AUSTRALIA'S TAXATION SYSTEM: the need for fundamental reform

Submission to the Senate references committee on Economics

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We welcome the attention being given by the Senate committee to reform of Australia's taxation system. Previous reviews and policy changes that have been initiated by the Australian government over the last half century have not produced a tax system that is fully fit for purpose. We hope that the current inquiry makes a significant contribution to redressing this situation and that our submission helps to Indicate appropriate and timely reforms. **The submission relates mainly to terms of reference (a), (e) and (h).**

Criteria for tax reform

It is important to state the criteria by which proposed improvements to the tax system are judged. These can be identified as equity, efficiency, simplicity and potency. **Equity** requires that the taxation system be fair, raising tax according to people's ability to pay, and contributing to greater equality of opportunity and outcomes. **Efficiency** requires that the tax system should not distort the economy by encouraging unproductive activities. **Simplicity** requires tax arrangements to be transparent and widely understood, avoiding complicated loopholes that enable tax avoidance. **Potency** requires that the tax system generates revenue sufficient to meet society's needs for public expenditure. Only if these conditions are met can the tax system be deemed satisfactory and sustainable.

Although this submission's primary focus is on the equity criterion, its proposals for tax reform also address the other criteria, including the beneficial efficiency effects of closing current loopholes in the system.

Growing inequality and cost of living stresses

An underlying tendency towards increased economic inequality has been evident in Australia. The tax system should be an instrument for reining this in, but it has increasingly become part of the problem rather than the solution. The latter would require **a shift in focus from taxing wages and earned income to taxing unearned income, wealth and capital gains.**

The current cost of living stresses in Australia, noted in term of reference **(a)** for the Senate inquiry, relate directly to economic inequalities. The stresses are felt most strongly by people on low incomes and with little wealth they can draw on. People living in relative poverty and struggling to make ends meet are the ones most hit hard by the rising prices of things they need to buy. Concurrently, wealthy people *benefit* from inflation in the value of the things that they own.

Housing rents are a striking example of this duality between the effects of rising prices on poor and rich people. Rapidly rising rents make it very hard for low-income people to 'make ends meet', while the owners of the rented properties benefit from their higher rental incomes as well as from the rising market value of their housing assets. The rising cost of living is primarily a crisis for people with already stretched budgets. For people with substantial wealth, there is no crisis: indeed, the inflationary process that has been driving the rising cost of living accentuates their relative economic advantage.

Consequently, there can be no resolution of the current cost-of-living stresses and the ongoing housing crisis without tackling the causes of the growing inequality in Australia.

The importance of focusing on wealth

Understanding the role of tax in relation to inequality requires recognising the **distinction between inequality of incomes and inequality of wealth**. Incomes comprise flows of wages, professional fees, profits, interest, rents and government transfers; whereas wealth comprises stocks of assets, such as shares and real estate. The two are related because wealth commonly yields extra income flows for its owners, typically coming as dividends, interest payments and rents. A big flow of incomes like these can enable the fortunate recipient to purchase yet more assets. So, there is a two-way connection between incomes and wealth.

The centrality of accumulated wealth in relation to the growing rich-poor divide in Australian society is evident in data provided by the Australian Bureau of Statistics. The ABS adjusts raw household income figures to take account of the differences of household size and composition. For household *incomes*, this data shows that the richest 20% of households receive, on average, 5.3 times more income than the poorest 20% of households. For household *wealth*, however, the top 20% of households have 154 times more than the bottom 20%. This is a huge disparity. Clearly, **while the distribution of incomes between households is markedly uneven, the distribution of wealth is very much more unequal.**

What would happen if current trends were to continue? Extrapolating over the next 40 years, the ratio of total wealth t*o* total income (as in the GDP data used in the national accounts) would increase from 7.5 times to 15.6 by the 2060's. In other words, the rate of increase in privately held wealth would be over twice as fast as the rate of increase in national income, as it is conventionally defined and measured. **The higher ratio of wealth to income would effectively eradicate any semblance of equality of opportunity from Australian society.** The wealth and power of the very rich - 'the 1%' economic elite - would become ever larger and the inter-generational transfer of wealth even stronger in shaping economic and social inequalities.

The broader implications of these processes were set out by Thomas Piketty's *Capital in the Twenty-First Century*. Looking at a wide array of countries, this and widely influential book showed that, if the rate of increase in a society's wealth exceeds the rate of growth in its national income, the wealth becomes more concentrated; and family dynasties loom increasingly large relative to the size of the economy. That is already happening in Australia, undermining claims to being a nation based on a 'fair go' for all.

Bringing capital gains into the picture

Deep and enduring tax reforms should focus on the capital gains that cause and amplify the large and growing inequality of wealth. The increasing concentration of private wealth creates cumulative advantages for a minority within the society but makes life more difficult for most households. **Because capital gains and wealth are currently either lightly taxed or completely untaxed in Australia, the overall tax burden is falling more heavily on to the wage-earners who can least afford it.**

A capital gain arises whenever an asset's market value increases. The asset may be an area of land, a house, a yacht, valuable art-work, company shares, bonds, or bank deposits, for example. The ownership of assets like these is integral to wealth accumulation. Regrettably, however, most discussion of inequality in mainstream media and politics ignores capital gains and their interaction with wealth, even though capital gains have been the major factor driving huge increases in wealth for the rich. Redress of this situation is necessary if the tax system is to become fit for purpose in dealing with current economic realities.

Capital gains are currently running at almost half of the other sources of Australian household income; and they are on track to become even more influential in shaping the pattern of inequality. Establishing a more central place for capital gains and wealth tax reform is crucial to consideration of how the tax system can be made more equitable, efficient and sustainable.

It is sometimes thought that, because wealth arises through thrift, no impediment should be put in the way of such a worthy process. Indeed, some thrifty households may increase their wealth by saving. In practice, however, the overall impact of this on total wealth in Australia is quite tiny. ABS data shows that there was no significant increase in household savings out of conventionally defined income during the 10 years to March 2023. Some households saved more, others saved less, but there was no overall growth in savings out of wage incomes.

Instead, the growth in wealth has come primarily from the increased value of capital assets. These capital gains are equivalent to an additional 42.9% in Australian household incomes. Total capital gains were around $1,000 billion during 2023-4, creating a massive flow that raised the total stock of private (non-governmental) wealth in Australia to around $15,000 billion. Because most households have low – sometimes zero - net wealth, they receive only a small portion these overall capital gains: it follows that the wealthiest households must be receiving prodigious amounts.

Again, information from the ABS helps to show the connection with inequality. Looking over the last 34 years (from September 1989 to March 2023), the data shows that wealth increased by a compound 7.3% p.a., compared with household income which increased by 5.4% p.a. Over the same period, inflation (CPI) increased at an annual average rate of 2.7%.

Extrapolating these trends over the next 40 years, capital gains would, on average, grow to be 1.1 times household income, as measured by the conventional definition of income. Those capital gains give negligible boost to the incomes of the bottom 20% of households; but, on average, they more than double the incomes of those in the top 20% of households. Adding these capital gains to income, especially because they incur little or no tax, makes the distributions of income and wealth so very much more unequal.

The clear inference to be drawn from these observations is that creating **a more sustainable and equitable set of tax arrangements needs wealth and capital gains to be the principal focal points for tax reform.**

Creating a tax reform agenda

How can these concerns be tackled? Three types of tax reform would address them most directly: making the taxation of capital gains more comprehensive; introducing an annual tax on holdings of wealth above a specified threshold; and introducing taxation on transfers of wealth. Any one of these would make a big difference: all three would be transformational.

First, there is a strong case for taxing capital gains more effectively. Since its introduction in 1985, capital gains tax (CGT) has always allowed one dwelling and the land on which it sits (the 'family home') to be tax exempt. Capital gains on other assets were fully taxable at standard income tax rates until 1999 when the Howard government introduced a 50% 'discount' on the rate of CGT payable. Since then, capital gains have been a major focal point for tax minimisation by those wealthy enough to have significant property holdings. A massive distortion has thereby existed in the nation's taxation and investment arrangements throughout the last quarter century.

The CGT discount creates an implicit incentive to hold non-productive assets rather than to invest productively in the Australian economy and incur the full corporate tax rate on any profits earned. Concern about this sort of distortion is evident in terms of reference **(e) and (h)** for the Senate inquiry. The potency of the whole tax system is also impaired because, whenever the discounted CGT rate is below the tax on company profits, there is an incentive for a business to represent or disguise profits as capital gains for the ATO's assessment of tax payable. **Terminating this CGT tax loophole should be the top priority, because it currently violates the equity, efficiency and potency of the tax system.** The discount has neither ethical nor economic justification. After all, who could seriously argue that income from the ownership of capital should be taxed more lightly than wage incomes generated by working for a living?

Second, a more general annual wealth tax also warrants consideration. Wealth taxation already exists in Australia, in that local government rates and State government land taxes both involve taxing *specific forms* of wealth. A more uniform wealth tax, applying to all forms of wealth, could be levied by the Commonwealth to generate revenue. This would require households to pay an annual tax, probably at a rate of about 2%, on the total value of their assets above a specified threshold, irrespective of the form in which that wealth is held. If the threshold were set at, say, $3 million, indexed annually for inflation, it would impact only very rich households. A large majority of households – perhaps 90% - would not be affected by the tax.

A wealth tax like this, targeting people most able to afford higher taxes without significant reduction in their standard of living, could be expected to slow the rate at which inequality of wealth is increasing. To make it part of a broader revenue-neutral reform package, it could be paired with raising the threshold level at which income taxes become payable, thereby reducing the cost-of-living stress for the low-income people referred to in the Senate inquiry's term of reference **(a)**. **A wealth tax would be potent, efficient, and equitable form of taxation**. It scores rather less well in relation to the simplicity criterion for assessing tax reforms because it would require the ATO to undertake regular asset valuations, adding an element of complexity that does not exist for income taxation. Notably though, asset valuation processes are already undertaken for land taxes and local government rates, so this need not be an insuperable concern. Nor would the impact on 'high wealth, low income' people if the wealth tax arrangements included a provision enabling deferral of the tax liability until such time as the assets are sold or passed on.

Third, taxing wealth transfers also needs to be on the reform agenda, although members of the Senate committee may be reluctant to stretch the current inquiry's terms of reference that far. Taxing wealth transfers involves inheritance taxation, sometimes known as estate duty, supplemented by the taxation of large gifts to prevent avoidance of the inheritance tax. These taxes could generate substantial public revenue, while also reducing the damage that massive inequalities in inherited wealth do to the liberal goal of creating greater equality of opportunity throughout Australian society.

Many nations have wealth transfer taxes; as Australia did, at both Federal and State levels, before PM Malcolm Fraser and Queensland premier Joh Bjelke-Petersen began dismantling them in the 1970s. The socio-economic and ethical cases for reintroducing a more carefully constructed form of inheritance and gift taxation are strong. Regarding equity, inheritance tax would **reduce the inter-generational transmission of inequality** that has become such a strikingly inegalitarian feature of Australian society. Regarding efficiency, there would not be significant work disincentive effects; and the effect of the tax would be to reduce the windfall gains that currently go to recipients irrespective of their productive economic contribution to society. It is a form of tax that 'ticks all the boxes' for those wanting Australia to be a more meritocratic and equitable society.

Possibilities for progress

The current Senate committee inquiry's other terms of reference include dealing with various anomalies in the arrangements for income and business taxation. Progress on these additional matters could make a significant contribution by reducing rorts and loopholes in the current tax system.

That progress would be more achievable, going beyond *ad hoc* and piecemeal changes, if set in the broader context of a more equitable, efficient and sustainable tax system. That is why this submission focusses mainly on proposing tax reforms to redress of the growing social inequalities in Australian society**.** The same policies would simultaneously reduce economic distortions and inefficiencies to the extent that they would **shift the structure of incentives from speculative financial activities to investment in value-creating productive activities.** Thus, there need be no trade-off between equity and efficiency: the tax reforms proposed here would improve both.

The type of tax reform initiatives on which this submission has focused would be controversial, because opponents would predictably seek to denigrate them as unworkable, unfair, even 'un-Australian'. Although the adverse depictions would originate from (and be funded by) vested interests, past experience has shown they would likely be effective in fuelling anxieties even among people not actually affected. Political courage is therefore needed when entering this territory. The soundness of the economic and ethical arguments matters, of course, but political determination and acumen are necessary too. But backing away from the reform challenge is being complicit in Australia becoming an increasingly unequal society.

The severe social, economic, and environmental consequences of becoming an increasingly unequal society are well documented. A large and expanding volume of international social science research shows the range of inequality's adverse effects. It shows that, in general, the countries with higher inequality tend to have worse macroeconomic performance. The more unequal nations also create bigger ecological footprints and generate disproportionately large climate change impacts. Furthermore, very unequal nations tend to experience more intense social problems, ranging from poorer physical and mental health to a higher incidence of violent crime and incarceration. Not surprisingly therefore, the international survey evidence also indicates a generally negative correlation between the extent of economic inequality and people's self-reported happiness and wellbeing. These are predictable outcomes from the loss of social cohesion.

Evidently, **greater inequality produces poorer economic outcomes and less contented societies**. **That is a real prospect for Australia if the current**

trends are allowed to continue because of excessive caution about making the necessary fundamental tax reforms.

Building on the impetus given by the Senate committee's current inquiry, we consider that it would be appropriate for the Commonwealth to **establish a broader inquiry into the causes of increasing wealth inequality in Australia**, **followed by a national tax summit** at which potential key reforms, such as those canvassed in this submission, could be presented and fully considered.

Endnote:

A longer paper that provides references on the data sources, calculations and social science literature to which the submission refers can be viewed on the website of The Australia Institute at:

https://australiainstitute.org.au/report/wealth-and-inequality-in-australia/