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The Intergenerational Report ignores booming wealth and capital gains

’Money doesn’t talk, it swears.’

‘Obscenity, who really cares.’

Bob Dylan

Discussion paper

David Richardson

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Preface

The author was struck by an ABS release on 24 June 2021 which showed household wealth in Australia had reached a phenomenal $12.7 trillion in March 2021 and had increased by $1.7 trillion over the previous four quarters.[1]

Just think about that. Where did that $1.7 trillion come from? How did an economy that increased its production by $2 trillion create an increase in wealth of $1.7 trillion over the same period?

A few days later, on 28 June 2021 the *Intergenerational Report* was released. The report contained many references to GDP but barely mentioned wealth or capital gains. Capital gains were mentioned in a perfunctory way and only in the context of mentioning the collections of capital gains tax. It seemed bizarre that the government could talk about such things as fiscal "burdens" and the call on taxpayers without mentioning $1.7 trillion in capital gains, and more importantly, who received that $1.7 trillion.

This report begins to redress that omission by including wealth and capital gains in the discussion of trends likely to persist over the next 40 years.

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[1] ABS (2021) *Australian National Accounts: Finance and Wealth*, 24 June.

Summary

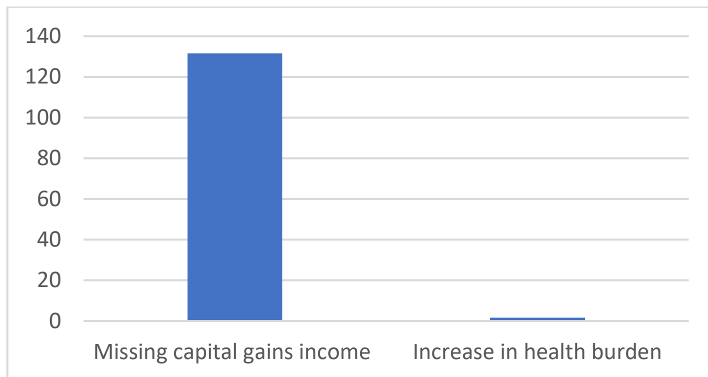
Household wealth in Australia is a massive $12.7 trillion in Australia and increased by $1.7 trillion from a pandemic low 12 months ago. By contrast GDP is a relatively modest $2 trillion (latest rolling 4 quarter figure). If these trends continue capital gains will be 56 per cent of household income in 40 years, up from a trend figure of 31 per cent now. Household wealth was 3.58 times GDP 30 years ago, is presently 6.37 times GDP and is projected to hit 14 times GDP in 40 years. Capital gains and the higher wealth it brings are just like any other income, wages, salaries, interest or dividends. But capital gains are not included in GDP.

The analysis behind the intergenerational reports is misleading to the extent that it compares almost everything with GDP. GDP is inadequate for many of the purposes for which it has been used. In the Intergenerational Report (IGR) context, GDP is not a good measure of Australia's capacity to pay for government services. Wealth is also a measure of capacity to pay while the annual increase in wealth (capital gains) should be included in income measures. When that is done capacity to pay is much larger both at the moment and when we project into the future. Indeed, the government's own 23.9 per cent taxation cap falls to 10.4 in 2060-61 using a comprehensive measure of income that includes capital gains. It will be ever more apparent that extreme inequality is being driven by booming wealth and capital gains that are lightly taxed if at all.

The IGRs have been used to try to suggest that future generations will be burdened by the need to provide for the aging population. Australians will experience something like an 80 per cent increase in real incomes over the next 40 years yet even that understates what is really going on. Income as conventionally measured has increased and will continue to increase, wealth has boomed and, with wealth, so capital gains have boomed. Including capital gains in income measures dispels any concern about future fiscal burdens. In 40 years projections show that per capita income including capital gains could be higher by 158 per cent. The idea that Australia will not be able to afford the present pattern of government services is just wrong.

The suggestion that there may be a small government deficit at 2.3 per cent of GDP in 40 years if we stick to the present artificial tax to GDP ratio invites the response "so what". The IGR says the deficit will be driven by such things as the health budget with more older people and more expensive technology. The following graph shows the

increase in the health spending “burden” compared with the capital gains income not measured in the IGR, both expressed as a proportion of GDP.



The graph clearly shows that the problems in future will be rather trivial compared with the missing incomes just from capital gains. But there will be enormous problems associated with the much higher wealth holdings being spread extremely unequally. The top quintile of wealth owners receives 108 times the capital gains of the bottom quintile. Instead of worrying about how future generations will bear the cost of an older population, the real issue will be the transfer of resources from rich old people to lower income older people. As the distribution of income continues to worsen Australia is going to have to get more serious about redistributing that income.

The findings in this paper represent a challenge to the government. Any attempt to compare the projected fiscal ‘problems’ with GDP should be required to justify why a narrow definition of capacity to pay is being used. Income as conventionally measured will be higher but wealth and capital gains will grow even more. Our ability to afford projected increases in government spending is beyond question.

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Introduction

The Intergenerational Report (IGR) has been published by the Australian Government roughly every five years. The idea of producing an intergenerational report was raised in the Howard Government's National Commission of Audit.[2] The IGR was clearly designed to scare us into accepting a neoliberal/austerity agenda. As the National Commission of Audit said:

> … urgent action is needed to moderate community expectations of government assistance, increase incentives for self reliance [sic] in old age and more equitably share the cost of age related services funded by government.[3]

The introduction to the first IGR said:

> While the National Commission of Audit, established by this Government in 1996, considered the impact of demographic change on Commonwealth finances, this report is the first by any Australian government to assess the long-term sustainability of government finances in detail.[4]

Ever since the theme has been to try and convince the public that the government sector is too big and needs to be wound back.

The 2015 IGR stressed 'the demographic challenges' and 'sets out what we need to do if we are to maintain and improve our standards of living' according to the Treasurer, Joe Hockey, in a foreword to the IGR.[5] The 'demographic challenge' is of course the expected higher proportions of older people. Debt was firmly in the government's sights in 2015 and the IGR said, ", we are living beyond our means. The Australian Government is currently spending over $100 million a day more than it collects and is borrowing to meet the shortfall. (p xv) The IGR added a 'warning' that debt can grow rapidly and used the Irish example of debt at 124 per cent of GDP in 2013. In contrast to that, the 2015 IGR claimed, the government's proposed measures would fix everything. The political nature of the exercise was clear when it presented three scenarios:

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[2] National Commission of Audit (1996) Report to the Commonwealth Government, June. A 'commission of audit' was proposed by Howard as Opposition Leader in 1995 to consider among other things 'the impacts of demographic change of Commonwealth outlays and how to make provision for them' as part of a small and conservative government agenda. See Howard JW (1995) 'The role of government: A modern Liberal approach', *The Menzies Research Centre National Lecture Series*, Parliament House Canberra, June.

[3] National Commission of Audit (1996) Report to the Commonwealth Government, June. http://www.finance.gov.au/archive/archive-of-publications/ncoa/chap6.htm

[4] Australian Government (2002) "Intergenerational Report", *2002-03 Budget Paper No 5, p. iii*.

[5] Australian Government (2015) *2015 Intergenerational Report: Australia in 2055*, March, p. iii.

- First was the government's plan which would "solve" the fiscal challenge.
- Second was the government plan modified by not including measures held up in the Senate.
- Third was the continuation of the policies from the last Labor Government.

The reader can guess which came in best and worst.

The most recent edition of the IGR is a bit different. The language about the threat of debt and deficits has been moderated. Clearly the government has decided that now is not the time to be throwing stones while living in a glass house. It is difficult to rail against debt and deficits when the present government's own increase in debt is expected to reach an estimated 30 per cent of GDP at June 2021 and higher levels in the near future with 41 per cent by June 2025.

Nevertheless the 2021 IGR still raises concerns about the ageing population and the fiscal implications when it says:

> Australia's greatest demographic challenge is the ageing population, caused by increasing life expectancies and falling fertility rates.... The falling old-age dependency ratio presents challenges for Australia's long-term economic growth and fiscal outlook. A working-age person's taxes will be required to support a greater number of people aged over 65. A larger older population will require greater government spending in healthcare, the Age Pension and end-of-life support.[6]

Without being explicit this passage certainly invites us to wonder if Australia will be able to "afford" the government expenditures associated with the aging population. However, this is certainly less extreme than earlier IGRs and the Treasurer admitted "each IGR has taken a more optimistic view than the one that preceded it."[7]

This paper argues that framing the demographic/fiscal tasks against GDP is incomplete and misleading if the discussion is to deal with the "affordability" of services to and support for the ageing population. Indeed, such things as the "affordability" of government services and other considerations need to be evaluated against Australia's wealth and increases in that wealth (capital gains) in addition to conventional measures of GDP.

[6] Australian Government (2021) *2021 Intergenerational Report: Australia over the next 40 years*, June, pp. 29,31.

[7] Frydenberg J (2021) "2021 IGR Release Speech", *Press Release*, 28 June.

What is missing in the IGR?

Whatever the subject being discussed in the IGR there is a reference to income or GDP.[8] The "tax burdens" are expressed as a share of income or GDP for example. Ability to pay, intergenerational issues and so on are also typically expressed in terms of proportions of income or are sometimes so obvious the comparison with income does not have to be made.

The IGR is largely confined to what is measured in the national accounts and specifically the magnitudes that contribute to GDP. Hence the emphasis in the IGR is based on the income components of GDP as if other measures of income and wealth were irrelevant. Capital gains for example are only mentioned in the context of the personal income tax system and the revenue the government derives from personal taxation. This is an important limitation. As it happens things can look dramatically different if capital gains are taken into account in a wider definition of income. It is often important to confine ourselves to GDP aggregates but when considering such things as living standards, wellbeing and so on it is also important to add back some of the things missing in traditional macroeconomic outlooks. Income as measured in the national accounts is a very inadequate measure of wellbeing. Wealth should be considered and, of course, if properly measured income itself would be so much higher if capital gains are included.

Net worth in Australia is another measure of affluence. Household net worth in March 2021 was $12.7 trillion,[9] over six times national income. Wealth is extremely important as a resource at the disposal of households. It also generates capital gains, the increments in the value of wealth as a result of price changes. These are too often ignored in macroeconomic commentary and are not taken into account at all in the IGRs. The issue of wealth is taken up in more detail below. By ignoring this massive wealth, the IGR biases the discussion towards a belief that Australia will be "unable to afford" a wide range of services in the future.

The distribution of income and wealth is almost entirely neglected in the IGR but is an important issue in Australia and will become increasingly serious as the distribution of income and wealth worsens into the future. With increasing inequality there are also worsening political power imbalances. The rich are in a better position to influence political outcomes and are able to achieve policy changes in taxation, industry and other policies

[8] In principle income and production are equal in a national accounting sense. see United Nations Department of Economic and Social Affairs (2003) Handbook of National Accounting: Studies in Methods Series F, No.85, New York. However, national income needs to adjust GDP for income accruing to foreigners, and residents' earnings from overseas.

[9] Net worth figures come from ABS (2021) *Australian National Accounts: Finance and Wealth*, 24 June.

that benefit the rich. There is a suggestion in some of the literature that some countries may get to a tipping point beyond which any reversal is almost impossible to achieve.[10]

[10] See Stiglitz J (2020) *People, power and profits*, NY: Norton and Zingales L (2012) *A capitalism for the People: Recapturing the lost genius of the American people*, Basic Books

Haig-Simons income concept

Public finance courses have stressed for generations that fiscal policy discussions should be using something along the lines of a comprehensive definition of income. Ken Henry's review of taxation referred to the pure:

> Schanz-Haig-Simons definition of income, under which income represents the increase in a person's stock of assets in a period, plus their consumption in the period (with consumption including expenditure other than that incurred in producing income). There are important equity reasons for maintaining this approach…[11]

So basically the definition says that one's income over a time period must be equal to consumption plus any increase/decrease in one's financial assets. Most discussions refer to the Haig-Simons (H-S) income concept which is simply defined as "consumption plus changes in net worth".[12] The references are to economists, Robert Haig[13] and Henry Simons[14], while the Henry discussion also refers to Schanz,[15] a German author of the nineteenth century. While tax systems tend to include realised capital gains for practical reasons, the H-S definition definitely includes capital gains on an accrual basis.[16] This reflects the view that capital gains are a resource to the income unit whether or not they are realised.

When the Hawke Government decided on a capital gains tax it was argued 'because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they should be included in any comprehensive definition of income.'[17]

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[11] Australian Government (2010) Australia's future tax system: Report to the Treasurer, Part Two Detailed analysis, volume 1 of 2, December, p 53.

[12] Staff of the Joint Committee on Taxation (2012) "Overview of The Definition of Income Used by the Staff of the Joint Committee on Taxation In Distributional Analyses", *Committee Document JCX-15-12*, 8 February, p 3.
https://www.jct.gov/publications/2012/jcx-15-12/

[13] Haig, Robert M., 1921. "The Concept of Income – Economic and Legal aspects." In Haig, Robert M. (ed.), The Federal Income Tax, 1–28. Columbia University Press, New York, NY.

[14] Simons, Henry C., 1938. Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy. University of Chicago Press, Chicago, IL.

[15] Schanz, Georg von, 1896. "Der einkommensbegriff und die einkommensteuergesetze." FinanzArchiv 13 (1), 1–87. The title apparently translates as "Income realized and the income tax law".

[16] Armour P, Burkhauser RV and Larrimore J (2013) "Levels and trends in United States income and its distribution: A crosswalk from market income towards a comprehensive Haig-Simons income approach", NBER Working Paper 19110, June at http://www.nber.org/papers/w19110.

[17] Australian Government (1985) *Reform of the Australian Tax System: Draft White Paper,* Canberra: Australian Government Publishing Service, p 77.

Given capital gains are a legitimate part of the tax base then attention should have been given to the behaviour of capital gains and their implications for macroeconomics generally and especially fiscal/budgetary policy and related topics. As a measure of capacity to pay tax measures of comprehensive income had to be relevant also for distributional analysis. Indeed, it might even be suggested that the onus should be put on analysists who do not include capital gains to justify that omission.

Back to basics, people consume or save their income; the former is a use of income while savings add to their stock of wealth. So income can be defined as consumption plus the increase in net worth. That definition makes it clear that capital gains on an accrual basis are included in any comprehensive definition of income. That definition also makes it clear that in principle it should be possible to use either:

1. consumption plus increase in net worth or
2. income plus increase in net worth minus savings.

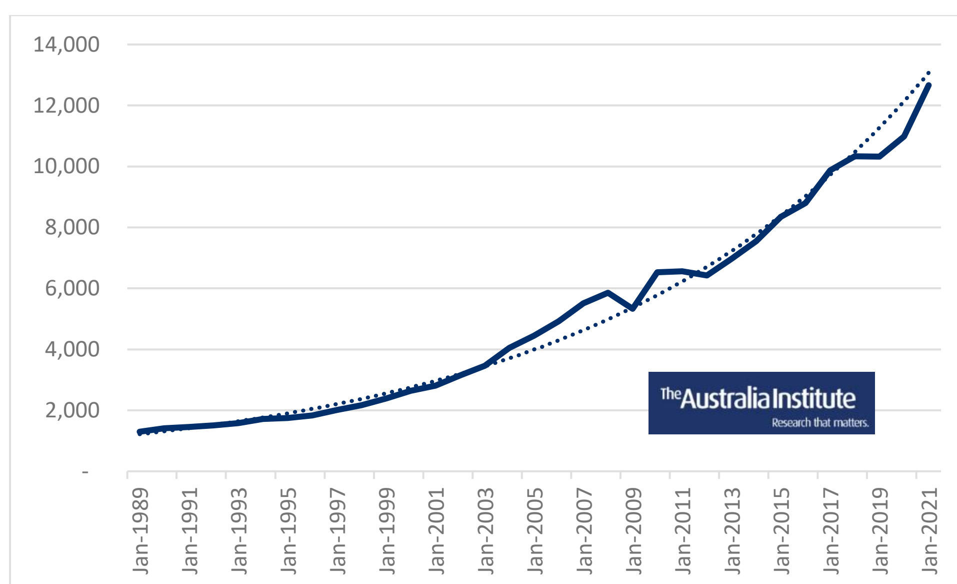
The two are equal given that ABS data for income excludes capital gains and comprehensive income is either consumed or saved. For most of this analysis either GDP itself or GDP *plus* capital gains as measured by the change in household net worth from year to year is used. GDP is used here even though if the interest is in questions such as any "burden" on Australians, the focus should be on those national accounting magnitudes relating to output due to Australian residents to match household net worth measures that relate to residents. Using GDP makes it easier to compare our results to the IGR. The other consideration is whether the analysis should include any capital gains accruing to other sectors, the government, corporations, and the rest of the world. The view here is that capital gains in especially the corporate sector are likely to be reflected in higher valuations of assets held by the household sector so that including the latter should be sufficient. Otherwise there would be an element of double counting.

The paper now turns to examine the empirical importance of net worth and increases in net worth among Australian households.

Net worth in Australia

Since September 1988[18] series net worth has been growing at 7.5 per cent per annum and, as mentioned above, is now (March 2021) $12,665 billion. At that rate in 40 years it would be $228,521 billion or roughly $89,160 billion in 2021 prices. Figure 1 plots household net worth over the period from March 1989 to March 2021 (the latest figure available as at the time of writing). These figures are shown in the solid blue line in Figure 1. Because of the volatility in the data a trend line has been included as the dotted line in Figure 1.[19]

Figure 1: Household Net Worth, $billions



Source: Author's calculations and ABS (2021) *Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2019-20*, 18 June.

Figure 1 shows a very steady upward trend in the movement of household net worth over the period since 1989. There is a hint in the graph that the upward trend might have been even higher were it not for the global financial crisis on the one hand and the weak economy just prior to pandemic and then the pandemic itself on the other hand. The strength of the trend suggests it is likely to continue well into the future. Had the trend just prior to the global financial crisis been estimated, using data from 1989 to 2008, the

[18] September 1988 is the first data point in the ABS series for household net worth.

[19] To cope with the volatility of capital gains other researchers have used cumulative measures of income. here the preference is to use trend annual data produced by the technique outlined in the text. Experimenting with alternatives it appeared the exponential functional form was the best fitting equation for the data. Hence the trend line has a high correlation coefficient of 0.9859 indicating that the trend line "explains" 99 per cent of the movement in the data. A correlation coefficient of 1.0 would be a perfect correlation indicating 100 per cent of the movement in the data is explained. "Explains" is put in inverted commas because statistical associations cannot be said to explain anything in a true cause and effect sense.

equation would have over-predicted the present outcomes. This suggests that in the absence of the upheavals since 2008, including the pandemic, household net worth might have been so much higher again by something of the order of $3 trillion.

The increase in wealth has taken us by surprise to some extent. While household net worth at March 2021 stood at 6.37 times GDP, in March 1990 it was a more modest 3.58. That would seem to suggest Australia has experienced a very substantial shift in the structure of the economy. Wealth now looms so much larger than it did three decades ago. Similar trends have been observed in other countries so that, for example, in the US wealth to income (net national income) increased from approximately 3.8 times in 1990 to 5.5 times in 2017.[20] Likewise in the UK the ratio of wealth to national income rose from 3.7 in 1995 to 5.7 in 2018.[21]

Of the total $12,665 billion in household net worth, household savings contributed just $1,215 billion in the period since March 1989,[22] the rest was capital gains worth some $10,116 billion over that period together with the opening balance of $1,298 billion in March 1989. As an aside, the Henry review into taxation suggested taxing capital and capital income lightly because people had to save out of post-tax income and taxing capital amounted to taxing that income twice. But when the overwhelming bulk of net wealth is generated by capital gains that argument disappears.

It is not clear what has driven the large increases in wealth either in Australia or elsewhere. Monetary policy has been implicated. Reductions in interest rates can increase the value of many assets since they increase the discounted value of any stream of income that may be associated with the ownership of particular assets or businesses. The relationship between interest and asset values can be best appreciated with an example. Suppose there is a share which is expected to generate a dividend of $2 per annum for ever. if interest rates are 10 per cent we might say the share is worth $20 by dividing the dividend ($2) by the interest factor (0.1). Put differently, $20 is the amount that yields $2 with interest rates at 10 per cent. Suppose now the interest rate falls to 5 per cent. Then the share value increases to $40. In this way the price of productive assets will be related negatively to interest rates. The latter increases usually means a fall in the former and vice versa.

Monetary policy and especially the low interest rates in response to the pandemic are sometimes blamed for increases in asset prices which inflate the wealth of the already

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[20] Robins JA (2019) “Capital gains and the distribution of income in the United States”, 2019 Meeting Papers 202, Society for Economic Dynamics.https://users.nber.org/~robbinsj/jr_inequ_jmp.pdf

[21] Advani A, Chamerlain E and Summers A (2020) “Is it time for a UK wealth tax?” Init*ial Report, International Inequalities Institute*. https://web.archive.org/web/20200711225346id_/https://static1.squarespace.com/static/5ef4d1da53822a571493ebd0/t/5efd1390a451b40fbf12b7ba/1593643938709/Is-It-Time-For-A-UK-Wealth-Tax.pdf

[22] Household savings figures are given in ABS (2021) *Australian National Accounts: National Income, Expenditure and Product*, 2 June.

wealthy. However, just looking at the graph in Figure 1 it is hard to discern the influence of the low interest rate policy. The trend before the global financial crisis was at least as strong under higher interest rates. That point is taken up later.

TREND ESTIMATES

The changes in household net worth are volatile but the trend line allows us to work with trend movements in net worth that are much less volatile. The estimated equation in Figure 1 implies that the trend increase in net worth is $936 billion for the year to March 2021. On average household savings are a modest 3.04 per cent of GDP as conventionally measured[23] which, at the moment, implies trend household savings should be of the order of $60 billion. Hence, trend capital gains are likely to be around $876 billion (($936 billion minus $60 billion) or 44 per cent of GDP. Capital gains will increasingly swamp conventional savings.[24]

In addition to the standard income concepts the ABS also gives us a series for more comprehensive definitions of income in a table headed "Analytical Measures of Household Income, Consumption, Saving and Wealth".[25] This gives a series "Gross disposable income plus other changes in real net wealth" which seems to be a very good estimate of H-S income in Australia. But perhaps the ABS could have called the measure something that suggested it is indeed a more comprehensive measure of income.

This paper could have used the ABS concept of comprehensive income; instead, convention is followed and GDP is used, albeit augmented with capital gains.

[23] Author's calculations based on ABS (2021) *Australian National Accounts: National Income, Expenditure and Product*, 2 June. The average was taken over the 30-year period from March 1991 to March 2021.

[24] Until the pandemic the figures have behaved as if there is no savings out of conventional savings and all capital gains are saved. As a technical point note that the World Inequality Report finds most of the increase in wealth is due to savings with a lesser role for capital gains. That report uses GDP while our focus is on the household sector. Savings by the corporate sector and rest of world may add to the value of assets that are included in household net worth. Hence savings elsewhere may be turning up as capital gains for the household sector. See Alvaredo F, Chancel L, Piketty T, Saez E and Zucman G (2018) *World Inequality Report, 2018*, Cambridge, Mass: Harvard UP at https://wir2018.wid.world/files/download/wir2018-full-report-english.pdf.

[25] Table 36 in ABS (2021) *Australian National Accounts: Finance and Wealth*, 24 June.

Capital gains in the IGR

The consequences of leaving capital gains and wealth out of the analysis in the IGR is very important. The hidden income of $876 billion (trend value 2019-20) will have a lot of consequences for notions of capacity to pay tax and general wellbeing and how those might be estimated. Moreover, given the relative stability of the estimated equation in Figure 1 it can be used to make rough projections over the next 40 years which show household net wealth grows at a very fast rate. At the moment (2021) household net wealth is 6.37 times GDP. On the projections net household wealth will increase to 14.0 times GDP in 2060–61.

One of the implications already mentioned is that capital gains will swamp income and/or GDP as measured in the national accounts. Using the equation in Figure 1, trend capital gains are 44 per cent of GDP in the year to March 2021. This means that a conventional analysis misses almost half the actual income in Australia.[26] When it is assumed that household net wealth continues to grow at 7.5 per cent over the next 40 years and using the average growth in nominal GDP assumed by the IGR (5.0 per cent) then in the year 2060–61 capital gains will increase to $18.2 trillion and will equate to some 132 per cent of GDP at that time. Some of that $18.2 trillion will be household savings ($0.42 trillion) implying capital gains of $17.8 trillion which will be 127 per cent of GDP. This is a large increase in the wealth to GDP ratio driven by just the small gap in the assumed growth in wealth, 7.5 per cent, compared with the 5.0 per cent increase in GDP. The gap of just 2.5 per cent per annum is sufficient to generate the rapid rise in wealth to income ratio that concerns Piketty.

This is very significant. Conventional thinking about income needs to be thoroughly re-examined because conventionally measured GDP will only be 43 per cent of H-S income in 40 years' time on these trends. This type of finding suggests Australia is on its way to some new Belle Époque as foreshadowed by Piketty.[27] That period leading up to World War 1 was described by Wikipedia as

> …a period [of European history] characterised by optimism, regional peace, economic prosperity, colonial expansion, and technological, scientific, and cultural innovations. In this era of France's cultural and artistic climate (particularly within Paris), the arts markedly flourished, with numerous masterpieces of literature, music, theatre, and visual art gaining extensive recognition.[28]

[26] GDP is much larger than household income with capital gains being 54 per cent of measured household income.

[27] Piketty T (2014) *Capital in the Twenty-First Century*, Cambridge Mass: Harvard UP.

[28] Wikipedia (no date) "Belle Époque" at https://en.wikipedia.org/wiki/Belle_%C3%89poque, accessed 29 July 2021

While that description applied to the life style of the elite, the importance of the period for Piketty was the extreme inequality in which the ranks of the wealthy could live in a style that was unattainable to those with even the best jobs.

Note too, income itself may be incomprehensibly bigger. Treasury predicts GDP per capita will increase by 84 per cent over the next 40 years. By contrast H-S income will increase by 180 per cent if capital gains follow the trend identified in Figure 1. That means observations such as the numbers of over 65-year-olds will rise relative to the number of workers is rather beside the point. Most income in 40 years' time may be capital gains which, if properly redistributed, have the potential to reduce the call on workers to support the aged. The IGR states that from 2019-20 to 2060-61, the number of people aged 65 and older will double to 8.9 million. On our calculations, H-S income will grow from $673,000 per 65-year-old to $1,355,000 in 2060-61, roughly doubling current H-S income per 65-year-old person. In addition many of these old people will be very wealthy. Some and perhaps many will be poor but others will be very wealthy indeed. ABS figures show 60 per cent of the net worth of households is held by households headed by someone 55 years or more and 84 per cent by households headed by a 45-year-old.[29] If there is to be a problem in the future it will be in redistributing income and resources among the old in particular. And the idea that millions of rich old people are a problem seems odd.

Given the huge increase in H-S income likely over the next four decades it is ludicrous to suggest there are any social needs Australia cannot "afford" if it wants to.

At this point it should be acknowledged that these projections are subject to error. They are based on a trend that explains the previous 30 years very well but without theoretical underpinning. That period included a number of unusual episodes from the "recession we had to have" to the pandemic. In that way our approach shares similar methodology problems with the IGR. Nor does it appear Australia might be approaching any steady state as might be the case with conventionally measured income. For example, the 2018 *World Inequality Report*[30] discusses possible future scenarios but suggests the income shares of the top one per cent may just continue to increase well into the future. But the same report suggests that in some of the major economies the top one per cent are taking 37 per cent of the *growth* in combined income in the US, Europe and China. If that is indeed the case it suggests the top one per cent are gradually converging towards the same percentage of total income—37 per cent, up from 33 per cent in 2017. But again that excludes capital gains.

[29] ABS (2021) *Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2019-20*, 18 June.

[30] Alvaredo F, Chancel L, Piketty T, Saez E and Zucman G (2018) *World Inequality Report, 2018*, Cambridge, Mass: Harvard UP at https://wir2018.wid.world/files/download/wir2018-full-report-english.pdf

Unlike conventionally measured income, there does not appear to be any mechanism that would stabilise a net worth to GDP ratio nor a capital gains to GDP ratio. The productive capital stock in an economy might also asymptote towards an equilibrium share of GDP.[31] However, wealth not only includes the industrial capital stock but also a lot of other assets, such as art works, jewellery, private dwellings and so on. The shift in the distribution of primary incomes away from labour may have increased the market valuation of the capital stock beyond what it might otherwise have been. That would have produced higher capital gains. However, that mechanism would only affect the 13 per cent of household wealth held in shares and other productive assets.[32] Of course some of the productive assets may be held indirectly through superannuation. Nevertheless, there do not appear to be any mechanisms that might stop the growth in wealth from continuing on as before.

FURTHER REFLECTIONS ON WIDE CONCEPTIONS OF INCOME

In considering why macroeconomic discussions traditionally ignore capital gains it might be noted that the traditional conception of income as equal to production has a lot of appeal. Most of the concepts in the national accounts are based on transactions between different players in the economic system. Capital gains, however, are not transactions. There are exceptions but for the most part the ABS income concepts derive from transactions and subsequently on transfers made out of the original income. In ABS usage, primary incomes are generated in the production of goods and services.[33] Primary income in that sense can be no more than GDP. The ABS also identifies secondary incomes which include such things as transfer payments to the unemployed and pensioners. However, while GDP cannot exceed spending, H-S income is not constrained at all by GDP or any other magnitude. The capital gains component of H-S income as a valuation phenomenon can in principle lead a life completely independent of other GDP magnitudes as seems to be the case.

[31] If net investment is say 25 per cent of GDP and GDP is growing at 5 per cent, then the capital stock to GDP ratio will stabilise at 5 (= 25/5). But there is no mechanism that ties capital gains to any national accounting magnitude. It is very important to distinguish wealth from the capital stock which is used in the production of goods and services.

[32] These include shares and other equity, non-dwelling construction, machinery and equipment, cultivated biological resources and intellectual property products. See ABS (2021) *Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2019-20*, 18 June.

[33] The ABS defines "Primary incomes are those incomes gained as a consequence of involvement in the process of production." Total primary incomes do include those received by residents from overseas minus primary income received by non-residents on account of Australian production. See ABS (2013) "Feature article: Recent trends in real income growth", *Australian National Accounts: National Income, Expenditure and Product, Mar 2013*, 5 June.

The use of GDP has been criticised in other contexts. The Australia Institute kicked off a lot of that discussion in the 1990s.[34] As is well known, national accounting aggregates were never intended as a measure of wellbeing. Instead, they merely set out to measure what was being bought and sold in the market. Those who designed the national accounts in the 1930s and 1940s knew they were not designing measures of human welfare but merely aimed “to provide a gauge of the size and health of the economy”.[35] Critics point to the way measured GDP will contract if someone marries their housekeeper or that cleaning up pollution can increase GDP. Hence GDP can be a perverse measure of wellbeing. These and other limitations of GDP are discussed in a report by Stiglitz and others commissioned by the French Government which kicked off a renewed worldwide discussion on the limitations of GDP.[36] It is interesting that to date there has been little discussion about whether GDP is the appropriate yardstick for evaluating fiscal issues.

During the Second World War Keynes was interested in measures of GDP and related magnitudes with the aim of measuring how much output might be increased or reoriented for the war effort.[37] For present purposes that is less important than the questions of how much tax to raise and how to distribute tax liabilities. Hence, the present paper is more interested in the capacity to finance spending which can involve wide definitions of income such as H-S income.

It might be noted at this point that the government has used alternatives to GDP as the comparator from time to time. For example, foreign aid is often expressed as a share of gross national income (GNI) in conformity with international standards. GNI is the income (excluding capital gains) received by national residents as distinct from GDP which refers to all the production that takes place domestically irrespective of the nationality of the people/entities undertaking the production.[38]

[34] See Hamilton C and Saddler H (1997) *The Genuine Progress Indicator A new index of changes in well-being in Australia, Discussion Paper Number 14*, October

[35] Syrquin M (2011) “GDP as a measure of economic welfare”, *ICER Working Paper No 3/2011*, http://ssrn.com/abstract=1808685.

[36] Stiglitz JE Sen A and Fitoussi JP (209) *Report by the Commission on the Measurement of Economic and Social Progress,*

[37] See Tilly G (2009) “John Maynard Keynes and the development of national accounts in Britain, 1895-1941”, *The Review of Income and Wealth*, Vol 55(2), pp. 331-359.

[38] Formally GNI is equal to GDP plus primary income receivable from non-residents less primary income payable to non-residents. See ABS (1998) *Balance of Payments and International Investment Position, Australia, Concepts, Sources and Methods*, 22 September. Unlike the large difference made by capital gains, the difference between GNI and GDP is marginal at less than 1 per cent of GDP.

Fairness

The latest figures suggest that in 2017-18 the top 20 per cent of households had an average wealth of $3.4 million. In real terms and given the projections, that should increase to approximately $27.4 million in 2060-61 and real capital gains in that year would be approximately $1.3 million for the average household in the top 20 per cent of households up from a trend of $170,000 in 2017-18 and most likely around $197,000 in 2020-21.[39] While the IGR says GDP per capita will be some 84 per cent higher in 2060-61, trend capital gains will be some 600 pe cent higher in real terms. As already seen, aggregate net worth will grow very significantly in the next 40 years and that of course suggests that capital gains are also likely to grow quickly.

It is already inequitable that capital gains are taxed so lightly. The idea of a fair tax is that two people with the same income, the same deductions and so on should be taxed the same no matter the source of that income. Capital gains or personal exertion or any other source of income should be taxed equivalently. Paul Krugman says, "the low tax rate on capital gains is bad economics, even ignoring who it benefits."[40] The failure to adequately tax capital gains is an enormous advantage to the rich.

The average top 20 per cent of wealth holders enjoyed capital gains of 108 times the capital gains of the lowest 20 per cent of wealth holders. That suggests capital gains will continue to inflate the incomes of the wealthy and so worsen the distribution of income in Australia. The following table examines the incomes of the five quintiles by wealth ownership. Table 1 presents total gross income as defined by the ABS and which excludes capital gains. In the next row capital gains themselves are given. Capital gains for each quintile are calculated by deducting the previous years' net worth from net worth in 2017-18 (the latest figures available)[41] That may mean incorrectly attributing some acquisition of assets to capital gains instead of savings, however, that should not change the orders of magnitude calculated here. The final row in Table 1 is our estimate of the H-S income.

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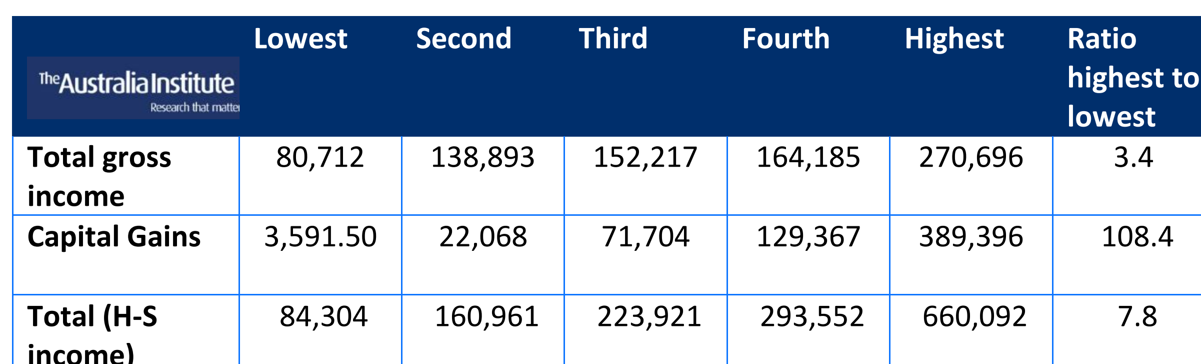
[39] The actual increase will be more than this given the increases to Mar 2021. However, this paper prefers to refer to trend capital gains which tend to be much less volatile. For these calculations we use the 7.5 per cent annual capital gains and deduct the IGR inflation projections of 2.5 per cent, the mid-point of the Reserve Bank target inflation range.

[40] Krugman P (2012) "The dubious case for privileging capital gains", *New York Times*, 19 January.

[41] In fact data limitations meant having to use the difference between 2017-18 and 2015-16 and dividing by two.

Table 1: Household Wealth Quintiles, Incomes received, 2017-18, $.



	Lowest	Second	Third	Fourth	Highest	Ratio highest to lowest
Total gross income	80,712	138,893	152,217	164,185	270,696	3.4
Capital Gains	3,591.50	22,068	71,704	129,367	389,396	108.4
Total (H-S income)	84,304	160,961	223,921	293,552	660,092	7.8

Source: Author's calculations and ABS (2021) *Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2019-20*, 18 June.

Before discussing the implications of Table 1 it is important to note that wealth and income are poorly correlated. While it may strike the reader as odd in that, for example, the bottom quintile has an apparently reasonably high gross income. Younger households may well enjoy reasonably high incomes. That means when considering the least wealthy we are not necessarily looking at the lowest income earners. Households with new entrants into the labour force are likely to have few assets but may have high incomes. At the other end of the wealth distribution, high wealth households may use companies and other vehicles to hold assets and receive income and may not necessarily pay themselves much of that income.

The important thing about Table 1 is that it shows rather dramatically how capital gains are critical to understanding income and wealth in Australia. Standard measures of income suggest the wealthiest households receive 3.4 times the income of the least wealthy. That seems a rather small degree of inequality. However, as might be expected, there is a large inequality in the distribution of capital gains with the ratio of top to bottom at 108.4 to 1 meaning the top 20 per cent of households receive 108.4 times the capital gains received by the bottom wealth quintile. The effect of capital gains then is to increase the top to bottom comprehensive income ratio which becomes 7.8 to 1, much higher than simple income measures might suggest.

Looking ahead, as net worth outpaces conventional income measures so too will capital gains increase relative to other incomes. That implies that ever higher capital gains will pull the income distribution further apart. For example, if capital gains were twice as high as shown in Table 1 then the top to bottom ratio would blow out from 7.8:1 to 11.9:1.

In its latest *Annual Economic Report* the Bank for International Settlements (BIS) has examined the effect of monetary policy on the distributions of income and wealth in the major high-income countries.[42] To the extent that lower interest rates encourage economic activity the BIS argues that should be associated with lower inequality that tends to follow

[42] BIS (2021) *Annual Economic Report 2021*, June at https://www.bis.org/publ/arpdf/ar2021e.pdf.

higher employment. In relation to wealth, the BIS suggests that lower interest rates may have increased wealth but not worsened the inequality in wealth ownership. Indeed, if housing is a higher proportion of wealth at the bottom of the distribution and if lower interest rates disproportionately affect house prices, then the distribution of wealth may even be improved.[43] But Table 1 illustrates the problem in thinking that way.

Suppose wealth increased across the board but without changing the ratio of the top to bottom wealth holders or any of the other distributional measures. That is likely to mean that the annual capital gains are also doubled. From Table 1 it was evident that the very unequal distribution of capital gains can greatly worsen the distribution of H-S income compared with conventionally measured income and it all gets so much worse as capital gains increase.

One thing is clear; higher levels of wealth generate higher capital gains as wealth gets bigger and wealth is likely to be associated with even higher future capital gains. And this greatly worsens the equity of the distribution of comprehensive income. This shows how the BIS fell into a trap by separately considering income and wealth distributions.[44] It is important to appreciate how they interact through the capital gains mechanism.

To complete this section, it is important to get a feel for how the distribution of H-S income may look in 40 years, in 2060-61, if the present trends continue. This exercise is attempted in Table 2 which can be thought of as a thought experiment that brings out the trends but without necessarily having confidence in the precise numbers. The first data column in Table 2 is the last data column in Table 1. The second data column in Table 2 is an estimate of how things might unfold in 2060-61. Total gross income is estimated by holding all incomes constant in present prices except for real wages which are assumed to grow at 1.5 per cent per annum as per the IGR. However, as already discussed, capital gains, or the total value of wealth, is expected to grow at 5 per cent per annum in real terms.

[43] As it happens, housing for the bottom and second bottom quintiles is 28 and 35 per cent of net worth compared with just 16 per cent for the top quintile. However, it is not clear that price increases for housing have outstripped the prices of other assets.

[44] Some Australian studies have also fallen into that trap. See for example, Productivity Commission (2018) *Rising inequality? A stocktake of the evidence, Commission Research Paper*, Canberra and Australian Government (2016) *Response to the Senate Community Affairs References Committee Report: Bridging our growing divide: inequality in Australia: The extent of income inequality in Australia*, December.

Table 2: Ratios of top to bottom wealth quintiles by income

The Australia Institute Research that matters	2017-18	2060-61
Total gross income	3.4	3.0
Capital Gains	108.4	108.4
Total (H-S income)	7.8	12.8

Source: Author's calculations and ABS (2021) *Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2019-20*, 18 June.

Under the assumptions specified the distribution of gross income as conventionally measured actually improves. Only wages are assumed to grow and that drives a favourable improvement in the distribution of incomes since labour income is higher in lower wealth quintiles.[45] The distribution of capital gains is unchanged from the distribution in Table 1 but the real gains themselves are increased by 2.5 per cent per annum for the bottom and top quintiles and all in between. However, because the distribution of wealth and capital gains is so much worse than income, as the capital gains continue to dominate other income sources so the distribution of H-S income gets so much worse. That is shown for example in the top to bottom income ratios stretching out from 7.8 to 12.8.

The exact numbers are uncertain, but these exercises drive home the point that the increase in wealth and associated capital gains will be associated with worsening inequality. Wealth tends to be held by the older people so that higher wealth levels will increase the disparities between young and older households. But even within the older households there will still be large numbers with low incomes and low wealth. Hence there will be in the future, as there is now, a problem associated with a good deal of inequality among older people. Those inequalities will be an issue for future generations to address.

[45] As we consider the other conventional sources of income that outcome might well be reversed.

Revenue implications

Any discussion of capital gains and expanded definitions of income raise the question of taxation and there are important implications for the revenue effort from our discussion to this point. The Australian tax system did not include capital gains tax until it was introduced by the Hawke Government in 1985 and applied to all assets purchased after 1983 but exempted the family home. An earlier attempt failed under the Whitlam Government. David Uren reminds us that the Whitlam Government was preparing to introduce a capital gains tax when it was dismissed.[46] Since the introduction of capital gains taxation it has been gradually watered down. The original version indexed the purchase price so that only real capital gains were taxed. Later the indexation was abolished in favour of halving the tax on nominal gains.[47] While the Coalition has been keen to water down the capital gains tax it has had to grudgingly admit a place for the tax. In its "Fightback!" action plan the Coalition had to admit:

> The taxation of capital gains is an essential element of any taxation system which continues to rely on income as a taxation base. Without it, there would be an incentive for some people to take their remuneration in the form of capital gain rather than income and escape their tax obligations. Without it, there would be a strong incentive to speculative property and share transactions.[48]

Despite the lip service to capital gains taxation in Australia, the tax is catching only a fraction of the actual capital gains. The budget papers show that in 2019-20 capital gains tax collections from individuals, companies and super funds were $16.1 billion and are expected to be a modest $20.5 billion in 2024-25.[49] On those figures, capital gains taxation is under 2 per cent of trend capital gains. Commonwealth tax collections are expected to be 22.3 per cent of GDP in 2020-21. Hence, the income recorded in national accounting figures is taxed at 21.5 per cent compared with under 2 per cent for capital gains. The average dollar in conventional income in Australia is over 10 times more likely to be taxed than a dollar in capital gains. That seems like a gross anomaly in our present tax system and a source of great injustice to the idea that each dollar of income should be treated the same.

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[46] Uren D (2013) "The old masters and ordinary apprentices", *The Australian*, 4 January.

[47] See Reinhardts and Steel L (2006) A brief history of Australia's tax system, Paper presented to 22nd APEC Finance Ministers' Technical Working Group Meeting, Khanh Hoa, Vietnam, 15 June.

[48] Coalition Parties (1991) *Fightback! Taxation and Expenditure Reform for Jobs and Growth*, 21 November.

[49] Australian Government (2021) "Statement 5: Revenue", *2021-22 Budget Paper No 1*, https://budget.gov.au/2021-22/content/bp1/download/bp1_2021-22.pdf While capital gains tax applies to more than just households, capital gains on assets held by other entities will in theory be reflected in the revaluations of those entities in the household sector's balance sheet.

Given that commonwealth tax is presently (2020-21) 22.3 per cent of GDP, it follows that tax as a share of H-S income is just 15.5 per cent. Moreover, that will get lower in the future as H-S income increases more quickly than conventional measures of income. The IGR assumes a cap of 23.9 per cent of GDP which applies through to 2060-61. In that year the projected estimates of capital gains could be 130 per cent of GDP in which case the 23.9 per cent tax cap, as currently defined, will imply a tax of only 10.4 per cent of H-S income in 2060-61.

One of the reasons for lower tax collections from capital gains is because capital gains are only assessed when the gains are realised. In addition, there are large tax expenditures associated with capital gains. There are exemptions on selling the family home worth some $50 billion,[50] discounts for individuals and small business who are only taxed on 50 per cent of the gain, roll-over provisions for small business and a number of other minor concessions. These are estimated to be worth some $10.5 billion in 2020-21.[51]

In the US it is more widely recognised that it is the top income earners who escape their fair share of tax through the low or concessional rates on capital gains. As Krugman says

> The main reason the rich pay so little is that most of their income takes the form of capital gains, which are taxed at a maximum rate of 15 percent, far below the maximum on wages and salaries. So the question is whether capital gains — three-quarters of which go to the top 1 percent of the income distribution — warrant such special treatment.[52]

Incidentally, for comparison, the top one per cent of taxpayers in Australia declare 56 per cent of all the capital gains declared to the Australian tax office but declare a much smaller 9.6 per cent of all taxable income. For the top ten per cent the figures are respectively 71 per cent and 21 per cent.[53] This confirms that capital gains overwhelmingly go to the rich and are taxed more lightly than regular income. By comparison Anthony Atkinson, Thomas Piketty, and Emmanuel Saez have pointed to the world-wide erosion of the tax base with the gradual removal of capital gains.

> The erosion of capital income from the progressive income tax base. Early progressive income tax systems included a much larger fraction of capital income than most present progressive income tax systems. Indeed, over time, many sources of capital income, such as interest income or returns on pension funds, have been either taxed separately at flat rates or fully exempted and, hence, have disappeared

[50] Australian Government (2021) *Tax benchmarks and variations statement, 2020*, January.

[51] Australian Government (2021) *Tax benchmarks and variations statement, 2020*, January.

[52] Krugman P (2012) "Taxes at the top", *New York Times*, 19 January. https://www.nytimes.com/2012/01/20/opinion/krugman-taxes-at-the-top.html

[53] Author's calculations from Australian Tax Office (2021) *Taxation statistics 2018–19*, at https://www.ato.gov.au/about-ato/research-and-statistics/tax-and-superannuation-statistics/

> from the tax base. In all cases, only realized capital gains are included, if at all, in tax statistics and no information on accruing capital gains is available.[54]

Of course, in the US as in Australia, capital gains attract tax only when they are realised. Part of the reason is obviously practical; measuring capital gains is difficult and many unique assets do not have deep and liquid markets in which market valuations can be used to assess the value of assets and how they change over time. However, the failure to tax capital gains until they are realised gives a large benefit to their beneficiaries. Capital gains are allowed to grow at compound growth rates until they are eventually realised, if at all. It remains very unfair that capital gains are tax free for the most part.

A topic not discussed so far is the implication for tax avoidance. One of the aims of the Hawke Government in implementing capital gains tax in 1985 was to reduce the incidence of tax avoidance since much of that avoidance took place by way of disguising ordinary income as capital gains which had not been taxable. That reminds us that ordinary definitions of income will miss a good deal because people are deliberately disguising income as capital gains. That makes the exclusion of capital gains from the IGR so much worse and incidentally hides a lot of the income at the top end of the income distribution.[55]

An alternative to taxing capital gains on an accrual basis is to tax wealth on a regular basis, a topic taken up in the next section. Before doing note that there are other policies that may also be worth examining but will not be pursued further in this paper. To begin with economic power and the associated monopoly profits are rife in Australia. Those feed into the non-labour incomes in Australia. Attempts to limit that power through such things as competition policies and price controls will slow down the accumulation of wealth on the part of rich Australian households. Action on the part of the labour movement to shift income from profit to wages would assist.

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[54] Cited in Roth S (2021) "Why the Flow of Funds Don't Explain the Flow of Funds: Sectoral Balances, Balance Sheets, and the Accumulation Fallacy", *MPRA Paper No. 105281*, May, p 13-14 https://mpra.ub.uni-muenchen.de/105281/1/MPRA_paper_105281.pdf

[55] This point is made in Advani A and Summers A (2020) "Capital Gains and UK Inequality", *WID.world Working Paper No 2020/09*, May.

Wealth tax

In principle, capital gains should be taxed as they accrue as is other income. Instead, to the extent they are taxed at all, it is only on realisation. In that way avoidance avenues can take place by simply not realising capital gains. The arguments against taxing gains as they accrue are pragmatic. It would be difficult to measure the value of assets each year to calculate tax liabilities.

If capital gains are difficult to tax because they are difficult to value then perhaps wealth should be taxed instead. Wealth could be deemed to have a provisional value equal to historic cost plus the general level of inflation since purchase. The existing capital gains tax could then be used to impose additional tax or give credit for any gains on realisation above or below the amounts previously assessed. Atkinson points out that while the increasing inequality due to capital gains suggests that tighter capital gains taxes may be warranted, in fact a good deal of the capital gains have already taken place and dramatically increased the wealth of the wealthy.[56] Past capital gains can only be captured by a wealth tax of some sort.

A capital tax or wealth tax is the major policy Piketty calls for to address the fundamental problem identified in his book—the tendency for wealth to grow more quickly than the economy generally and so for wealth to be more and more unequally distributed among the population.[57] Piketty suggests that those with fortunes worth less than €1 million (A$1.59m) might pay nothing, while a tax of 1 per cent would apply to fortunes between €1 million and €5 million, and 2 per cent to those greater than €5 million. Piketty thought the tax would need to involve international cooperation with respect to rates, definitions and similar so as to avoid countries being played off against each other. A wealth tax as a tax on capital is not related to the rate of return on capital or the way it is invested and so wealth owners will be undeterred from seeking out the best pre-tax return options. Such a tax design would indeed seem leave the investor with a fixed tax irrespective of the return they might earn.

[56] Atkinson AB (2015) *Inequality: What can be done?* London: Harvard University Press.

[57] See Piketty T (2014) *Capital in the Twenty-First Century*, Cambridge Mass: Harvard UP. Piketty's work leads him to the conclusion that everything is dominated by the rule; $r > g$ where r is the rate of return on capital and g is the growth in the economy. If r exceeds g then the stock of wealth is growing more quickly than the size of the economy. This is not the place to argue that point. The fact of inequality alone is enough to argue for taxes on both high incomes and high wealth holdings.

ESTATE DUTIES

Countries that do not want to tax wealth have the option of taxing wealth accumulation on the death of the owner of the estate. Estate duties have the advantage that the tax applies at the time when the deceased's affairs need to be managed and re-ordered. In addition, estate duties raise the revenue before the wealth is passed on to beneficiaries. Estate duties can perform important functions in addition to raising revenue. Estate duties support the progressivity of the tax system as a whole by way of a levy on wealth at least once a generation. They also limit the growth of large accumulations of wealth that reflect the often arbitrary circumstances of the deceased. The latter is particularly important given the growing consensus that the worsening inequality needs to be addressed both for its own sake and for the improvement in social and economic outcomes associated with a more equal distribution of wealth in Australia.

In the meantime *The Economist* describes how family business dynasties have been able to thrive and how they impose dangers to the economy. It quotes Warren Buffett who compared family succession to "choosing the 2020 Olympic team by picking the eldest sons of the gold-medal winners in the 2000 Olympics".[58]

At one time all states and the Commonwealth levied inheritance taxes on the estates of the deceased. Queensland under Premier Joh Bjelke-Petersen was the first to abolish inheritance taxes. Part of the motivation in Queensland was to attract retirees to move to Queensland. Other states felt compelled to follow the lead of Queensland. Eventually even the Fraser federal government felt it needed to abolish inheritance taxation. This pattern of events was unfortunate.

According to the 1975 Asprey Report[59] when all states and the Commonwealth last levied estate duties they raised around 3 per cent of Commonwealth taxation. If the estate duties were levied at comparable rates today and raised 3 per cent of tax revenue then they would be collecting around $15 billion in additional revenue.[60] Of course using historical figures risks underestimating the impact since it is well known that the death and gift duties were riddled with loopholes that allowed easy tax avoidance. It would be hoped that a modern

[58] The Economist (2015) 'All too human: How families can cause trouble for their firms', The Economist, 18 April at http://www.economist.com/news/special-report/21648173-how-families-can-cause-trouble-their-firms-all-too-human

[59] Taxation Review Committee (1975) *Full Report*, AGPS, at https://adc.library.usyd.edu.au/data-2/p00087.pdf

[60] This figure is based on expected Commonwealth revenue in 2021-22 reported in Australian Government (2021) "Budget strategy and outlook", *Budget Paper No 1, 2021-22*.

estate duty would be much more effective in checking the growth of capital accumulations in Australia. Henry projected that bequests are likely to rise to around $85 billion or four per cent of GDP by 2030. Hence bequests represent a considerable tax base although they may need to be accompanied by explicit wealth taxes. All but four OECD countries imposed estate duties according to the Henry report.[61]

Stiglitz has argued that Europe should pursue wealth taxes more aggressively both for the revenue potential but also to address concentrations of family wealth built up through inheritance.[62] That would include annual wealth taxes but also death duties. Stiglitz cites studies that show inherited wealth discourages work on the part of the beneficiaries. That makes sense; people who can live in comfort without working are unlikely to take it up.

Mike Truman, the then editor of the journal *Taxation*, argued:

> the problem with inheritance tax is that we're not paying enough of it…For all its faults in practice, it is in principle a perfect tax. … the tax liability comes at a point where those who did have the money no longer need it, and those who are about to get the money have managed quite well so far without it. Except in a very few cases, there is no problem with liquidating assets in order to get the funds to pay the tax.[63]

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[61] The exceptions are Australia, Canada, Mexico and Slovak Republic. [61] Australian Government (2010) *Australia's future tax system: Report to the Treasurer, December 2009, Part Two: Detailed Analysis, Vol 1,* (Henry Review).

[62] Stiglitz JE (2020) *Rewriting the rules of the European Economy*, NY: Norton.

[63] Truman M (2006)'A perfect tax?', Taxation, 2 March 2006.

Back to the IGRs

We mentioned in the introduction that the IGRs were designed to persuade Australians that they could not afford the level of government services they had traditionally enjoyed. The first IGR was issued as a part of the 2002-03 budget papers but given the circumstances at the time, the government had the difficult job of trying to convince the electorate that the future looked bleak despite the large surpluses of the time. Treasurer Peter Costello's 2002-03 budget result was a surplus of $7.4 billion or 0.9 per cent of GDP yet the IGR projected a deficit of 5.0 per cent of GDP by 2041-42.

Just like the 2021 IGR, wealth and capital gains were not mentioned in 2002. Almost everything was compared with GDP just like today. Over that time GDP increased by 173 per cent from $754.3 billion to an estimated $2,059 billion.[64] Meanwhile household wealth increased by 302 per cent from $3.15 trillion to $12.7 trillion.[65] The annual increment in household wealth, basically capital gains, increased by 402 per cent from $334 billion to $1,676 billion. These are set out in Table 3.

Table 3: GDP, household net worth and capital gains

The Australia Institute Research that matters.	GDP	Household net worth	Capital gains
	$ billion	$ trillion	$ billion
2002	754.3	3.15	334
2021	2,059	12.7	1,676

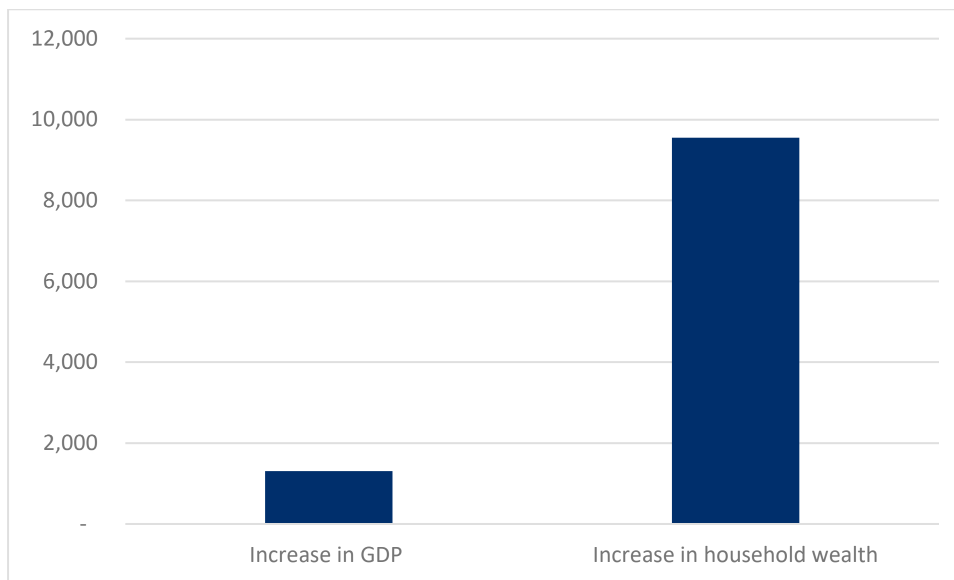
Source: Author's calculations based on ABS (2021) Australian National Accounts: National Income, Expenditure and Product, 2 June and ABS (2021) Australian National Accounts: Finance and Wealth, 24 June.

It is clear from Table 3 that wealth loomed less large at the time of the first intergenerational report. By the time of the fifth IGR in 2021 wealth had grown to $12.7 trillion and capital gains were $1.7 trillion and not far behind the $2 trillion size of the economy. The comparison between the increase in GDP and household wealth is illustrated in Figure 2.

[64] Author's estimate based on ABS (2021) *Australian National Accounts: National Income, Expenditure and Product*, 2 June and official forecasts in Australian Government (2021) *2021-22 Budget Paper No 1*.

[65] ABS (2021) *Australian National Accounts: Distribution of Household Income, Consumption and Wealth, 2003-04 to 2019-20*, 18 June.

Figure 2: Changes since the first intergenerational report, $ billion

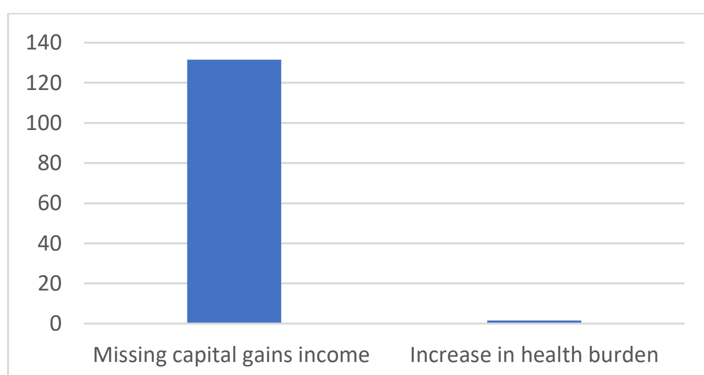


Source: Author's calculations based on ABS (2021) Australian National Accounts: National Income, Expenditure and Product, 2 June and ABS (2021) Australian National Accounts: Finance and Wealth, 24 June.

Figure 2 dramatically illustrates the relative magnitudes of what the IGR chose to concentrate on, changes in GDP, compared with what the IGRs chose to ignore, the increase in household wealth.

One of the pressures on spending due to the ageing population is the health budget. That is being driven both by demographic factors as well as expensive new technologies. It is therefore interesting to compare the increase in the health budget projected for 2060-61 with the projections for capital gains income the IGR has failed to include for that year. Both projections are expressed as a share of GDP for 2060-61.

Figure 3: Increase in health budget compared with missing capital gains income, % GDP



Source: Author's calculations based on ABS (2021) Australian National Accounts: National Income, Expenditure and Product, 2 June, ABS (2021) Australian National Accounts: Finance and Wealth, 24 June, and Australian Government (2021) *2021 Intergenerational Report: Australia over the next 40 years*, June, pp. 29,31.

Figure 3 shows rather dramatically that the capital gains income that is excluded from the IGR towers over the apparent problem of the projected increase in the health budget in 2060-61. The impression of difficulties trying to finance government services in 2060-61 evaporate when we take account of what is missing in the IGR.

The onus should be on the government to justify confining its attention to GDP and ignoring the additional capacity to pay tax and finance government services as is suggested by data on wealth and increments in wealth. Why has the government ignored capital gains when the Ken Henry report into taxation made it clear that capital gains should be included in discussions about tax?

Conclusions

This paper has shown that the Intergenerational Report fails to take account of some of the major trends in Australia that will determine Australian wellbeing, how that wellbeing is distributed between the rich and poor and the extent to which Australia can “afford” government services in the context of an ageing population.

Broad definitions of income should be used when looking at questions such as the future wellbeing of Australians and how that might be affected by the revenue raising efforts of future governments along with trends in government spending. Household wealth has been steadily creeping up being recently boosted by almost half of GDP (trend estimate) and that magnitude is accelerating. Traditional exercises like the intergenerational reports look at fiscal policy against the backdrop of GDP and other national accounts measures. Wealth and increases in wealth, or capital gains, are missing in that analysis but are very important in considering whether or not Australians can “afford” government services, many of which are essential in any event.

A consideration of the likely scenarios for wealth and capital gains in Australia suggests the Australian tax system is missing out on a very large tax base to the benefit of the wealthiest of Australian households. Moreover, the worsening of the income and wealth distributions in recent decades is likely to get ever worse being driven by accelerating capital gains. Attempts to understand fiscal pressures in 40 years’ time need to take into account the fact that income received as capital gains might be well over the value of GDP or income as conventionally defined. Just as wealth has increased in Australia over the last 30 years, going from 3.58 to 6.37 times GDP, it is likely to further increase in future decades. If present trends were to continue household wealth would be 18 times GDP in 2060-61 while per capita income including capital gains will be 158 per cent higher.

Income should be measured properly using comprehensive measures of income such as the Haig-Simons income measure discussed in this paper. By including capital gains in income the distribution of income in Australia looks so much worse than when capital gains are ignored. And the distribution of income is getting worse. Observers who focus on just the distribution of income or wealth in isolation miss an extremely important dynamic that ever increases the income disparities in Australia.

At the moment, using conventional income measures, the income of the wealthiest 20 per cent of households is a relatively modest 3.4 times the income of the least wealthy 20 per cent. For various reasons that may be a rosy reading of the data. Nevertheless, adding capital gains the 3.4 stretches out to 7.8 times. Our projections to 2060-61 suggest that income ratio will be much worse increasing to 12.8 times. Failure to comprehensively

measure income is almost like measuring turnover in a produce market by counting sales of just the yellow fruit.

Implications for the Intergenerational Report are clear. The assumed taxation cap of 23.9 per cent of GDP in 2060-61 will imply taxation will be only 10.4 per cent of our measure of comprehensive income. Using GDP as the comparator is like just measuring the yellow fruit.

The findings in the present work suggests Australia is on its way to some new Belle Époque as foreshadowed by Thomas Piketty.[66] That period leading up to World War 1 was characterised by such inequality that the wealthy could live in a style that was unattainable to those with even the best jobs. Piketty's argument suggests Australia is heading towards not some stable equilibrium in the distribution of income but a distribution characterised by ever increasing income and wealth inequality. The mechanisms that produce this increasing inequality are open-ended. People seem unhappy with the idea that the wealth to income ratio may be ever increasing. They seem to think that something must bring that to an end although Piketty notes that in the past increasing inequality has only been stopped by wars and revolutions. That is a rather bleak conclusion but there are reasons for being more optimistic.

Given the likely huge increase in income (widely defined) over the next four decades it is ludicrous to suggest there are any social needs Australia cannot "afford" if it wants to. But that is likely to mean bringing more of the capital gains into account. Eventually Australia is going to have to face the need to tax capital gains more seriously and/or bring accumulated wealth into the tax system. It is apparent that the Intergenerational Report is completely missing some of the real challenges facing Australia. Yet the booming wealth and capital gains in the system is just one of the forces that will profoundly affect the social and economic structures emerging over the next 40 years.

People sometimes phrase the intergenerational problem in terms of the burden an ageing population will impose on future generations. But the data force us to think of another way of looking at this issue. The future generations are going to have to ensure that the rich and very rich old people assist the poor old people in their communities. We have misallocated our worries towards thinking that the problem is one of entitlements to government services when it is not.

[66] Piketty T (2014) *Capital in the Twenty-First Century*, Cambridge Mass: Harvard UP.