

POLICY PAPER

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MYTH VS REALITY: THE CASE AGAINST INCREASING CAPITAL GAINS TAX





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Myth vs Reality: The case against increasing Capital Gains Tax

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REDUCING THE BURDEN FOR
FUTURE GENERATIONS



POLICY Paper 18

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Introduction

Australia's capital gains tax (CGT) policy has been largely settled for almost 20 years. However, it has come under renewed scrutiny as a result of the Australian Labor Party's federal election platform proposal to effectively increase the tax by 50%.

This paper looks at the evolution of CGT to this point, including how past reforms were justified. It then examines whether discounting capital gains or indexing for inflation — or indeed, a combination

of the two — is the better model. The paper then considers the principles underlying CGT, and whether they should lead to more or less of the tax. Finally, it takes a look at revenue considerations and other reform options.

The paper finds that the case for increasing CGT is weak, and based on a number of myths about the tax, that — if accepted by the public unquestioningly — run the risk of a serious policy error being made.

How we got to where we are: evolution of Australia's capital gains tax

Prior to 1985 there was no general capital gains tax in Australia, although capital gains could be taxed under the income tax provisions in some specific circumstances.

The first general CGT took effect in September 1985 as part of a package of measures to broaden the base and lower the rates of personal income tax. Existing holdings were grandfathered. The new CGT was not adopted as a separate tax, but as an integral part of the personal income tax. Standard income tax rates

applied, but to capital gains adjusted for inflation (provided the asset had been held for at least 12 months). Thus it was essentially a tax at full marginal rates on real capital gains. Inflation adjustment was achieved by indexing the cost base of each asset to the consumer price index. The following example illustrates how the indexation system worked:

Shares in XYZ company were acquired at a cost of \$10,000 (including brokerage) on 23 July 1987. They were sold for \$20,000 (after

brokerage) on 28 September 1998. From the September quarter 1987 to the September quarter 1998 the Consumer Price Index rose by 44.2%, resulting in an increase in the cost base from \$10,000 to \$14,420. The real taxable gain was therefore \$5,580. At a shareholder's marginal rate of 48.5% (for example) in 1998, tax of \$2,706 would have been payable.

In light of subsequent developments, it is important to add that an averaging provision was inserted to address the effect of lumpiness in realised gains pushing taxpayers into higher tax brackets. This averaging provision allowed taxpayers to pay at the marginal rate determined by dividing their capital gain for the year by five and adding that amount to other taxable income. This was a valuable concession for many taxpayers.

In November 1999, following the Ralph Review of Business Taxation, the indexation method was scrapped (subject to taxpayers retaining the option of indexation for existing holdings up to that point) and replaced with a 50% discount for assets held for at least 12 months. This meant that half of nominal capital gains were to be added to a taxpayer's other taxable income and taxed at regular marginal rates. Importantly, the 50% discount was accompanied by abolition of the averaging provision — a fact that subsequently received very little recognition by critics of the 50% discount. For superannuation funds, the discount was lower at one-third, in recognition of the

low tax rate applying to such funds. The following example illustrates how the discount system works:

Shares in ABC company were bought for \$10,000 (including brokerage) on 2 March 2000 and were sold for \$20,000 (after brokerage) on 10 February 2007. The gross capital gain of \$10,000 is discounted by 50% to \$5,000 in the case of an individual taxpayer. At a marginal rate of 46.5% in 2007, tax of \$2,325 would have been payable.

One of the myths often heard in public debate is that the 1999 reform "halved capital gains tax." It did nothing of the kind, as the 50% discount replaced a discount in another form, as well as an averaging provision.

In 2009 the Henry tax review recommended reducing the discount to 40% in the context of a uniform discount applying to various forms of capital income.¹ However, this was not accepted by the government.

The Labor opposition in the 2016 federal election pledged to reduce the 50% discount to 25% with grandfathering at 50% for existing holdings. However no reduction in the discount is proposed for superannuation funds, which means they will receive a larger discount than individuals rather than a smaller discount as is presently the case. These details remain Labor's policy for the 2019 election. It is important to add that the policy has nothing to say about restoring the averaging provision, so it must be assumed none is proposed.

How the reforms were justified

The tax policy principles relevant to CGT are discussed in more detail later. Here, we recall the policy considerations as documented at the time of each of the above changes.

(a) 1985

The main consideration in the original adoption of CGT in 1985 was that:

- capital gains were legitimately part of income and excluding them from taxable income created a distortion;
- there was an incentive for taxpayers to structure their affairs to the extent possible to transform ordinary income into capital gain; and
- the benefit flowed mainly to those on high incomes.²

However, it was also recognised that capital gains that merely matched inflation did not constitute income — in the sense that they did nothing to increase the taxpayer's purchasing power — and should be excluded from tax. It was also recognised that marginal income tax rates at the time were very high (as high as 61%) and reducing them was part of the *quid pro quo* for bringing capital gains into the tax net. The averaging provision was also a *quid pro quo*.

(b) 1999

The switch to a 50% discount in 1999 was in part driven by what was seen as the complexity of the indexation and averaging provisions. However, it is important to understand in light of subsequent criticism that the discount was not put forward as simply an alternative way of adjusting for inflation.

The Ralph review recognised various reasons for discounting capital gains in addition to inflation, such as:

- the disincentive effect of CGT on saving and investment;
- the riskiness of investments giving rise to capital gains;
- the distortionary asset lock-in effect of CGT; and
- the prevalence of lighter CGT burdens in other countries in the context of increased international capital mobility.

Thus, to the extent the 50% discount was more generous to the taxpayer than an indexation system, the greater generosity was seen as being justified by these considerations. In the words of the Ralph Review:

The Review's recommendations for capital gains taxation are designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources.³

(c) Current controversy and proposals for further change

The basis for the 50% discount as enunciated by the Ralph review has largely been overlooked in more recent commentaries. The most common line of argument is that the discount was meant to be an allowance for inflation; and as inflation was much higher than it is now, a 50% discount is no longer justified. This is wrong on a number of points:

- First, as discussed above, the 50% discount was not intended to be merely an allowance for inflation.
- Second, in 1999 inflation had already fallen to a 10-year average of just under 2.5% — not very different from its current 10-year average — so it is incorrect to say that on inflation grounds alone a reduction in the discount is justified now. Inflation has been below 2.5% in recent times, but it would be rash to base a change in CGT policy on this, particularly as the Reserve Bank retains an inflation target range with 2.5% as its mid-point.
- Third, critics of the 50% discount fail to recognise that it was partly to compensate for the removal of the averaging provision.

These misrepresentations of the reasons for the 50% discount appear in the Labor opposition's case for cutting it to 25%, but the opposition places more emphasis on the implications for house prices and affordability and for fiscal sustainability. Labor's CGT

proposal is outlined in a document titled 'Positive plan to help housing affordability', which puts the argument that the CGT discount interacts with negative gearing and "gives investors an unfair advantage over first home buyers" and "have not achieved their aim to boost housing supply and encourage the building of more new houses" but have "led to over-investment in loss-making on existing property."⁴

As a "fiscal challenge", the Labor policy document portrays the CGT discount as a "tax subsidy" of \$8.6 billion that is growing at an "unsustainable" rate and is disproportionately "beneficial to high income earners." It is a "distortionary setting," the correction of which "will lead to a more efficient allocation of funding in the economy."

The Coalition — as it is defending the status quo — has not outlined its case as fully, but in public statements has dwelt upon the link to negative gearing and housing. The Prime Minister, for example, has stated:

If you now take the sledgehammer of negative gearing and capital gains tax changes — if you abolish negative gearing as we know it — then you're inviting a housing market crash.⁵

The emphasis of both Labor and the Coalition on housing is open to the criticism that they are ignoring the large portion of the CGT base that is not housing. Of total itemised capital gains reported by individual taxpayers (the target of Labor's policy) in the three years to 2015-16, only 38% were in respect of 'real estate situated in Australia', some of which would have been non-residential real estate.⁶ This makes it clear that CGT policy has much broader implications than for housing alone; CGT is a provision of the tax law with broad applicability to all assets. The Labor policy seems to acknowledge this by retaining the existing discounts for small business assets and superannuation fund assets, but fails to recognise that a majority of people's assets (other than the principal place of residence) are not in the form of housing.

Moreover, the contribution of CGT policy to house price growth is moot. House price booms have many causes and the upsurge in prices from the early 2000s can be explained largely by reductions in interest rates and supply constraints. House prices also boomed at times under the previous version of CGT and in other countries with a variety of CGT regimes. There were also house price slumps before 1985, when Australia had no CGT.

The claim that the CGT discount has failed in its "aim to boost housing supply and encourage the building of more new houses" is odd; because that wasn't the objective of the discount (aside from the broad objective of increasing the incentive to all forms of investment).

Describing the CGT discount as a “tax subsidy” is pejorative language that fails to recognise the broad case for concessional taxation of capital gains, as outlined in the Ralph Review of business taxation. Basing the policy of reducing the discount partly on the fact that mainly high income earners benefit commits the now familiar fallacy of looking at one small slice of the overall tax/transfer system rather than the distributional effects of the system as a whole. The data on growth of the revenue cost of the discount seeks to alarm with large numbers that are uncertain projections into the future, while failing to recognise that actual capital gains tax revenue from

individuals and trusts since 1999 has grown faster than other tax revenue (see Figure 3 below).

The claimed revenue cost of the CGT concession of \$8.6 billion a year is Treasury’s estimate of the revenue foregone in 2016–17. Treasury is at pains to point out that this is not an estimate of the revenue that could be gained by abolishing the discount. The revenue gain would be much smaller as taxpayers adjusted to the higher tax rate — for example, by not realising capital gains that they would have realised at a lower tax rate.

To discount or to index?

As described above, the history of CGT in Australia has been a mix, at different times, of discounting and of indexing for inflation. Both have their strengths and weaknesses, but in the end the choice comes down to what the policy objective is.

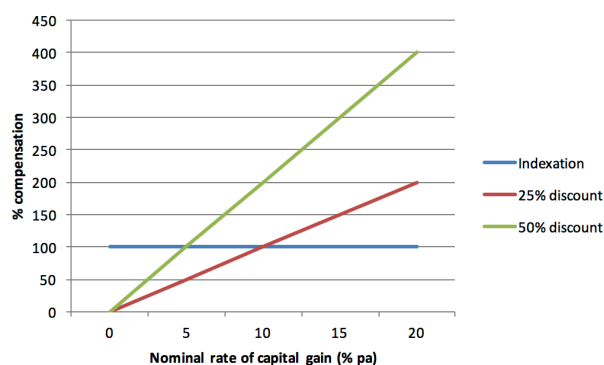
Indexing is the only exact way of accounting for inflation and ensuring only real gains — and all real gains — are taxed. No uniform percentage discount can do that. The problems with indexation are its complexity and the fact that it takes no account of the other reasons for concessional taxation of capital gains. The complexity comes from the taxpayer having to look up consumer price index data and index the cost base of every holding (including every parcel of shares if the taxpayer holds multiple parcels in the same company acquired at different times).

A uniform percentage discount is simpler, although the taxpayer still has to keep track of the cost base of each parcel. It also enables policymakers to set a discount they believe takes account of all the reasons for concessional taxation relative to taxation at full rates. However, there is no science in setting the discount. As we have seen, the government in 1999 selected 50%, the Henry tax review recommended 40%, and Labor is proposing 25%.

One benchmark is the degree to which the discount at least compensates fully for inflation. For a given rate of inflation, the lower the rate of capital gain in nominal terms and the lower the discount factor, the less likely is it that the discount will make full allowance for inflation.

To investigate more fully, we assume inflation at the 2.5% mid-point of the Reserve Bank’s target range (also the actual average rate in the inflation-targeting era) and relate it to nominal capital gains expressed at annual rates.⁷ Figure 1 illustrates the degree of compensation for inflation under an indexation

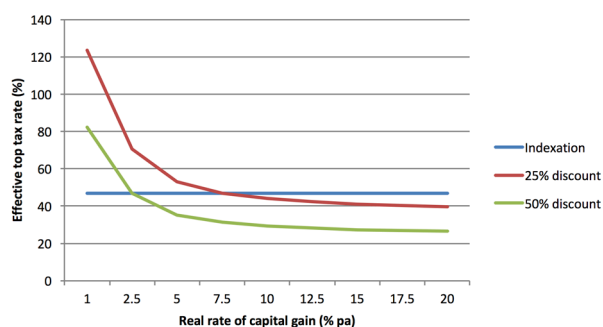
Figure 1: Compensation for 2.5% inflation rate under CGT regimes



regime, a 50% discount and a 25% discount. Indexation compensates exactly for inflation; the 50% discount under-compensates for all nominal capital gain rates under 5% a year and over-compensates above 5%; whereas the crossover point for the 25% discount is much higher at 10% a year capital gain.

This makes it clear that the 25% discount would fail to compensate fully for inflation in many situations, and probably in the vast majority. A nominal capital gain of, say 7.5% a year may not sound much, but it represents a 44% increase in value in five years and a 107% increase in 10 years. Yet under a 25% discount and with inflation at 2.5%, it would not be fully compensated for inflation. It is also well in excess of the long-term average rate of increase in the Australian share price index (5.2%) and national average house prices (6.8%) and home unit prices (5.9%).⁸ Moreover, the capital gains of any investor matching these averages would in fact be lower on account of capitalised costs of acquisition and disposal. The conclusion is that in many cases, the 25% discount system would impose tax on purely inflationary gains as well as real gains.

Figure 2: Effective tax on real capital gains at top marginal rate, with 2.5% inflation



Given that the 50% discount achieves full compensation for all capital gains of 5% a year or above, it appears more appropriate if the policy objective includes compensating for inflation in most scenarios. It still taxes some purely inflationary gains, but not as much as the 25% discount does.

The pre-1999 indexation system achieved precise compensation for inflation in all cases, but no over-compensation. The 25% discount would clearly represent a more severe tax on capital gains than the pre-1999 system. The 50% discount is probably more generous than indexation, but the comparison is muddled by the fact that the indexation system included an averaging provision, whereas the 50% discount does not.

Another way to compare the different CGT concessions is to look at tax paid as a percentage of real (inflation-adjusted) capital gain under various assumptions. Figure 2 illustrates the results in the case of the top marginal rate bracket of 47%. Under the indexation method, there is no tax on nominal capital gains up to 2.5% a year, and a 47% tax on all real gains. Under both the 25% and 50% discounts, tax may apply even when there is no real gain, and at low real gains the tax is at very high rates — particularly in the case of the 25% discount, which involves tax of 47% or more on real returns up to 7.5% per annum. Above that rate, the tax gradually diminishes. The pattern is the same for the 50% discount but tax rates on real gains are lower, dropping to 26.5% for a real capital gain of 20% a year, compared with 39.7% with a 25% discount.

Table 1 brings together the data for the compensated percentage of inflationary gains and the effective tax rate on real gains in the cases of high, average and low rates of capital gain.

Is there a discount rate that compensates for inflation at average capital gains? While averages may be calculated for various asset classes, there is no such thing as an overall average rate of capital gain. However, the Henry tax review in 2009 proposed a discount rate of 40% as being more appropriate if the aim is to compensate for inflation.⁹ This would equate to a 2.4% inflation component of a nominal capital gain of 6%, which as we have seen above, is a little above the historical average share market gain and a little below the historical average house price gain.

Table 1: Capital Gains Tax Scenarios

		% of inflation compensated		Effective tax rate on real gain			
				@ 47% tax rate		@ 39% tax rate	
Nominal gain	% per year	25% discount	50% discount	25% discount	50% discount	25% discount	50% discount
High	20	200%	400%	40.3	26.9	33.4	22.3
	10	100%	200%	47.0	31.3	39.0	26.0
Average	6.8 (Houses)	68%	136%	55.7	37.2	46.3	30.9
	5.2 (Shares)	52%	104%	67.9	45.3	56.3	37.6
Low	3	30%	60%	220.0	147.0	175.5	117.0

Should policy over or under-compensate for inflation?

If we take full compensation for inflation as a benchmark in CGT design, there is a question as to whether policy should settle for that benchmark or aim to under-compensate or over-compensate. As we have seen, the existing 50% discount probably over-compensates on average whereas a 25% discount would under-compensate on average.

Reasons to under-compensate

There are four reasons why policy may lean towards under-compensation, or indeed no compensation at all:

(i) Tax on realisation is concessional

In Australia — and indeed all countries that apply CGT — it applies only when the capital gain is realised, whereas conceptually the income (or increase in net worth) flowing to the taxpayer accrues year-by-year. Accrual taxation of capital gains is administratively very difficult. Taxing only on realisation of gains represents a deferral of tax and therefore a benefit to the taxpayer — and one that increases the longer an appreciating asset is held before realisation. In effect it represents an additional discount that widens as more time passes.

The benefit is difficult to quantify, as it depends on so many variables; but the New Zealand Tax Working Group recently described one scenario with a standard tax rate of 40%, in which the effective rate of a realisation-based CGT is 38% at five years, 35% at 10 years and 28% at 25 years.¹⁰ On this basis, it appears that the effective discount from realisation is small other than for long-term holdings of 10 years or more. It is certainly small relative to the benefit of inflation-adjustment of capital gains, and could not be a substitute for inflation adjustment other than for very long-term holdings such as longer than 25 years.

(ii) Consistency with other forms of income from saving

The argument is sometimes made that as the tax system does not systematically adjust for inflation — for example, nominal interest income is taxed at full rates without any allowance for inflation — there is no reason for the capital gains tax to do so. However, two wrongs don't make a right. The appropriate policy response is to correct over-taxation wherever it affects saving. The real issue here is that different types of income from saving are taxed in radically different ways in Australia, creating distortions and biases. There is a case for greater uniformity, but with discounts that recognise the case for saving being taxed at lower rates than other income (see below).

This was the thinking behind the Henry review's recommendation for a uniform 40% discount for various forms of income from saving, including capital gains and interest.

(iii) Vertical equity

The proposition based on equity is that as the bulk of capital gains by value accrue to higher income taxpayers, a watered-down CGT is not sufficiently 'progressive'. However, progressivity should be assessed for the tax system as a whole, not its individual components, and the Australian system is highly progressive. Equity is an issue for the design of CGT. It is important to understand that CGT is not a separate tax but is integrated into the personal income tax system. Thus, a CGT with a uniform percentage discount such as the 50% discount is still progressive in itself; unlike a flat-rate CGT at all income levels, which would not be.

(iv) Income switching

A lower tax rate for capital gains than for other income may encourage taxpayers to search for ways to transform income from types that attract full taxation to types that attract concessional capital gains tax. It is difficult to disguise labour income as capital income, but investment strategies may be tweaked to take advantage of lower capital gains tax. Switching from assets generating ordinary taxable income to assets generating capital gains purely for tax reasons is contrary to economic efficiency.

Reasons to over-compensate

There are several reasons for CGT concessions in addition to compensating for inflation. Some of these reasons were taken into account in setting the current 50% discount, but have been largely overlooked in current discussion of CGT.

(i) Disincentive effects

Capital gains are a form of income from saving, taxation of which creates a bias against saving for future consumption. This bias is greater the longer the period over which saving produces taxable income. This discriminates against taxpayers who choose to defer consumption and save. Such taxpayers pay a higher lifetime tax bill than those with similar earnings who choose to save less.

This consideration applies even in the absence of inflation, but is reinforced by the presence of inflation.

In the case of capital gains, it is also reinforced by the fact that investments generating capital gains often

involve higher risk — clearly more so than interest on a bank deposit — and the fact that the capital gains tax law does not allow capital losses to be set against ordinary income. This treatment of losses means that some losses may never generate a tax offset if there are no future capital gains to offset them.

Another consideration is that capital is more internationally mobile than other tax bases, and concessional treatment of capital gains is the norm in other countries. Introduction of the 50% discount improved Australia's international competitiveness from a position in which Australia was among countries with the harshest capital gains taxes. Halving the discount to 25% would take Australia back towards the camp of countries with the most severe capital gains taxes and significantly reduce international competitiveness.

These considerations add up to a strong economic efficiency case against taxation of capital gains, which undermines investment, productivity and economic growth.

The Ralph Review of Business Taxation in 1999 was strongly influenced by these incentive and economic efficiency effects in favouring a 50% discount.

(ii) Bunching of realised capital gains

The practice of taxing realised rather than accruing capital gains, while being of benefit to taxpayers as discussed above, also imposes a cost in that realised gains are bunched and may push the taxpayer into a higher marginal rate bracket than they would be in had the gains been taxed annually on accrual. This can be addressed by an averaging provision such as

applied up to 1999, but an alternative approach is to apply a discount to full taxation of the actual gains.

(iii) The lock-in effect

Taxation of gains on a realised basis provides an incentive for taxpayers to hold on to assets without realising gains. It locks them in to assets that would otherwise be sold. On this view, capital gains tax is essentially a tax on asset turnover, and therefore turnover will be reduced. This results in an inefficiency in capital markets if it results in investors holding assets where the rate of return is below what could otherwise be obtained.

Others see the lock-in effect as a benefit as it discourages short-term trading and speculation. However, short-term trading has a positive role to play in an efficient capital market. If there is such a thing as 'good' and 'bad' short-term trading, it is difficult to make the distinction in practice.

(iv) CGT as double taxation

It is sometimes stated that CGT represents 'double taxation' in the sense that capital gains are taxed at two levels. This can happen if the capital gain in shares reflects a company's earnings that have been both taxed as corporate income and retained thereby boosting the value of the equity. This is similar to the 'double taxation' of dividends at both the company and shareholder level, which provides a case for dividend tax relief such as the imputation system. The same case can be made for capital gains tax relief on realised gains from company shares.

Summing up

There is much more to CGT policy than how to adjust for inflation. If it were just that, then the most sensible change would be to revert to the pre-1999 indexation system and accept its greater complexity. As discussed in the preceding section, there are many relevant considerations apart from inflation. These work both ways, but on balance they favour some degree of concession in taxation of capital gains.

Discounting is a better way to reflect all the relevant considerations than indexation and has the additional advantage of simplicity. Alternatively, discounting could be combined with indexation, with the latter being applied to calculate real capital gains and then a discount, much smaller than the current discount, applied to those gains.

Determining the appropriate size of any discount is more judgement than science. However, the starting point is the extent to which the discount at least

removes the purely inflationary component from taxable capital gains.

A 25% discount fails that test as it falls short of full compensation at all nominal capital gains below 10% per annum — which would be most capital gain events. It would over-compensate at higher rates of capital gain, but on balance it would be more onerous than the indexation regime that applied from 1985 to 1999 — and therefore the most burdensome CGT regime Australia has ever had.

The existing 50% discount achieves full compensation for inflation at a much lower threshold rate of nominal capital gain — namely 5% per annum — and gives greater recognition to the other reasons for concessionality.

A case could be made for a somewhat lower discount — such as the 40% recommended by the Henry review — but it should not go as low as 25%.

It is clear that any percentage discount provides a greater degree of concessionality, relative to indexation, the higher the rate of capital gain. This was illustrated in Figure 2. In this way, the discount system provides a built-in incentive for investors to make assets work harder and maximise the real rate of return. In addition, the realisation basis of CGT provides a built-in incentive to hold assets for longer. Many would consider these to be desirable features of any CGT.

The size of any discount should also have regard to the level of the standard tax rates to be discounted. The lower they are, the smaller the discount needs to be to achieve an appropriately low rate of CGT. However, while personal income tax thresholds have

been increased substantially since the 50% discount was introduced in 1999, marginal tax rates have not changed greatly. For example, the top marginal rate has only been reduced from 48.5% to 47%, meaning that the top effective CGT rate has fallen insignificantly from 24.25% to 23.5%. This alone is not a justification for reducing the size of the discount.

A reduced discount would be understandable if it were accompanied by substantial reductions in marginal rates. However, Labor's policy is not only to halve the discount but also to increase the top marginal rate while other marginal rates remain unchanged. With both the lower discount and the increased marginal rate, the effective top rate of CGT would rise from 23.5% to 36.75% — an increase of 56.4%.

Revenue considerations

Revenue gain is the primary motivation for increasing CGT. In 2015-16, CGT from all sources (companies, individuals, trusts and funds) was \$11 billion, or 3% of total Commonwealth tax revenue. Labor's policy of halving the discount applies only to individuals, who contributed \$6.5 billion in 2015-16.

According to Treasury's Tax Expenditures Statement, the discount for individuals and trusts resulted in foregone revenue of around \$8 billion in 2015-16.¹¹ (This excludes the CGT exemption for principal place of residence.) However, this does not mean that halving the discount would generate an extra \$4 billion a year. Potential revenue gain is different from revenue foregone, as the gain is affected by the behavioural response of taxpayers, which could be substantial in the case of CGT.

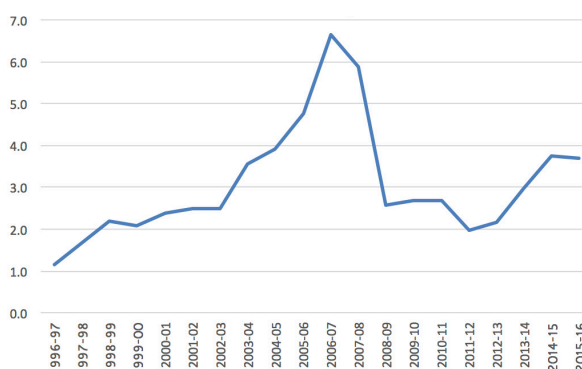
Elsewhere, Treasury has estimated that Labor's policy would add around \$2 billion a year to revenue in 2017-18 terms.¹²

Figure 3 shows the history of CGT revenue from individual taxpayers. Such revenue was never more than 2.2% of personal income tax revenue before the 50% discount was introduced, and then averaged 3.7% in the 2000s before slipping back to 2.9% so far in the 2010s. Interestingly, the adoption of the 50% discount in 1999 seems to have had no observable effect on revenue. If anything, CGT revenue has been stronger since the 50% discount than before it.

There could be a number of reasons for this. One is that the system is still maturing, with a diminishing proportion of asset sales enjoying pre-CGT grandfathering. While this may explain some of the revenue growth in the 1990s and 2000s, it is a stretch to say the system is still maturing now — 33 years since assets were grandfathered.

Another explanation could be that CGT revenue benefitted from buoyancy in prices of shares and real

Figure 3: CGT revenue as % of total income tax revenue, individuals



estate after 1999, leaving aside the share market crash of 2008-09 that depressed CGT revenue for a number of years as realised losses ballooned and were used to offset realised gains. More recently, CGT revenue has returned to a more normal level. Asset market volatility translates into CGT revenue volatility, obscures trends and underlying levels of revenue, and makes comparisons over time difficult.

However, another reason CGT revenue held up after the 50% discount was introduced is that it stimulated asset turnover and realisation of capital gains. The lock-in effect discussed above was loosened, and gains that would not have been realised under the indexation regime were realised under the discount regime; thereby negating some of the loss of revenue.

This is relevant to consideration of how much revenue a halving of the discount would generate. It is not clear what assumptions the Treasury estimate is based on. However, as halving the discount would tighten the lock-in effect, there is potential for a large reduction in turnover and realisation that would be self-defeating from the viewpoint of revenue gain.

Conclusion

Halving the CGT discount would represent a 50% increase in the CGT and result in a more burdensome CGT than Australia had before the 50% discount replaced cost base indexation in 1999.

If the objective of changing the CGT is to compensate for inflation, no flat percentage discount will achieve it other than by chance; and a 25% discount will not be sufficient to achieve it in many cases. Even the 50% discount fails to achieve it if the rate of nominal capital gain on an asset is less than twice the rate of inflation.

Inflation compensation would be better achieved by returning to the cost base indexation system that applied up to 1999.

However, there are many justifications for a concessional CGT other than compensating for inflation, and those reasons are being overlooked in the current debate sparked by Labor's proposal to halve the discount. A flat percentage discount is a simple design and should be thought of as a rough and approximate way to recognise all the reasons for a concessional CGT.

Rather than halve the discount, it would be better to either:

- Retain the 50% discount, OR
- Restore cost base indexation and apply a smaller discount (say 10 – 20%) to real gains.

Endnotes

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Robert Carling is a Senior Fellow at the Centre for Independent Studies, an independent public policy research and educational institute based in Sydney. He undertakes research into a wide range of public finance issues and regularly comments in the media on taxation and other budget issues. Before joining the CIS, he was a senior official with the New South Wales Treasury and before that, with the Commonwealth Treasury.

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