. For this reason Henry's recommended treatment of superannuation savings was quite concessional as compared to an income tax ideal.<sup>21</sup> Nor did the Henry Report consider changes to the taxation of owner-occupied housing albeit that some owners might be impacted by reweighting the land tax system away from stamp duties. So the tax applying in both housing and superannuation would continue to approximate an ET.

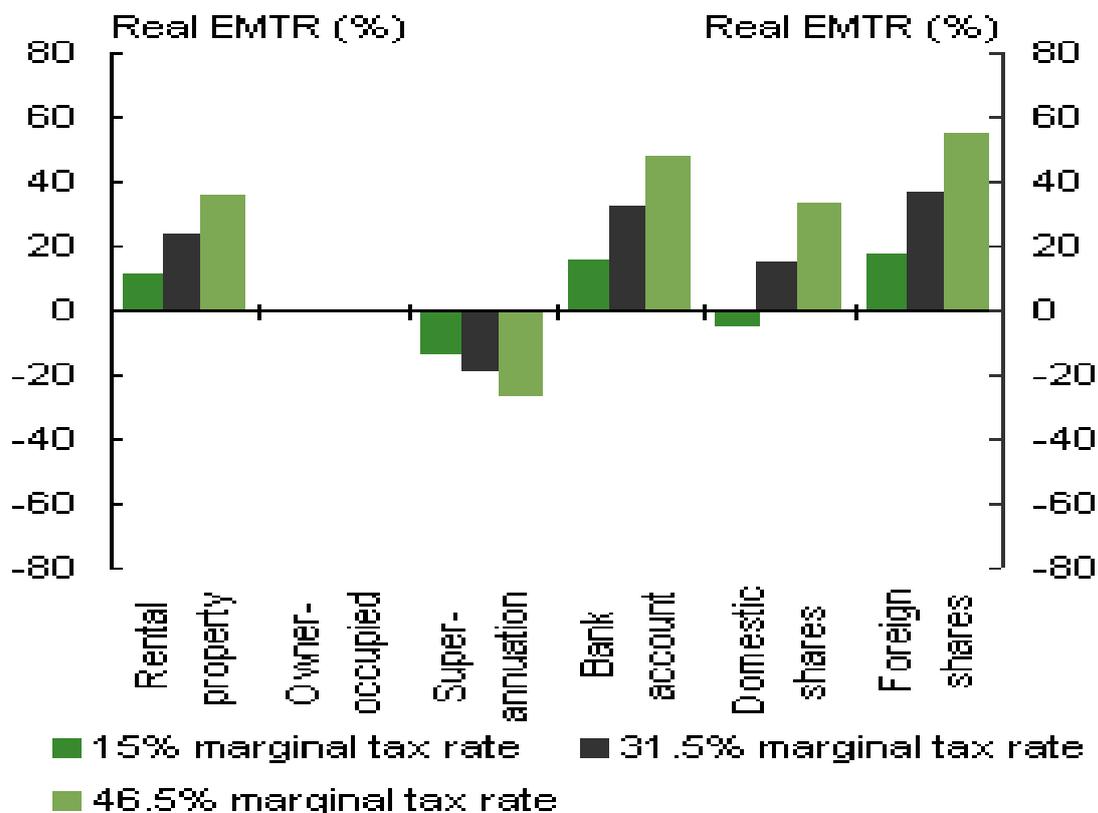
Henry's proposed tax system would reduce disparities in effective tax rates by applying an across-the-board 40 per cent discount to income, capital gains and interest expenses. Thus bank accounts would be more lightly taxed than at present, and there would be some recognition of the effect of inflation. Geared property investments would become less concessional. The broad impact of the Review's recommendations is shown in Figure 2.

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investment untaxed. The negative rate for superannuation reflects the reduction in tax otherwise payable on wages by making contributions out of pre-tax income. The estimates do not model interactions with the transfer system.

<sup>21</sup> Treasury 2010 b Ch. A2; see the earlier discussion in the text.

Figure 2: Real effective marginal tax rates for selected asset classes under Henry recommended approach



Source: Treasury 2010b Chart A1-22 p73 Panel b

Compared to figure 1, figure 2 shows considerably lower effective tax rates on bank accounts and, to some extent, rental property. Taxation of superannuation is more consistent, with tax breaks for all income classes (and no tax penalty for low income earners). Foreign and domestic shares, and the tax break for owner-occupied housing, are unaffected.

The bottom line is that the Henry recommendations would have helped to modify the stark differences in the current tax treatment of savings but would have left the current hybrid income/expenditure (IT/ET) tax treatment of savings intact. In particular housing would continue to be subject to an expenditure tax treatment [savings are exempt] and superannuation would be subject to a better-than expenditure tax treatment [savings are subsidised<sup>22</sup>]. Tax theorists recognise that this hybrid treatment is the source of horizontal and vertical inequity and substantial inefficiency.

### A better approach – an annual wealth tax (AWT)

Ultimately the only way to put all forms of saving on the same tax footing is to fully tax superannuation and housing in the same manner we tax all other property income. This requires, outside of super tax reform, that housing capital gains be assessable (revenue

<sup>22</sup> Henry did not put a figure on the costs of his suggested changes to superannuation, but appears to contemplate an approximately revenue-neutral result. Current tax expenditures are concessional even if costed against an ET ideal; the cost on this basis is \$5.8 billion in 2013-14 – see TES, Treasury 2013a Appendix A.

\$14b), there be no 50% discount (\$17.5b), and that imputed rent be assessable (say \$20b<sup>23</sup>). The exclusion of housing from the pension asset test costs a further \$7b.

An alternative way to put all investments on a similar tax footing is to move to a consistent expenditure tax basis. However this would involve forgoing considerable revenues and is not the approach favoured in the tax discussion paper.

If housing were fully taxed these extraordinarily large revenue gains could be used to compensate the bulk of taxpayers and welfare beneficiaries. For example they would finance swingeing increases in the tax-free threshold, and large rises in base rates of pensions and allowance, sufficient to compensate homeowners with houses of median value. However there would need to be provision for tax to be deferred for those who are asset-rich but whose annual cash flows were insufficient to pay taxes due. On application, tax could be deferred until sale of the property with an interest rate at or around the long-term bond rate.<sup>24</sup>

Another approach to fully tax owner-occupied housing and superannuation is tax super contributions but not fund earnings, and to have an annual wealth tax which includes all assets.

An annual wealth tax (AWT) is one of the policy recommendations of T Piketty in 'Capital in the twenty-first century'.<sup>25</sup> He suggests a comprehensive international agreement to establish a progressive tax on individual wealth, defined to include every kind of asset. Wealth below 200,000 euros would be taxed at a rate of 0.1 percent, wealth between 200,000 and one million euros at 0.5 percent, wealth between one million and five million euros at 1 percent, and wealth above five million euros at 2 percent.

An AWT would directly address the distribution of wealth. As Richardson and Denniss note, the distribution of wealth in Australia, like that in other countries, is much more unequal even than the distribution of income.<sup>26</sup> And whereas tax transfer policies substantially ameliorate the uneven distribution of market incomes, no such policies impact the wealth distribution except indirectly.

An AWT was also proposed in the prestigious Meade Report for the UK Institute for Fiscal Studies in 1978, although this was in the context of their preference for a direct expenditure tax. However the more recent Mirrlees Committee was not persuaded, although it did look favorably on wealth transfer taxes.<sup>27</sup>

If the average real yield on assets is 6% and the annual wealth tax top rate is 3%, the AWT is equivalent to a 50% top marginal rate on, inter alia, housing imputed income and superannuation investment income. Note that if the AWT is sufficiently broad, the need to act on negative gearing and the capital gains discount greatly reduces. Under some options there need be no tax on capital incomes at all – see below.

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<sup>23</sup> The Treasury TES does not regularly include the imputed rent TE. Pulo (2012) estimated this figure to be \$27.5b in 2012-13. However there are offsets to the total for capital gains and imputed rent, these being \$7.5b for interest and \$13.5b for other costs. This puts the total tax expenditure on owner-occupied housing at \$36.5b in 2012-13. The Grattan Institute have a lower net figure of around \$24b but add in land tax exemption (\$5b) and pension asset test exemption (\$7b) to give a similar net cost – see Kelly 2013 Figure 4.1 p22.

<sup>24</sup> See Dennis and Swann 2014 "Boosting retirement incomes the easy way – extending the pension loans scheme to all retirees" for one such proposal.

<sup>25</sup> Piketty 2014

<sup>26</sup> Richardson D and Denniss R 2014 "Income and wealth inequality in Australia"

<sup>27</sup> Mirrlees et al 2011

A third approach to consistently taxing savings is to use a system mid-way between an ET and a comprehensive income tax. Although this would in effect be a hybrid ET/CIT, the distortion of savings choices involved in the existing hybrid would be eliminated. The AWT proposal is one method for achieving such a neutral outcome, either by having a high threshold or by levying the AWT at a rate less than that suggested by the full CIT.

## Problems with the AWT and some solutions

Wealth taxes have a poor history as revenue raisers. Partly this is due to political pressures leading to poor design, with numerous thresholds or exemptions.<sup>28</sup> Partly it is due to the tax clashing – stacking - with existing taxes on capital income, thus exacerbating the effective tax rate problems documented by Henry. Partly it is due to the possibility of avoiding the tax by shifting domicile.

The domicile problem is addressed by Picketty in his suggestion for an internationally harmonised tax. We do not believe that shifting domicile would be a big issue if an Australian AWT were carefully designed as a method of ironing out effective tax rate disparities. It would be an issue if the tax rate were to become confiscatory – we do not advocate this.

The clash or ‘stacking’ problem can be got around by rebating from the AWT any taxes on capital income. In this way the AWT would become a form of *alternative minimum tax* (AMT) on capital income. This is similar to the current operation of the pension assets test although that test operates as an AMT on all income, not just capital income. The US already operates an alternative minimum tax (AMT) on personal income.<sup>29</sup> If a wealth tax had this feature the rates could be higher than those suggested by Picketty, whose suggested AWT is an addition to existing taxes on capital income. For example, the top rate could be 3 per cent consistent with a marginal tax rate of 50% on an earnings yield of 6%.<sup>30</sup>

Note that under the AMT/AWT approach, efficient treatment of savings is achieved if the AMT is binding; whereas it is not achieved if the income tax (IT) is binding. (By ‘binding’, I mean that tax paid by the individual is in practice computed by reference to this particular tax.) This creates an argument for a relatively heavy AWT so that most taxpayers are not subject in practice to the IT. Thus issues such as the appropriate adjustment for inflation are completely sidestepped.<sup>31</sup> It also creates a context where existing negative gearing and capital gains concessions might be more sensible.

The greater the tax breaks on savings, the more the IT starts to look like an ET. In the pension deeming approach the IT is converted into a wage tax (a form of ET) by disregarding asset incomes and only taking account of deemed income. The combination of an ET and an AWT can be configured to be conceptually similar to a fully comprehensive IT.

Another possible approach utilises deeming, such that wealth is deemed to yield say 5-6% pa<sup>32</sup> and this deemed income is added to other taxable income (actual capital income is disregarded) so that the wealth tax is fully integrated into the progressive IT. Income from

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<sup>28</sup> See for example Denk 2012 *Tax reform in Norway*

<sup>29</sup> This is because rich people were paying little or no income tax. Instead of the logical solution of fixing the tax base, the US legislature introduced an alternative base with fewer holes.

<sup>30</sup> If the real yield from wealth is 6% and the top marginal tax rate is 50%, an income tax result is approximated by a wealth tax rate of 3% assuming no other taxes on capital income. A 6% deeming rate is equivalent.

<sup>31</sup> The AWT rates are set to take account of the expected *real* yields from assets.

<sup>32</sup> This, historically, the real yield on property and share investments has been 7 per cent. These assets might yield less in the future as economic growth may be slowing, and the deeming rate needs to take this into account.

some assets such as bank accounts would be deemed at a lesser rate, with the deeming rates to reflect the expected real yield on the asset. For housing deeming might initially be restricted by utilising a high threshold and/or a low deeming rate; ideally this concessionality should diminish over time so that housing ultimately ceased to be a tax favoured investment.

In the welfare system Henry and Shepherd have both argued that the separate asset test should be replaced by a general regime of deeming, which would return us to the 'merged means test' which operated up to the 1970s.<sup>33</sup> The pension asset test is really a form of annual wealth tax utilising the AMT approach; it seems anomalous that we would confine wealth taxation to the not-so-well-off.

Deeming for the income tax can be combined with the AMT approach, although the AMT would be restricted to capital income. This creates the same tax efficiency outcome as the AWT/AMT approach and better integration with the progressive income tax rate structure. In particular a single deeming rate can apply across most assets, with progressivity being achieved by the impact of the IT rate structure.

Because such a policy would be very redistributive it would need to be phased in over a long period to avoid disruption. Asset prices would be impacted, particularly for housing.

An AWT is normally regarded as a 'left' policy idea. The approach suggested here is meant to be neutral insofar as any left-right view can be accommodated by parameter changes. Taking asset income out of the income tax base converts it to an expenditure tax – ET -, in the form the Meade Committee called an ITSUR.<sup>34</sup> The key feature of an ET is that the real yield on savings is equal to the underlying real yield on the investments they finance – i.e. there is no intertemporal tax wedge. This result can be achieved by an income tax which exempts capital income or by a consumption tax of either the direct or indirect type. Adding an AWT converts the ET back towards a comprehensive income tax (CIT).

For example the left might wish the AWT rates to be relatively high, sufficient perhaps to approximate a CIT outcome.<sup>35</sup> Those of conservative disposition might modify the rate structure to approach an expenditure tax outcome. The proposed base structure is flexible enough to accommodate either result; the key feature is that irrespective of the net outcome the tax treatment of all types of savings and investment would be neutral and it is hard to see why conservatives would wish to quarrel with such an aim<sup>36</sup>. This approach to tax design

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<sup>33</sup> Deeming was used extensively in the social security means test up to the early 1970s, but the deeming rate was a very high 10% pa. It was suggested as a solution to tax reform by Fleming and Little 1974 and D Dixon 1985 and endorsed by Prof. J Head in Head and Krever 1997. It has been utilised in the Netherlands and canvassed by tax reformers in NZ in the form of the 'risk-free return' method meant to get around the issue that NZ does not have a comprehensive tax on capital gains.

<sup>34</sup> Income tax with savings yield remitted. The equivalence with an expenditure tax is explained in Meade 1978.

<sup>35</sup> A CIT outcome, with a 50% top tax rate, allows the wealthy to consume half the real yield from their wealth. Some might wish to go further than this with a tax rate structure sufficiently high to eat into high wealth holdings. My own view is that if we could actually achieve a comprehensive income outcome, this would ensure that wealth, if not used productively, would diminish in the hands of owners and this outcome would be sufficient. If over time this failed to offset the observed tendency of wealth inequality to rise, then the issue could be re-visited.

<sup>36</sup> Under the deeming approach the income tax is converted into what Meade 1978 called an 'income tax with savings yield remission' –ITSUR - a form of expenditure tax. Other forms of expenditure tax such as the cash-flow consumption tax can be combined with an AWT to move the tax base back closer to an income tax. Such a 'hybrid' income-expenditure tax would be far preferable to the hybrid tax we now run, as it is neutral between all forms of savings. The only residual non-neutrality is the residual bias against saving (inter-temporal non-neutrality), which many would argue is needed in a fair tax system.

also allows for ETs of different type to be sensibly included in the tax mix. For example the ET component can comprise an indirect consumption tax (value added tax or GST) plus a progressive consumption tax (ITSYR or cash-flow tax).

If wealth were taxed widely and integrated with the income tax we could abolish separate social security means tests and claw-back pensions and allowances by a simple system of income tax surcharges. This option is canvassed in Ingles 2001. At the moment the income tax base is so full of holes that this option is not sustainable.

With a neutral treatment of savings the potential efficiency of the income tax<sup>37</sup> starts to approach the efficiency of the GST, which efficiency (i.e. tax take relative to economic distortion) is the core argument for expanding the GST. The other differences are the proportional nature of the GST (which could be replicated under an IT, albeit with the same compensation issues) and the intertemporal distortion caused by an IT relative to an ET. However the intertemporal distortion is the subject of much argument, and the Tax Discussion Paper tends to regard it as unimportant.<sup>38</sup> The bottom line is that it is wrong to simply associate big impact tax reform with an expanded GST.

There are good arguments for including wealth more consistently in the tax base. However the arguments for higher wealth taxes on the pensioner population – by means testing housing for example – need to be considered in the context of the generally inconsistent treatment of assets in the income tax system. In our view, there are strong arguments for reforming the taxation of housing more generally. The exemptions of imputed rent from the tax base, and the exclusion of capital gains from owner-occupied housing, are massive tax expenditures which together cost the revenue around \$36b per annum. Reform on these fronts would automatically impact on wealthy pensioners since part – up to half - of their pension is clawed back through the income tax.<sup>39</sup> Appropriate taxation of housing is also achieved by an AWT provided that housing is not carved out of the AWT base.

## Conclusion

The taxation of asset incomes is a mess, with very different effective tax rates applied to capital incomes from different sources. The Henry Report, consistent with the Murray Report, tried to chip away at the tax system's very generous treatment of some capital incomes but its recommendations fell short of the full transformation that is really required. In the long term this might be achieved by an annual wealth tax which is fully integrated with the individual income tax either by acting as an alternative minimum tax or by using deeming, or both. Alternatively it can be achieved by combining an AWT with an expenditure tax of either the direct or indirect type, or both together.

Short of this, we support the Murray Report in seeking to close down capital gains discounts and negative gearing. We have also suggested in another Paper that the rich be made to

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<sup>37</sup> By efficiency I mean the economic distortions caused by a tax relative to the revenue raised. See, for example Treasury 2015b and also the Henry Report for some discussion of relative tax efficiency. The other action to improve the income tax efficiency is to remove the host of tax expenditures and special rebates which clutter it, and which the Government has added to in the 2015-16 Budget.

<sup>38</sup> A key issue here is the elasticity of savings with respect to the real interest rate. There is little persuasive evidence of such elasticity. Treasury 2015b appears not to regard the intertemporal distortion as a big issue (pp58-60), although the Henry Report thought it justified concessional treatment of superannuation savings.

<sup>39</sup> This clawback could be made more effective by changes to the very generous senior Australians and pensioners' tax offset, or SAPTO.

pay at least some tax by adoption of the 'Buffet rule'.<sup>40</sup> However more comprehensive taxation of capital income using an AWT as an alternative minimum tax would make such a rule unnecessary and would be a more comprehensive structural reform to problems in the taxation of capital income more generally.

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<sup>40</sup> Grudnoff 2015, TAI. The Buffet rule would likely operate as an AMT based on income; the AWT could operate as an AMT based on wealth in just the same manner as the pension assets test. However it would be confined to asset income, unlike the pension asset test which is referenced to income from any source.

## List of abbreviations

ACOSS Australian council of social service

AMT alternative minimum tax

AWT annual wealth tax

CIT comprehensive income tax

CT consumption tax

ETR effective tax rate

ET expenditure tax

FSI Financial system Inquiry (Murray, Chair)

GDP gross domestic product

GST goods and services tax

IT income tax

ITSYR income tax with savings yield remission

NCOA National Commission of audit (Shepherd, Chair)

NZ New Zealand

TAI the Australia Institute

TE tax expenditure

TES tax expenditure statement (Treasury)

VAT value added tax (known in Australia as GST)

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