The case for reducing the capital gains tax discount

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Adam Smith is often regarded as the founder of modern economics. It was he, writing in the second half of the 18th century, who first proposed that the pursuit of self-interest (by 'the butcher, the brewer, and the baker') was the principal source of wealth and prosperity. It was he who first characterized 'market forces' as an 'invisible hand' guiding those motivated by the pursuit of self-interest also to 'promote the public interest'. He was one of the first to identify the 'division and specialization of labour' as a primary source of productivity growth.

In the work for which is today best remembered, *An Inquiry into the Nature and Causes of the Wealth of Nations* (published in 1776), Smith set out four principles, or 'canons' as he called them, of good tax design. The first of these was that 'The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the state'[1].

Capital gains – increases in the value of assets which people own – are a form of income or 'revenue' which people accrue 'under the protection of the state', just as much as other forms of investment income – such as interest, dividends or rent – and just as much as wages or salaries earned from working. That's why, since September 1985, capital gains have been subject to income tax.

In principle, there is no reason why income from capital gains should be treated any differently by the taxation system than income from any other source – since income from capital gains enhances an individual's (or a company's) 'capacity to pay' no less than any other kind of income. Indeed, Malcolm Turnbull, in a paper co-authored with ANU academic Jeromey Temple in August 2005, wrote that "the arguments for taxing capital gains at the same rate as income are compelling"[2].

However, there is also a principled argument that, to the extent that the increase in the value of an asset has merely kept pace with the general rate of inflation, it does not represent any increase in 'purchasing power' or 'capacity to pay', and thus should not be subject to taxation. For that reason, when Australia's capital gains tax was first introduced in 1985, it provided that only increases in the value of an asset over and above the increase in the consumer price index during the period for which that asset has been held by a taxpayer should be included in the taxpayer's taxable income – that is, that only 'real' capital gains were subject to tax.

Although seemingly simple, this arrangement often proved complex in practice, especially when assets were paid for in instalments, or when investors spent money which added to the value of their assets (as is often the case with property investments).

Partly for that reason, in 1999 the Howard Government replaced this arrangement with one that, since then, has taxed half the full nominal value of capital gains (ie, without any adjustment for inflation) earned by individuals at the applicable marginal rate – or, alternatively, taxed the full

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[1] Adam Smith, *The Wealth of Nations* (London, 1776), Book V, Chapter II, 'Of the Sources of the General or Public Revenue of the Society', Part II.

[2] Malcolm Turnbull and Jeromey Temple, *Taxation Reform in Australia: Some Alternatives and Indicative Costings* (August 2005), p. 10.

nominal value of capital gains at half the applicable marginal rate. That is, capital gains earned by individuals are subject to a 50% discount for tax purposes[3].

This change was also recommended by the Review of Business Taxation chaired by businessman John Ralph.

The Ralph Review envisaged that it would "enliven and invigorate the Australian equities market", "stimulate greater participation by individuals", and "achieve a better allocation of the nation's resources"[4].

In fact the 1999 changes to the capital gains tax regime did nothing of the sort. Australia has not become a nation of shareholders: the proportion of Australian adults owning shares, directly or indirectly, declined from 39.7% in 1998 (the year before these changes took effect) to 35.7% in 2014[5]. Nor have we become a nation of entrepreneurs: the proportion of Australian adults who are owner-managers of their own businesses has fallen from 11.6% in 1998 to 10.6% in 2015[6]. What we have become, or at least become more of than we were, is a nation of landlords and property speculators: the proportion of adult Australians who report receiving rental income to the Australian Tax Office has risen from 8.9% in 1997-98 to over 11% in each of the three years 2011-12 through 2013-14.

This shouldn't be altogether surprising. The post-1999 capital gains tax regime has been much more generous to property investors, compared with the taxation arrangements which applied between 1985 and 1999. The relative 'generosity' (from a taxpayer's perspective) of the two successive regimes depends on the inflation rate and the rate of return on particular investments. Analysis by the Grattan Institute suggests that property investors have been more lightly taxed by the post-1999 regime than they would have been under the arrangements which applied between 1985 and 1999, whereas the reverse is true for share investors, given that capital city house prices have at more than two-and-a-half times the inflation rate since 1999, whereas share prices have risen by less than 20% more than inflation rate over the same period[7].

The introduction of a capital gains tax regime which has proved to be significantly more generous to property investors than its predecessor, and to other investors, appears to have played a significant role in enhancing the appeal of 'negative gearing' as an investment strategy. Since 1998-99, the proportion of individual taxpaying landlords claiming deductions for interest expenses has risen from 71.6% to 82.0%; while the proportion reporting net losses (after interest) has risen from 51% to a peak of 68% in 2011-12, before falling back to just under 63% in 2013-14 as interest rates have fallen to record lows. Collectively, individual landlords reported net profits averaging $75mn per annum in the ten years to 1998-99; since then, they have reported net losses averaging more than $5bn per annum. The change to the capital gains tax regime in 1999 had the effect of converting 'negative gearing' from a strategy whose primary purpose was to allow investors to defer income tax, into one which allowed them to defer *and* permanently to reduce their tax liabilities, by allowing them in

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[3] For superannuation funds, capital gains are subject to a 33⅓% discount – ie, they are taxed at a 10% rate rather than the 15% applicable to their other income. Companies do not get any tax discount for capital gains.
[4] Review of Business Taxation (John Ralph, Chairman), *A Tax System Redesigned* (Canberra, July 1999), p. 585.
[5] Australian Stock Exchange, *The Australian Share Ownership Study 2014*, and previous issues.
[6] Australian Bureau of Statistics, *Labour Force, Australia, Detailed – Electronic Delivery* (cat. no. 6291.0.55.001), April 2016.
[7] John Daley and Danielle Wood, *Hot property: negative gearing and capital gains tax reform*, Grattan Institute (Melbourne, 2016), p. 10.

effect to convert wage and salary income taxable at full marginal rates in the year in which it is earned, into capital gains taxable at half marginal rates in the year in which they are realized.

And given that the overwhelming majority of property investors purchase established dwellings, rather than new ones, it is hard to characterize their activities as 'entrepreneurial', or in any other way of the sort that would be especially deserving of explicit encouragement through the tax system.

The Australian Treasury estimates the cost to revenue of the 50% capital gains tax discount for individuals and trusts at $6.84bn in 2016-17, rising to $9.10bn by 2019-20[8]. That's a cost which results in a larger budget deficit than otherwise (and hence more debt to be serviced and repaid by future generations), or which requires more tax to be collected from other taxpayers and/or less spending than would otherwise be possible.

The benefits of the capital gains tax discount accrue disproportionately to high-income earners. Tax Office statistics show that, in 2013-14 (the latest available year), the 2.9% of taxpayers in the top tax bracket earned 58% of the capital gains reported in that year (a much larger share than their 17.7% share of total taxable income) and paid 74.0% of the total amount of capital gains tax paid by all individuals in that year. Since the amount of capital gains tax paid by individuals in the top tax bracket in 2013-14 was $3.5bn (out of total individual capital gains tax payments of $4.8bn), one interpretation is that the 50% capital gains tax discount was worth $3.5bn to them (equivalent to 7.1% of the total amount of tax they paid), as against $1.2bn to the remaining 97% of taxpayers (equivalent to 1.1% of the total amount of tax paid by them).

As noted earlier, the desire to avoid taxing that part of income from capital gains which merely 'compensates' an investor for the impact of inflation is a defensible rationale for taxing capital gains less heavily than an equivalent amount of wage or salary income. However, it is worth noting that capital gains are not the only type of income which includes an 'inflation compensation' component. Most obviously, interest income includes a component intended to provide 'compensation' for the impact of inflation on the underlying principal sum, which is one reason why interest rates tend to vary in line with inflation (unless precluded from doing so by government regulations). Yet there is no correspondingly concessional treatment of interest income for tax purposes. This works to the detriment of lower-income households, most of whose discretionary savings (if they have any at all) earn interest, as opposed to more tax-advantaged forms of investment income such as dividends or capital gains.

The preferential tax treatment of capital gains, compared with other types of investment income, thus distorts saving and investment decisions, as well as detracting from the equity of the personal income tax system. For these and other reasons, the Henry Review recommended that the tax discount on capital gains be reduced to 40%, and that this discount be extended to other forms of savings or investment income[9]. This recommendation has also been supported by the Business Council of Australia[10]. Even the Property Council of Australia appears to have shifted its thinking on this question: its submission to the Abbott Government's tax white paper process advocated

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[8] Australian Government, 2016-17 Budget Paper No 1, *Budget Strategy and Outlook* (Canberra, May 2016), p. 4-20. These estimates exclude the (much larger) revenue cost of the complete exemption of owner-occupied housing from capital gains tax (a separate issue which I have not considered here).

[9] Ken Henry et al, *Australia's future tax system – Report to the Treasurer* (Canberra, December 2009), Part Two – Detailed analysis, Volume 1, pp. 70-76.

[10] Business Council of Australia, *Realizing Our Full Potential: Tax Directions for a Transitioning Economy* (Melbourne, March 2015), pp. 62-64.

retention of the full 50% capital gains tax discount[11], but more recently has appeared "prepared to have a conversation around the edges" of this topic[12].

However, the choice of a 40% discount was entirely arbitrary, and the Henry Review provided no rationale for choosing that figure rather than some other one. Any other figure would be no more or no less arbitrary than 40% - or 50%. Reducing the discount to, say, 33⅓% (as currently applies to superannuation funds), or to 25% (as proposed by the Australian Labor Party) would also be arbitrary. It would also be – by design - *less* concessional than the present regime: but it would *still be* concessional, compared with the tax treatment of wage and salary income. As such, it could not legitimately be depicted as 'penalizing' saving, investment or 'risk-taking'. If it were extended to other types of investment income (such as interest), it would be both more equitable as between taxpayers at different points on the income distribution, and more neutral as between different types of saving and investment vehicles – all of which constitute, in my opinion, powerful arguments for reducing the tax discount on capital gains.

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[11] Property Council of Australia, *Prosperity and fairness: using tax reform to grow the economy*, Submission to the Re:think Tax Discussion Paper (Sydney, June 2015), p. 34.
[12] PCA Chief of Policy and Housing Glenn Byres, quoted in Jennifer Duke, 'Industry bodies defend negative gearing, but leave changes to capital gains tax on the table', www.domain.com.au, 10th February 2016. See also comments by PCA CEO Ken Morrison in Kara Vickery, 'Billions wiped from Federal Government coffers through capital gains tax property discount', www.news.com.au, 8th January 2016.