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TITLE: **Time to reform capital gains tax**

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A recent paper by The Australia Institute questions whether Australia should continue to provide capital gains concessions that amount to well over $10 billion a year.

A capital gain is an increase in the value of an asset such as a property or shares. The gain can be measured either over a year (an accrual basis) or at the time of disposal (a realisation basis). The comprehensive income ideal implies that real capital gains should be taxed as ordinary income as they accrue; in contrast to this ideal, however, capital gains are taxed very concessionally.

In Australia, short-term capital gains have always been taxed as income but gains on assets held for more than a year were first taxed in 1986 under the Hawke/Keating tax reforms, which also exempted pre-1986 assets and excluded housing. Gains on post-1986 assets were taxed in full but indexation applied. The Howard/Costello Government abolished indexation when, following the 1999 Ralph Review of Business Taxation, it substituted a 50 per cent concession, allowing half of any capital gain to be tax free. Income derived from capital continued to be taxed in full.

This situation is of particular benefit to the well-off for two reasons.

First, the well-off receive a disproportionate share of capital gains—the top one per cent of taxpayers receives 39 per cent while the top 10 per cent receives 64 per cent of such gains.

Second, the higher the marginal income tax rate that would otherwise apply, the higher the benefit that is afforded by the concession. A taxpayer on the top rate of 46.5 per cent benefits from a 23 percentage point discount but a taxpayer on the zero marginal rate (income under $14,000) gets no benefit at all.

These concessions undermine the progressivity of the income tax regime. Executives are able to craft executive pay packages with a strong bias towards these tax breaks and the self-employed, assisted by their own raft of concessions, are unlikely ever to have to face a capital gains tax bill.

In the US, capital gains concessions are similarly egregious. US billionaire Warren Buffet has complained that his $47 million income, derived mainly from capital gains, was taxed at only 17 per cent, much lower than his secretary's 30 per cent bill.

Why is this form of tax so concessional? Although the rationale behind the concessions is the encouragement of risk-taking and an enterprise culture, a properly-designed CGT is actually neutral with respect to risk. Nor does a concessional rate work to attract foreign investors because foreign holders of Australian shares are not taxed on their gains. And if it is considered desirable to tax income from capital at a lower rate than other income, why restrict it only to capital gains? The incentive argument does not hold water.

The suggestion that capital gains should be taxed at full marginal rates does not imply a recommendation for the re-introduction of indexation. Indexing gains while allowing deductions for full nominal interest costs, creates a tax bias favouring geared investments. In addition, the non-indexation of gains is a counterbalance to the benefits that arise from tax deferral, which occurs because gains are only taxed on realisation and not as they accrue.

There are strong equity and efficiency arguments for taxing all income from capital at the same rate; the current concessions are wrong in principle and regressive in practice.

A sounder and fairer tax system would be achieved by eliminating the 50 per cent discount; incorporating all pre-1986 assets; introducing a deemed realisation of assets on death; and including owner-occupied housing above a certain value (for example, where the value is greater than twice the median house price).

Some will see the spectre of death duties and taxes on housing wealth looming in our proposals and we recognise that these are emotive issues. They should not, however, distract from the main recommendation, the elimination of the capital gains discount. The focus should be on why the wealthy enjoy the unique privilege of having a sizeable part of their real income taxed at half the normal rate.

Closing this loophole would allow the revenue thus gained to be used for meaningful tax reform that shares the burden more appropriately.

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