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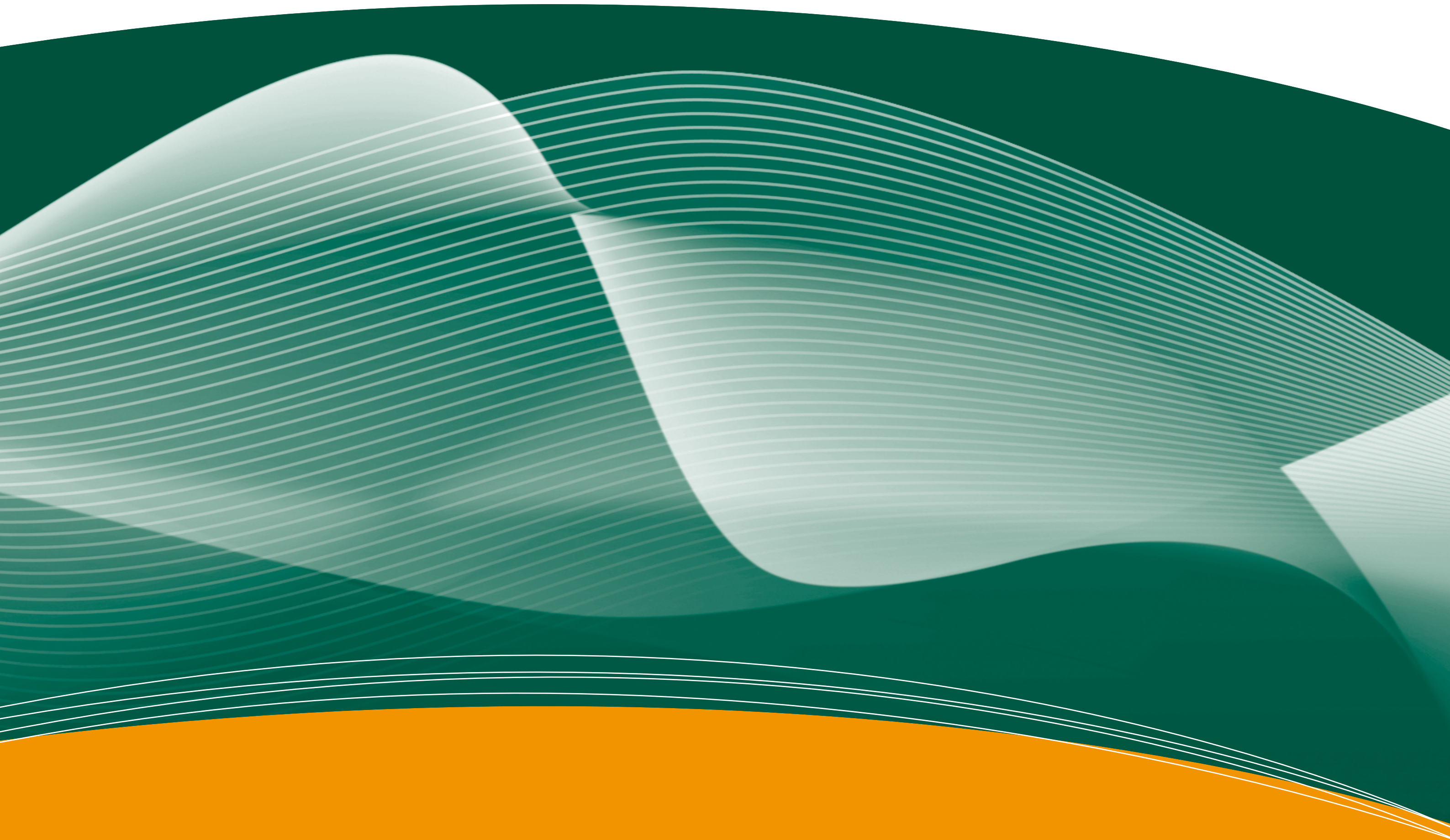
Reforming Capital Gains Tax: The Myths and Reality behind Australia's Most Misunderstood Tax

Stephen Kirchner



Perspectives on Tax Reform (19)

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Executive Summary

- Capital gains tax (CGT) has been a feature of the Australian tax system since 1985. The reforms instituted by the Ralph Business Taxation Review in 1999 sought to alleviate one of the world's highest capital gains tax burdens that resulted from Australia's then internationally anomalous taxation of capital gains at the same rates as ordinary income. The Ralph review recognised that an improved capital gains tax regime was needed to stimulate saving, investment and economic growth.

- However, the Ralph reforms left an ambiguous legacy in terms of overall tax burden on capital gains. While the 50% CGT discount for individuals is widely thought to have halved the effective marginal tax rate on capital gains, it has been less widely acknowledged that the abolition of inflation indexation *raises* the marginal tax rate when capital gains are less than twice the rate of inflation. The implications of the Ralph CGT reforms vary widely depending on the type of taxpayer, asset class, and inflation environment.

- The review of the tax system by Treasury Secretary Ken Henry (the Henry review) has identified Australia's relatively high tax burden on capital as a priority for further reform. It remains to be seen how and to what extent the Henry review proposes to alleviate the tax burden on capital when it reports in March 2010. Given the constraints under which the Henry review is being conducted, any further reform of capital gains tax is likely to reflect new trade-offs made as part of reforms to the overall tax system. There is a risk that the review may see some backsliding on the Ralph CGT reforms.

- Further reform of CGT should instead seek to build on the Ralph reforms by extending the current concessional treatment of capital gains tax. Given the scope for substantial gains in economic efficiency, as well as dynamic revenue gains from an expansion of the tax base that would offset any static revenue losses, further reform of CGT should be viewed as a priority for the tax reform process.

- The economic case for taxing capital gains is widely acknowledged to be weak, even by supporters. CGT raises little revenue, but at a substantial cost in terms of economic welfare. The case for taxing capital gains rests almost entirely on equity considerations.

- Growth in CGT realisations and revenue from individuals and funds since 1999 has outstripped that from companies, which did not benefit from a discount under the Ralph reforms. Individuals received a larger discount than funds (50% versus 33%), yet CGT revenue collected from the former has exceeded growth in the latter. The CGT share of Commonwealth tax revenue has nearly doubled since the Ralph reforms, from 3.4% to 6.6%. The data suggest that the Ralph reforms have seen more CGT revenue being collected, not less. This is consistent with international evidence on the responsiveness of capital gains realisations and tax revenue to changes in the CGT rate and predictions made a decade ago by those who advocated reform of Australia's CGT regime.

- In conjunction with negative gearing of investment property, the principal residence exemption from CGT and the Ralph capital gains tax discount are widely seen as skewing saving and investment decisions in favour of housing and putting upward pressure on house prices. Critics of capital gains tax concessions have focused on the short-term demand-side implications of this tax treatment, while ignoring the implications for long-run housing supply.

- Looking through the regular cyclical fluctuations in housing activity, the dwelling investment share of GDP has been little changed on average over the post-War period under three different CGT regimes (pre-September 1985, post-September 1985, and post-September1999). However, this investment is yielding fewer new dwelling units per person than at any time

since the late 1960s due to increased constraints on the supply of new housing. The result has been upward pressure on house prices and rents and reduced housing affordability. The solution to this housing affordability problem is not to impose new taxes on housing but to alleviate the supply-side impediments to the construction of new homes.

- Options for further reform include a flat tax rate for capital gains, the abolition of minimum holding periods for concessional tax treatment, and the reinstatement of the indexation of capital gains for inflation.

Introduction

> The crucial issue about the capital gains tax is not its revenue-raising capacity. I think it is a very poor tax for that purpose. Indeed, its major impact is to impede entrepreneurial activity and capital formation. While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero.
>
> *—Alan Greenspan, testimony before the US Senate Banking Committee, 25 February 1997* [1]

Capital gains tax (CGT) has been a feature of the Australian tax system since 1985. While there is still widespread support for a CGT as a part of this system, there is also persistent dissatisfaction with its operation. The reforms instituted by the Ralph Business Taxation Review in 1999 sought to alleviate one of the world's highest capital gains tax burdens that resulted from Australia's then internationally anomalous taxation of capital gains at the same rates as ordinary income. The Ralph review recognised that an improved capital gains tax regime was needed to stimulate saving, investment and economic growth.[2]

However, the revenue-neutrality constraint under which the Ralph reforms were implemented traded off the former averaging and inflation indexation provisions for the introduction of CGT discounts for individuals and funds, among other changes. The Ralph reforms left an ambiguous legacy in terms of overall tax burden on capital gains. While the 50% CGT discount for individuals is widely thought to have halved the effective marginal tax rate on capital gains, it has been less widely acknowledged that the abolition of inflation indexation *raises* the marginal tax rate when capital gains are less than twice the rate of inflation. The implications of the Ralph CGT reforms vary widely depending on the type of taxpayer, asset class, and inflation environment.

The review of the tax system currently being undertaken by Treasury Secretary Ken Henry (the Henry review) has identified Australia's relatively high tax burden on capital as a priority for further reform. It remains to be seen how and to what extent the Henry review proposes to alleviate the tax burden on capital when it reports in March 2010. Given the constraints under which the Henry review is being conducted, any further reform of capital gains tax is likely to reflect new trade-offs made as part of reforms to the overall tax system. There is a risk that the review may see some backsliding on the Ralph CGT reforms. There has been speculation the review might propose an increase in the effective tax rate on capital gains[3] or an extension of the tax to include owner-occupied housing[4] as part of an effort to address anomalies in the tax treatment of different saving vehicles highlighted by the review.

The review of the tax system currently being undertaken by Treasury Secretary Ken Henry (the Henry review) has identified Australia's relatively high tax burden on capital as a priority for further reform.

This paper argues that any further reform of CGT should instead seek to build on the Ralph reforms by extending the current concessional treatment of capital gains tax. The paper does not seek to reconcile this proposal with broader demands for tax reform or the constraints imposed on the Henry review. However, given the scope for substantial gains in economic efficiency, as well as dynamic revenue gains from an expansion of the tax base that would offset any static revenue losses, further reform of CGT should be viewed as a priority for the tax reform process.

The paper begins by considering the rationale for taxing capital gains. The economic case for taxing capital gains is widely acknowledged to be weak, even by supporters. CGT raises little revenue but comes at a substantial cost in terms of economic welfare. The case for taxing capital gains rests almost entirely on equity considerations. In particular, it is commonly assumed that the absence of capital gains tax affords opportunities for tax avoidance by converting income into capital gains, particularly on the part of wealthy taxpayers. However, this problem is asserted far more frequently than it is demonstrated. Moreover, it ignores the fact that CGT is itself readily avoided in a manner that is harmful to economic efficiency. The preoccupation with preventing

avoidance ignores the significant costs arising from CGT that ultimately harm the ability of the tax and transfer system to satisfy equity objectives.

The second section examines some of the data on capital gains tax in Australia. The pre- and post-Ralph CGT regimes are compared to the tax treatment of capital gains in other countries. Capital gains are added to ordinary income on a realisation basis and then taxed at marginal rates after concessions and discounts. Since taxpayers can chose the timing of the realisation, the effective marginal tax rate on capital gains in Australia is to some extent a matter of choice (technically, the effective marginal tax rate is endogenously determined). This makes it very difficult to isolate and estimate the effects of the Ralph reforms on CGT realisations and revenue. However, growth in CGT realisations and revenue from individuals and funds since 1999 has outstripped that from companies, which did not benefit from a discount under the Ralph reforms. Individuals received a larger discount than funds (50% versus 33%), yet CGT revenue collected from the former has exceeded growth in the latter. The CGT share of Commonwealth tax revenue has nearly doubled since the Ralph reforms, from 3.4% to 6.6%. The data suggest that the Ralph reforms have seen more CGT revenue being collected, not less. This is consistent with international evidence on the responsiveness of capital gains realisations and tax revenue to changes in the CGT rate and predictions made a decade ago by those who advocated reform of Australia's CGT regime.

The third section considers the relationship between capital gains tax and investment in housing. In conjunction with negative gearing of investment property, the principal residence exemption from CGT and the Ralph capital gains tax discount are widely seen as skewing saving and investment decisions in favour of housing and putting upward pressure on house prices. Critics of capital gains tax concessions have focused on the short-term demand-side implications of this tax treatment while ignoring the implications for long-run housing supply. Looking through the regular cyclical fluctuations in housing activity, the dwelling investment share of GDP has been little changed on average over the post-War period under three different CGT regimes (pre-September 1985, post-September 1985, and post-September1999). However, this investment is yielding fewer new dwelling units per person than at any time since the late 1960s due to increased constraints on the supply of new housing. The result has been upward pressure on house prices and rents and reduced housing affordability. The solution to this housing affordability problem is not to impose new taxes on housing but to alleviate the supply-side impediments to the construction of new homes.

In addition to equity considerations, much of the support for CGT is based on hostility to speculation and speculative gain, which is often portrayed as being somehow 'undeserved' rather than the hard-earned return to saving and investment. The fourth section argues that all saving and investment is inherently speculative. Speculation is essential to the efficient allocation of capital, and the tax system should reward rather than penalise the entrepreneurial search for capital gain. There is thus no reason for the tax system to favour longer-term investments over shorter-term 'speculative gains.' There is no economic basis for minimal holding periods before qualifying for concessional CGT treatment.

Even where the optimal tax literature identifies potential departures from the general case against capital taxation, there is still no basis for concluding that labour income and capital income should be taxed at the same rates.

The fifth section argues for further reform of capital gains tax, building on the approach taken by the Ralph reforms a decade ago. Reform options include a flat tax rate for capital gains, the abolition of minimum holding periods for concessional tax treatment, and the reinstatement of the indexation of capital gains for inflation.

Why tax capital gains?

As the Henry review process has noted, the literature on optimal taxation (how to raise revenue at the lowest economic cost) argues that capital income should not be taxed because it distorts the choice between current and future consumption, reducing saving and investment. The burden of capital taxation in a small, open economy like Australia's generally falls on saving rather than investment, with foreign capital inflows taking the place of any reduction in domestic saving,

leaving domestic investment unchanged.[5] Even where the optimal tax literature identifies potential departures from the general case against capital taxation, there is still no basis in this literature for concluding that labour income and capital income should be taxed at the same rates.[6]

The excess burden of a tax is the economic activity lost as a result of the tax and increases in proportion to the square of the tax rate. As tax rates increase, the excess burden will rise faster than revenue raised. The full economic burden of a tax needs to take account of these efficiency costs, which may exceed the amount of revenue raised.[7] The greater mobility of capital compared to labour results in a larger dead-weight loss (or excess burden) from taxes on capital than labour. Before the Ralph reforms were introduced in 1999, Diewert and Lawrence estimated the dead-weight loss of capital taxation in Australia as being as high as 48 cents for every dollar of revenue raised. These efficiency losses point to the scope for dynamic revenue gains from reductions in capital taxation that would offset static revenue losses through an expansion of the economy and the tax base. The dead-weight losses from capital taxation can also be thought of as the economy-wide rate of return that could be expected from a reduction in government spending that in turn funded a reduction in capital taxation.[8]

Capital gains are taxed on a realisation basis, giving an incentive for the owners of taxable assets to hold on to them to avoid paying the tax rather than selling them to those who value them more highly. This 'lock-in' effect results in a less efficient allocation of the capital stock, reducing productivity and economic growth. Reducing or eliminating capital gains tax unlocks these unrealised capital gains. In principle, it would be possible to tax capital gains on an accrual rather than a realisation basis, alleviating the lock-in effect. In practice, taxing capital gains on an accrual basis is likely to add to the complexity of CGT so that the net welfare gains from moving to accrual-based system for CGT are ambiguous. As even its advocates concede, there is no international consensus on what capital gains are or how they should be taxed, making for unavoidable complexity in the administration of the tax. The relevant provisions of the pre-1998 Australian legislation were described as an 'incoherent mess.' Even following its rewrite in the late 1990s, the 500 pages of CGT legislation in the *Income Tax Assessment Act 1997* defined 39 separate CGT events, each with its own set of provisions.[9] The inherent complexity of capital gains taxation is one of the reasons it is particularly inefficient at raising revenue.

Capital gains are taxed on a realisation basis, giving an incentive for the owners of taxable assets to hold on to them to avoid paying the tax.

Estimating the responsiveness (or elasticity) of capital gains tax realisations and revenue to the tax rate on capital gains is fraught with difficulty. The empirical literature on this question has produced mixed results.[10] However, experience with CGT abroad suggests that higher capital gains taxes are self-defeating as a revenue raiser and that lowering tax rates on capital gains can be positive for CGT revenue and the broader tax base.[11] In the case of the United States, Moore and Kerpen note that 'over the past 30 years, a consistent pattern has emerged: every time the capital gains tax has been cut, capital gains tax revenues have risen. Every time the capital gains tax has been raised, capital gains tax revenues have fallen.'[12] As we shall see, the Ralph reforms in Australia also point to revenue gains from lowering the effective tax rate on capital gains.

The rationale for taxing capital gains is based on the Haig-Simons view that the tax base should incorporate the broadest possible definition of income, including additions to real net worth.[13] The Haig-Simons view is based on notions of equity rather than efficiency and has its basis in legal rather than economic reasoning. The Haig-Simons conception of the tax base is motivated by considerations of both horizontal and vertical equity. Horizontal equity maintains that all income, including additions to net worth, should receive much the same tax treatment, regardless of how it is derived (or more simplistically, that 'a buck is a buck'). However, as Treasury Secretary Ken Henry has noted, 'the logic of income from all sources … being subject to a common progressive tax schedule is now widely accepted to be flawed.'[14] The comprehensive income view ignores the fact that saving and investment takes place out of after-tax income. Taxing capital gains arising from saving and investment amounts to double-taxation. Since an asset's capital value is the discounted value of its future income stream, the returns to the asset are taxed twice. CGT is applied to the disposal of an asset, while the yield of an asset is also taxed as ordinary income.

This double-taxation not only discourages saving but rewards the accumulation of debt because debt reduces the additions to net worth the Haig-Simons concept of income seeks to tax.

The returns to human capital (wages and salaries), by contrast, are taxed only once. As Grubel suggests, one could adapt the argument often made against capital gains tax concessions to make a case that the relatively favourable tax treatment of ordinary income encourages overinvestment in human capital at the expense of financial and other capital.[15] Investments in human capital seem to enjoy much better public relations, so the relatively favourable tax treatment extended to the returns to human capital compared to financial and other capital is seldom questioned.

The Australian tax system provides relief from double taxation in the form of dividend imputation credits for company tax, but this principle has not been recognised in the case of CGT. Retained corporate earnings are also taxed twice by Australia's tax system: first as company profits and then as capital gains in the hands of shareholders. Capital losses are not treated symmetrically with capital gains, with the latter added to ordinary income for tax purposes, while the former can only be offset against other capital gains. While this is designed to prevent some forms of tax arbitrage, this is one of the ways in which capital gains are treated differently to ordinary income, contrary to the notion of horizontal equity that is supposed to underpin the Haig-Simons view of income. Few developed countries tax capital gains at the same rate as ordinary income, an anomaly in Australia's tax system the Ralph review sought to remedy. Even the pre-Ralph regime CGT was concessional in taxing only real capital gains and its use of averaging provisions. Yet there is still support among many commentators for reinstating the pre-Ralph regime, which gave Australia some of the world's highest rates of tax on capital gains.

CGT is also motivated by considerations of vertical equity, the view that the wealthy should pay proportionally more tax. There is a widespread belief that the failure to tax capital gains would provide wealthy taxpayers with the opportunity to convert ordinary income into capital gains and thereby avoid tax. As even the advocates of CGT readily concede 'the essential role of the CGT is not therefore to raise revenue. It is to act as a "backstop" to the income tax system—to act as an integrity measure.'[16] The 1985 Draft White Paper on the Reform of the Australian Tax System (RATS) that paved the way for the introduction of CGT argued that the absence of a CGT was 'at the core of many avoidance arrangements.'[17] Yet no estimates have ever been made of the additional revenue this anti-avoidance measure is supposed to have captured.[18]

The incentive to convert income into capital gains does not necessarily translate into the ability to do so.

The incentive to convert income into capital gains does not necessarily translate into the ability to do so and the opportunity for avoidance via this mechanism is asserted far more often than it is demonstrated. As economist Jude Wanniski recounted, 'Alan Greenspan … told me he had spent decades trying to figure out how to convert ordinary income to capital gains and couldn't figure out how to do it.'[19] CGT is itself a largely voluntary tax that is easily avoided by not realising the gain. Reductions in capital gains tax generally yield increases in tax revenue because of an increase in realisations—in other words, a reduction in tax avoidance. To the extent that lower rates of CGT induce increased realisations that would otherwise go untaxed, this results in more revenue being collected from wealthy taxpayers, not less. Reductions in CGT are also likely to lead to an expansion in the tax base. Tax avoidance schemes are the result of high marginal tax rates that make such schemes economic, such as the punitive 60% top marginal rate that prevailed in 1985 for incomes above $35,000 (around $82,000 in today's dollars). The best way to render tax avoidance schemes uneconomic is to lower existing tax rates rather than erecting a wider tax net.

Capital gains tax concessions are often condemned as 'subsidies' to the rich. Just as high income earners benefit more in absolute terms from reductions in income tax, it should not come as a surprise that those who do the most saving and investing will benefit more in absolute terms from capital gains concessions. It is widely recognised that the labour supply decisions of taxpayers are influenced by income tax rates, but this is also true of saving and investment behaviour. The size and distribution of so-called 'tax expenditures' on capital gains tax concessions are not independent of the tax rates that are applied to saving and investment. Reductions in these 'tax expenditures' are likely to come at the expense of saving and investment and ultimately harm the ability of the tax and expenditure system to serve equity objectives.

CGT harms equity in other ways. To the extent that CGT hinders capital formation, it may lower Australia's capital-labour ratio and reduce long-run productivity growth. Since productivity growth is the main determinant of sustainable real wages growth, the incidence of CGT falls on both labour as well as capital. The final economic incidence of the tax is likely to be very different from its first-round statutory incidence.

Capital gains tax in Australia

Australia has the highest reliance on capital taxation in the OECD, with around 33% of all tax revenue derived from taxes on capital income, including CGT. The overall tax burden on capital is around 11% of GDP, the fourth highest in the OECD. By contrast, the tax burden on labour is 12% of GDP, the fourth lowest in the OECD.[20] In 2006–07, CGT raised $17.3 billion, a modest 6.6% share of total Commonwealth tax revenue. However, this is a significant increase on the $4.6 billion in CGT raised in 1998–99, the year before the Ralph reforms, when CGT amounted to only 3.3% of Commonwealth tax revenue.

The pre-Ralph CGT regime imposed one of the highest effective tax rates on the disposal of shares among developed countries.[21] Australia was one of the few countries in the world to tax capital gains at the same rate as ordinary income. The post-Ralph regime resulted in an improvement in international competitiveness but still left Australia with a relatively high tax burden on capital gains, particularly compared to those countries without a general capital gains tax.[22] Figures 1 and 2 are based on a representative CGT event, namely the acquisition and disposal of shares, under assumptions specified by Wyatt, Phillips and de Lange.[23] They show average tax rates for high and low income earners in a range of countries, including Australia under the pre- and post-Ralph regimes.

Figure 1

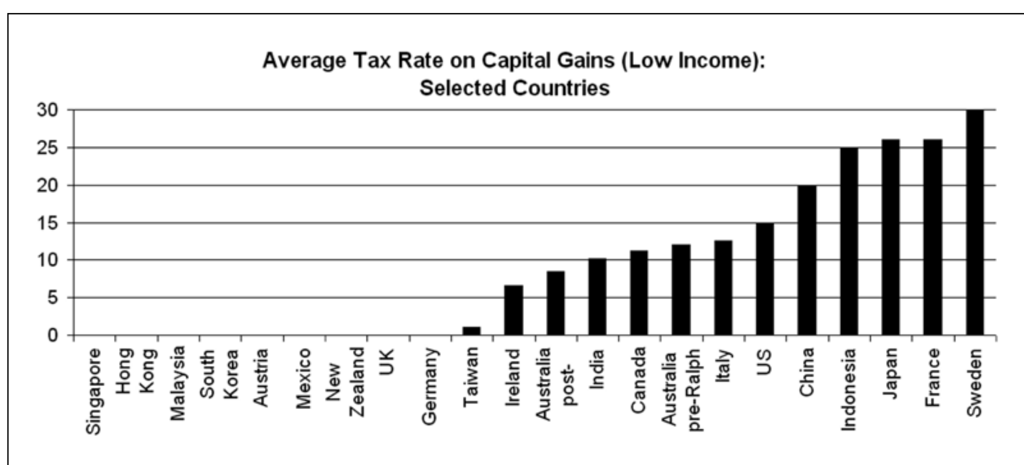
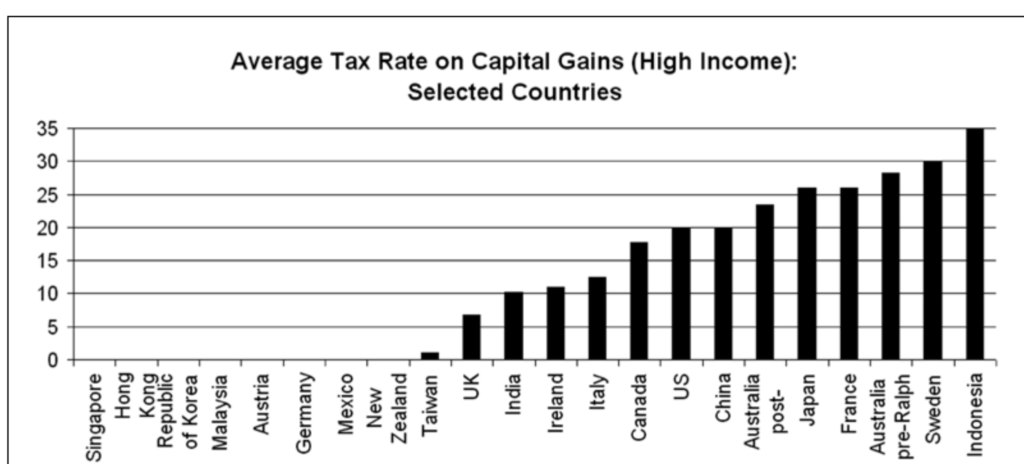


Figure 2



Source: Wyatt, Phillips and de Lange (2003).

A number of countries, including New Zealand, Singapore and Hong Kong, have no general capital gains tax regime and so are shown with a zero average tax rate. Concessional tax treatment also yields a zero tax rate for some countries under the assumptions used by the authors (e.g. Germany). The Ralph reforms improved the international competitiveness of Australia's CGT regime but still left Australia with a relatively high tax burden on capital gains. This was partly a function of high marginal income tax rates that have also been reduced since 2003.

The implications of the Ralph reforms for the CGT tax burden vary across different taxpayers, asset classes, and inflation environments.

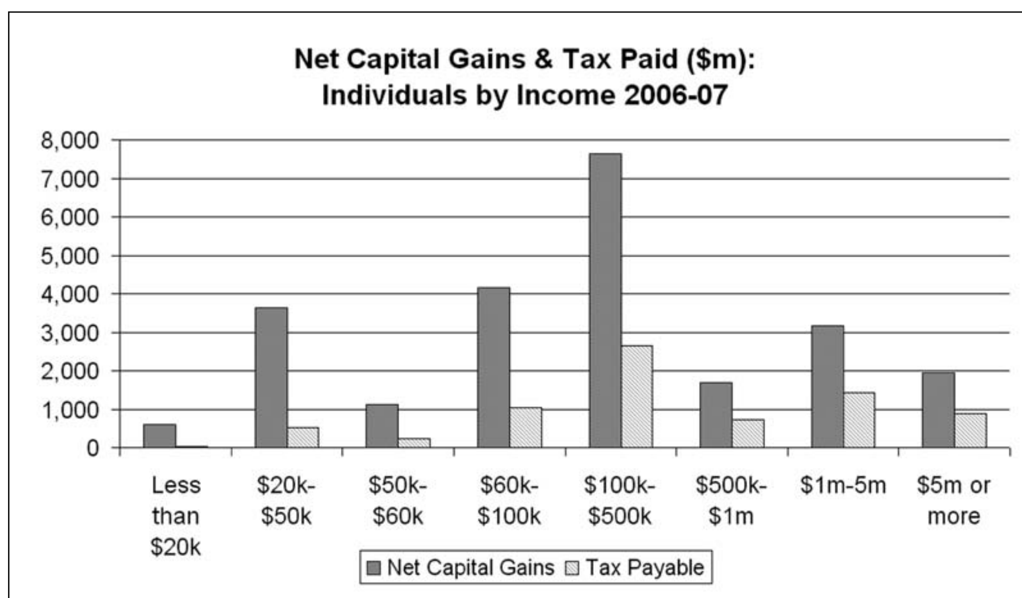
However, the implications of the Ralph reforms for the CGT tax burden vary across different taxpayers, asset classes, and inflation environments. CGT is not paid by foreign portfolio investors, but it does apply to foreign direct investment (FDI) in Australia. The Henry tax review has noted the very high responsiveness (or elasticity) of FDI to the tax burden in a world of highly mobile capital.[24] Australia's relatively high tax burden on capital gains, together with its relatively restrictive regulatory regime for FDI, helps explain Australia's chronic underperformance in attracting foreign direct investment and its over-reliance on potentially volatile short-term portfolio flows to finance the shortfall between domestic investment and saving (the current account deficit).[25] The recent financial crisis points to some of the risks associated with being overly reliant on short-term portfolio inflows to fund domestic investment.

The Ralph reforms traded-off the former averaging and inflation indexation provisions for a 50% CGT discount for individuals and 33% for funds, but not for companies. While these discounts are widely thought to have reduced by half the effective marginal tax rate on capital gains for individuals, it has been less widely acknowledged that the abolition of indexation raised the marginal tax rate when capital gains are less than twice the rate of inflation.

Capital gains in Australia are taxed on a realisation basis and added to ordinary income to be taxed at marginal tax rates after the application of concessions and discounts. The marginal tax rate on taxable capital gains is notionally the taxpayer's top marginal income tax rate, but because taxpayers can choose the timing of any realisation, they can also choose their effective tax rate (technically speaking, the effective marginal tax rate faced by taxpayers is endogenously determined). As already noted, taxpayers can defer realisation until income is temporarily lower. Together with frequent changes in statutory income tax rates on overall income, this makes it difficult to isolate the effects of exogenous changes in tax rates on realisations and revenue from the behavioural responses of taxpayers.

Net capital gains and CGT paid by individuals in different income brackets are shown in Figure 3 for the 2006–07 tax year.

Figure 3



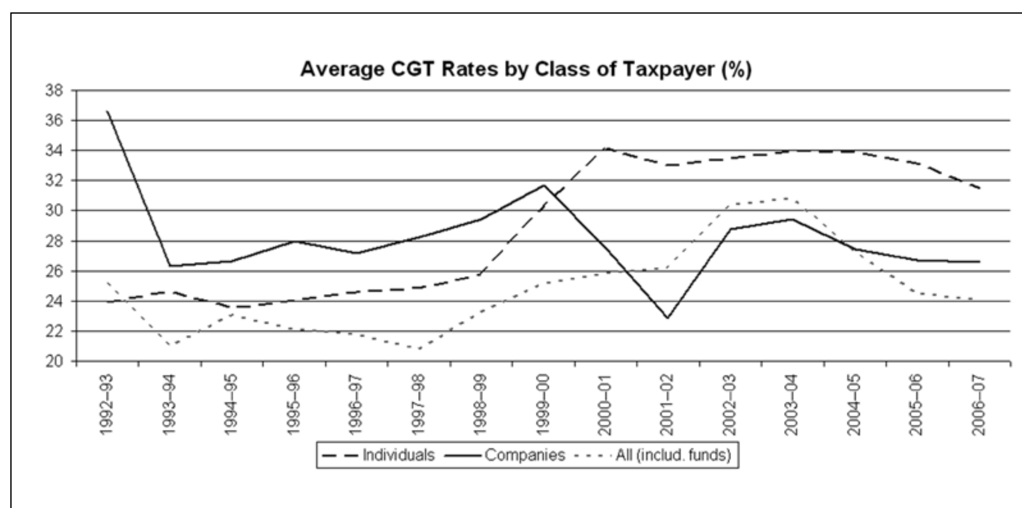
Source: Australian Taxation Office, *Taxation Statistics, 2006–07*.

CGT revenue from individuals seemingly mirrors the progressivity of the income tax, with those earning more than $100,000 paying 75% of CGT, despite being responsible for only 57% of net capital gains, based on the 2006–07 tax year. However, one-off CGT realisations can temporarily place low income earners in higher income and tax brackets so these data understate the tax burden on low income taxpayers (this 'bunching' problem was less pronounced under the pre-Ralph averaging provisions). By the same token, wealthier taxpayers are likely to defer realisations until years in which income is temporarily low or until retirement. The distribution of capital gains and tax paid across income brackets can thus be misleading as to the progressivity of CGT. The fact that one-off realisations can place individuals in higher tax brackets is one source of the so-called 'lock-in' effect. This effect could be reduced by applying a flat tax rate to capital gains. Like stamp duty, the application of CGT on a realisation basis acts as a transactions tax that reduces both economic efficiency and revenue collected.

The fact that one-off realisations can place individuals in higher tax brackets is one source of the so-called 'lock-in' effect.

Australian Taxation Office (ATO) data on CGT realisations and tax paid make it possible to calculate average tax rates on capital gains for individuals and companies, as shown in Figure 4 ('all taxpayers' includes funds).

Figure 4

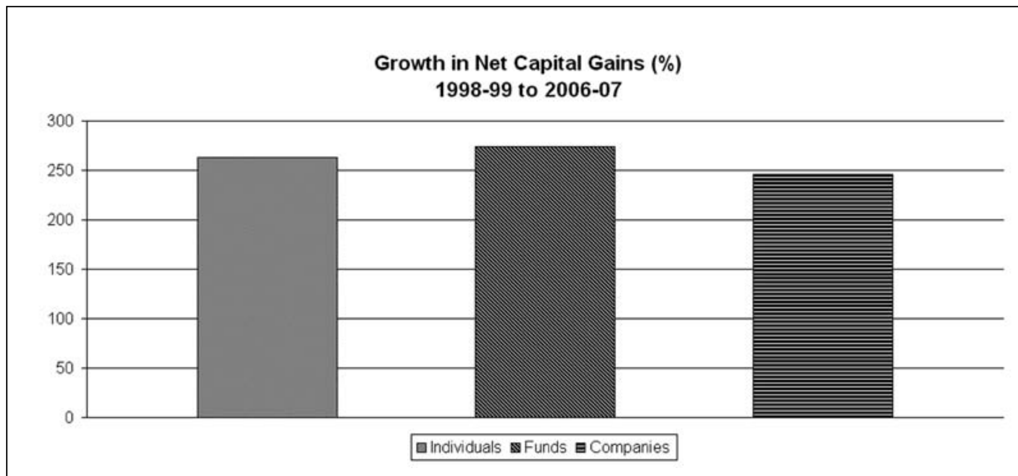


Source: Australian Taxation Office, *Taxation Statistics, 2006–07*.

Changes in the average tax rate over time reflect changes in CGT realisations and their distribution across different income tax brackets, as well as changes in both the CGT and broader tax regime. The average tax rates implied by these data for individuals are well below the top marginal rate applicable to individuals, which belies the progressivity suggested by the distribution across income groups shown in the previous Figure. This points to the diversion of the stock of taxable assets into the hands of those with lower tax rates, such as those with temporarily lower incomes and super funds.[26] CGT promotes rather than prevents tax avoidance through this 'tax clientele' effect.

Since the 1999 Ralph reforms, growth in net capital gains for individuals and funds has outstripped growth in net capital gains reported by companies, which were not discounted as a result of the reforms (Figure 5).

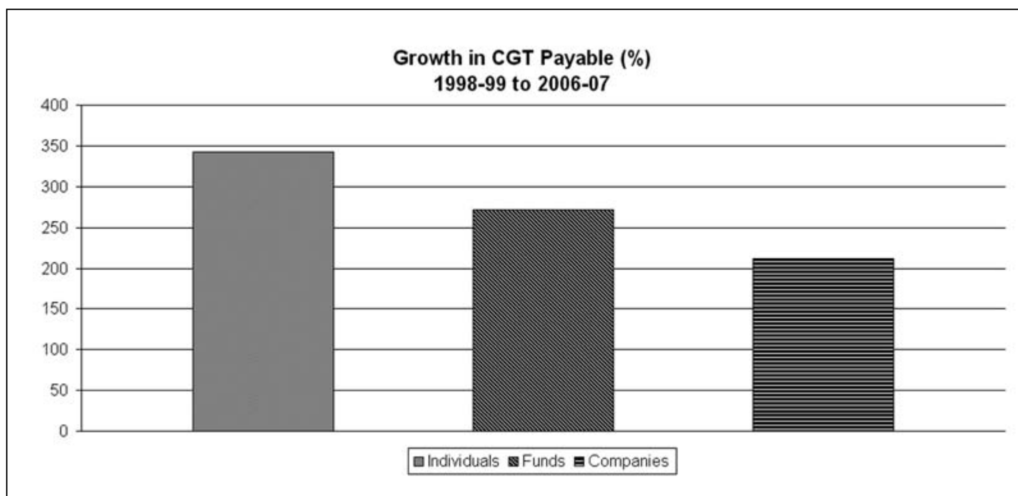
Figure 5



Source: Australian Taxation Office, *Taxation Statistics, 2006–07*.

The growth in realisations flowing from the post-1999 CGT discounts is reflected in the change in CGT payable by the three classes of taxpayers in the years since 1999. Growth in CGT revenue from individuals and funds has outstripped that paid by companies (Figure 6).

Figure 6



Source: Australian Taxation Office, *Taxation Statistics, 2006–07*.

It is noteworthy that individuals enjoyed a larger discount under the Ralph reforms than superannuation funds (50% versus 33%), yet yielded a larger increase in CGT payable. The reforms also saw a change in the relative importance of individuals and companies in overall CGT revenue. In 1998–99, individuals accounted for 37% of CGT paid, while companies accounted for 41%. By 2006–07, the share of CGT paid by individuals rose to 44%, while the share paid by companies fell to 34%. The share paid by funds was relatively steady. The Ralph review expected its CGT measures to generate an additional $350 million in revenue between 2000–01 and 2004–05.[27] While it is not possible to reliably estimate the contribution of the Ralph reforms compared to the counter-factual of no reform, it is worth noting that CGT payable increased by just over $3 billion over this period. The 2001–03 bear market in equities, which followed the introduction of the Ralph reforms in 1999, lowered CGT payable in the early part of this decade and was often misused by the media to claim that the Ralph CGT reforms had cost the government revenue.[28] A longer run of data across these stock price cycles makes clear this was not the case.

The Commonwealth Treasury's annual Tax Expenditures Statements under the Charter of Budget Honesty are frequently misreported as a measure of the revenue forgone as a result

of various CGT concessions, including the Ralph capital gains discount. For example, George Megalogenis has falsely claimed that 'The latest calculations from Treasury say the concession will cost taxpayers $6.87 billion in revenue forgone in 2007–08.'[29] As the Treasury makes clear, its approach to measuring tax expenditures does not measure revenue forgone. The methodology makes no allowance for changes in behaviour on the part of taxpayers in response to CGT or other tax concessions. To avoid double-counting, the Treasury includes the value of other CGT concessions in its estimates of the tax expenditures on the post-Ralph CGT discounts. This overstates the value of tax expenditures on the Ralph CGT discounts, while understating the value of other CGT concessions.[30]

The data point to a positive impact on CGT revenue from the Ralph reforms, consistent with overseas experience and some of the larger estimates of the elasticity of capital gains tax realisations and revenue with respect to the tax rate. Before the Ralph reforms were enacted, Alan Reynolds predicted that lowering CGT rates would 'raise much more revenue than current law, quite possibly twice as much in the long-run.'[31] In the event, the CGT share of Commonwealth tax revenue nearly doubled. Australia's pre-Ralph CGT regime would most likely have yielded less revenue had it remained in operation. However, the longer-run implications of the Ralph reforms may vary under future asset return and inflation environments.

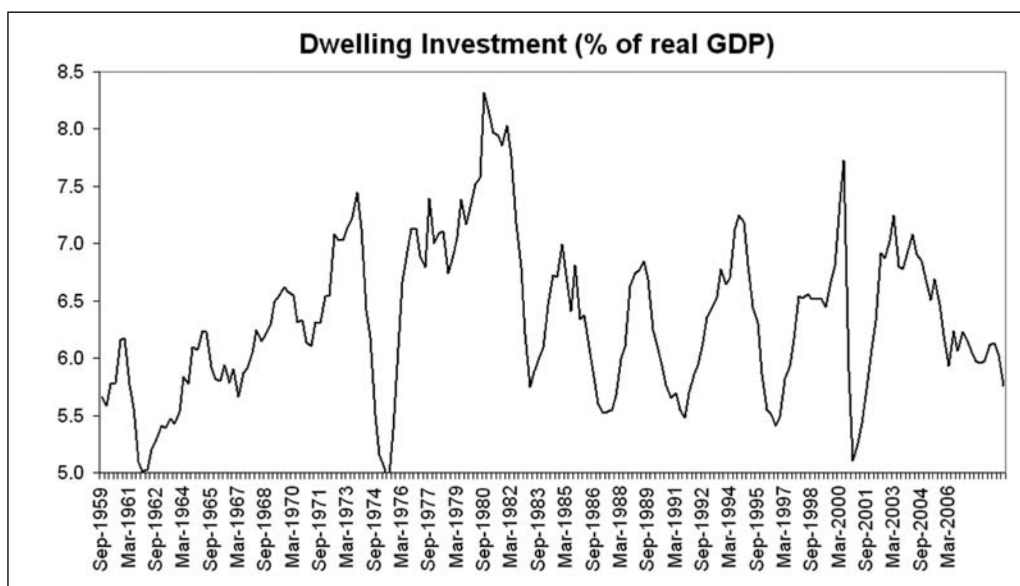
The data point to a positive impact on CGT revenue from the Ralph reforms.

Capital gains tax and housing

The principal residence exemption from CGT has long been blamed for skewing saving and investment decisions in favour of housing. It has long been suggested that Australia 'overinvests' in housing. It has also been suggested that the exemption is responsible for house price appreciation and reduced housing affordability.[32] While the value of the principal residence exemption and other CGT concessions is capitalised into the value of the housing stock (as with other taxable assets that benefit from concessional treatment), this is a one-off effect that does not explain ongoing price appreciation.

Continued house price inflation cannot co-exist with 'over-investment' in housing unless constraints on new housing supply prevent this investment expenditure from translating into additional dwelling units. The dwelling investment share of GDP has cycled around a mean of 6.3% for most of the post-War period. Neither the introduction of CGT in 1985 nor the Ralph reforms in 1999 has led to a fundamental change in the average contribution of dwelling investment to economic growth (see Figure 7).

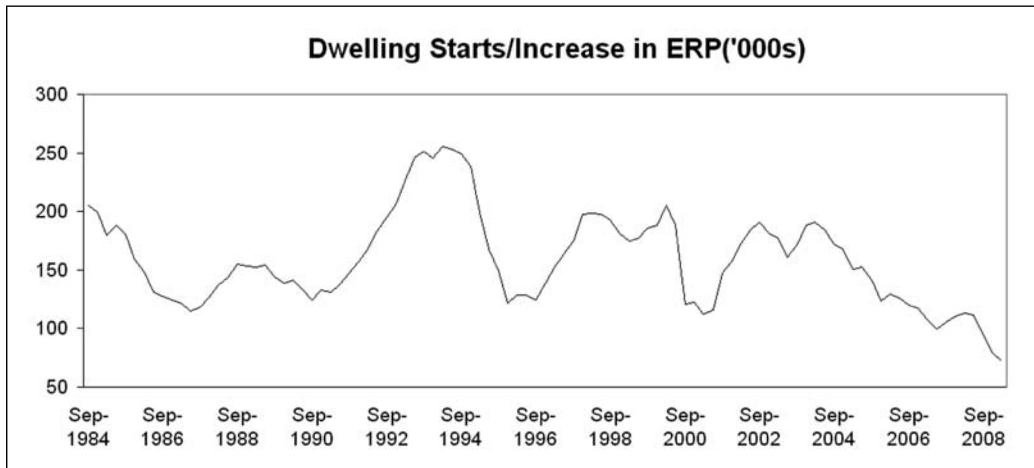
Figure 7



Source: Australian Bureau of Statistics

Unfortunately, this investment is yielding fewer dwelling units relative to the additional population that needs to be housed. In the March quarter 2009, Australia saw only 72 new dwelling commencements for every 1,000 persons added to the estimated resident population (ERP) (see Figure 8), the lowest ratio of commencements to the change in population for any quarter going back to 1984, the period for which we have comparable data. On a narrower measure of commencements and compared to the number rather than the change in the resident population, Australia is producing fewer dwelling units per person than at any time since the late 1960s.[33] While the dwelling investment share of GDP cycles around a stable mean, the ratio of dwelling starts to the estimated change in resident population shows evidence of steady decline.

Figure 8



Source: Australian Bureau of Statistics

Australia faces a growing shortage of dwelling stock due to what RBA Governor Glenn Stevens has called 'serious supply-side impediments' to building new homes.[34] It is these supply-side constraints that are putting upward pressure on house prices and inflation, not the concessional CGT treatment of housing. Increasing the CGT burden on housing by abolishing the principal residence exemption would only add to the supply-side constraints that have put upward pressures on house prices and rents. As a tax on transactions, CGT on owner-occupied housing would reduce further turnover in the housing stock and lead to a less efficient allocation of that stock. Analysis of the welfare consequences of capital gains tax concessions often ignores these supply-side effects. As John Freebairn has noted, the benefits of capital gains tax concessions 'fall primarily on the supply-side' of the housing market.[35] Yet he focuses only on the demand-side when analysing the welfare consequences of CGT concessions.

Australia faces a growing shortage of dwelling stock due to what RBA Governor Glenn Stevens has called 'serious supply-side impediments'.

Abolition of the principal residence exemption would also establish the tax deductibility of mortgage interest payments on the principal residence, encouraging Australians to borrow more heavily to invest in housing to offset the tax burden on ordinary income. In principle, deductibility could be limited or quarantined from other income, but this would be inconsistent with the approach taken to deductibility in relation to other assets. Currently, the absence of deductibility for mortgage interest on owner-occupied housing means that reducing mortgage debt dominates the after-tax return on other forms of saving, giving households a strong incentive to reduce that debt. The increased leverage that would result from the deductibility of mortgage interest payments would add to the demand for housing, while the removal of the principal residence exemption would weigh on supply, making housing less affordable. The deductibility of mortgage interest would also offset any extra CGT revenue collected from the abolition of the principal residence exemption, making it a poor revenue raiser. As the Productivity Commission inquiry into First Home Ownership noted, 'reducing the application of CGT in other areas could conceivably deliver better outcomes for the community than imposing it on owner-occupied housing.'[36]

In conjunction with negative gearing arrangements that have been in place since 1987, the 50% capital gains tax discount for individuals is also widely seen as skewing saving and investment decisions in favour of housing. The housing boom in Australia around 2002 and 2003 was widely blamed on the introduction of the Ralph CGT discounts in 1999. In reality, as Reserve Bank research has found, the boom was attributable to the inability of housing supply to respond flexibly to the increased debt servicing capacity of households that emerged in a low inflation and low interest rate environment.[37] It should also be noted that the boom in house prices at the beginning of the decade occurred in the context of a bear market in equities between 2001 and 2003. It is hardly surprising that the demand for housing should increase at a time when prices of a major competing asset class are declining. Pronounced house price inflation was also a global phenomenon at this time, which favours the view that global, rather than country-specific factors such as the Ralph reforms, were the main cause. The weakness in equity markets between 2001 and 2003 also accounts for the weakness in overall CGT revenue in these years, which was wrongly attributed to the Ralph reforms by many in the media.[38]

The Productivity Commission inquiry into First Home Ownership noted that 'changes to the capital gains tax regime, coupled with long standing negative gearing arrangements, *were seen* to have contributed to higher prices through encouraging greater levels of investment in housing [emphasis added],' although the Commission itself did not actually model the effects of the tax changes.[39] Increased investment in housing could only lead to higher house prices if supply-side constraints were reducing the number of new dwelling units per dollar invested. If increased demand for dwelling investment puts upward pressure on prices, this is an argument for easing these supply-side constraints, not for further discouraging housing investment with higher taxes, particularly a CGT that would compound lock-in effects already created by other transaction taxes such as stamp duty. Basing tax policy on structural impediments to new housing supply would be to compound one set of bad public policies with another.

Basing tax policy on structural impediments to new housing supply would be to compound one set of bad public policies with another.

Housing is not the only asset class that qualifies for negative gearing and the concessional treatment of capital gains. The supposed distortion arising from these concessions cannot explain why housing would be favoured by investors over other asset classes such as equities, particularly given the much higher transaction costs associated with real estate. The share of individual taxpayers claiming a net rental loss in 2006–07 was 9%, only a small increase on the 6% negatively gearing property in 1995–96.[40] This does not suggest a rush of taxpayers seeking to take advantage of what many suppose to be a tax giveaway and also undermines the notion that taxpayers can readily convert ordinary income into concessionally-taxed capital gains. The choice to invest in housing must be driven by broader factors apart from the CGT concessions. Moreover, one effect of the Ralph 50% CGT discount for individuals was to *reduce* the percentage value of the principal residence exemption, easing any distortion from the exemption. Those who complain about a distortion arising from the principal residence exemption cannot also logically complain about the introduction of a CGT discount as part of the Ralph reforms.

The failure to comprehend the supply-side as opposed to the demand-side implications of capital gains tax for dwelling investment and housing affordability is exemplified by journalist George Megalogenis, who has variously called the CGT concession a 'rort'[41] and 'the greatest generational heist of the decade'[42] and has absurdly suggested that housing affordability could be improved 'by making property less attractive than other investments, such as shares or superannuation.'[43] Similarly, John Garnaut has described the concessional treatment of capital gains as a 'boon to speculators … gouging billions from tax revenues with the benefits going overwhelmingly to the rich.'[44] We have already seen that this is a misreading of the Treasury's tax expenditures data.

The outraged language often used to describe the CGT treatment of housing is indicative of the depth of hostility to both housing as an investment and the idea of speculation and speculative gain (see next section). Dwelling investment is widely characterised in the media as 'unproductive,' yet housing investment produces an essential service, namely shelter. The growing national shortage of dwelling stock and the upward pressure this puts on house prices and rents has its most adverse impact on those with low incomes.[45] Only the already well-housed could be so callous as to think

of housing as 'unproductive' or conclude that Australia 'overinvests' in housing. The outrage over CGT and other tax concessions for housing is fundamentally misplaced and should be directed against the structural impediments to new housing supply. Taxing capital gains on owner-occupied housing could even give policymakers a perverse incentive to restrict housing supply to reap more CGT revenue from higher house prices.

Why the tax system should reward, not punish speculation

The hostility to the concessional CGT treatment of housing is often extended to saving and investment via other asset classes as well, reflecting deep-seated societal suspicion towards 'speculation' and speculative gain. Capital gains are commonly viewed as somehow easy and therefore undeserved. For example, a report for the Brotherhood of St Laurence referred to capital gains on housing as 'effectively unearned' as part of its argument for the abolition of the principal residence exemption on 'high value' homes above $500,000.[46] This will come as news to those who have worked and saved hard to buy their own home. The notion of capital gains as the return to unproductive or speculative activity drives the view that taxing these gains will not have adverse economic consequences and may even direct people into what are deemed to be more 'productive' activities. The owners and managers of assets are also frequently accused of having a bias in favour of short-term profits at the expense of longer-run gains. These views are a large part of the motivation behind the minimum 12-month holding period for assets before qualifying for concessional CGT treatment under the Ralph reforms. Minimum holding periods and tapered tax rates are a common feature of concessional CGT regimes internationally.

The decision to save and invest rather than consume is inherently speculative.

The decision to save and invest rather than consume is inherently speculative, since there are no guarantees that these saving and investment decisions will deliver the desired rates of return. Few people invest with the intention of making a capital loss. Speculation is fundamental to the operation of a market economy. Capital markets need entrepreneurs to direct capital into more highly valued uses. This process is subject to considerable uncertainty and is often risky. As part of the overall division of labour in an economy, entrepreneurs specialise in bearing these risks and uncertainties.[47] Capital gains are the pay-off to this specialisation, while the price of entrepreneurial error is capital loss. Speculation is inseparable from the experimentation and innovation that drives capital allocation, new business formation, technological change, long-run economic growth, and growth in real wages. Seen in this light, entrepreneurial speculation is potentially highly productive and should be rewarded by the tax system, not penalised.

The idea that investors suffer from a short-term bias implies that there are unexploited profit opportunities in longer-term investments. As Reynolds has noted, markets do not value stocks or others assets based on the motivation of those who own the assets or the time-frame of their investment. The owners and managers of firms and other assets are influenced by the market value of the assets. There is no reason to believe that short-term investment strategies necessarily induce short-term business strategies.[48] Minimum holding periods encourage investment in assets with longer maturities (including housing) at the expense of those with shorter maturities which may yield higher before-tax returns. They lock investors into assets that have performed well in the past, but may not perform as well in the future, denying capital to emerging opportunities that may earn higher rates of return. This reduces the dynamism of the economy. Imposing higher tax rates on short-term capital gains may even promote short-termism by encouraging investors to realise capital losses early when the tax benefits are greatest.

Reforming capital gains tax

The Henry tax review has already conceded that the 'comprehensive income' view of the tax base, which originally motivated the introduction of CGT in Australia, is flawed.[49] It has also highlighted the need to alleviate Australia's relatively high tax burden on capital. Capital gains tax should be eased as part of this reform process, not least because of the scope for dynamic revenue gains makes it one of the less expensive reform options. There are a number of reform options

short of outright abolition that might be considered as a way of reducing the dead-weight and other costs that CGT imposes on the Australian economy.

A low flat rate of tax for capital gains

A low flat rate of tax on capital gains would alleviate the lock-in effect that arises from one-off realisations placing taxpayers in higher income and tax brackets. It would also work against the 'tax clientele' effect, whereby the stock of taxable assets is diverted into the hands of taxpayers with lower tax rates, such as super funds, and the realisation of gains by those with temporarily lower incomes. The flat tax rate should be seen as augmenting rather than replacing the existing capital gains tax discounts for individuals and funds and need not be aligned with other tax rates. It is noteworthy that Germany moved to a flat 25% tax rate for capital gains from the beginning of 2009 as part of a broader tax reform effort.[50]

A low flat rate of tax on capital gains would alleviate the lock-in effect that arises from one-off realisations placing taxpayers in higher income and tax brackets.

Abolish minimum holding periods to increase capital agility

The current minimum holding period of 12 months before qualifying for concessional tax treatment should be abolished. This would encourage increased turnover of assets and reduce lock-in effects, increasing the ability of investors to capitalise on emerging opportunities and quickly shift capital to more highly valued uses. This would bring forward realisations that would have been taxed at concessional rates anyway.

Reinstate inflation indexation of capital gains

Indexation for inflation should be a fundamental principle guiding tax reform, including reform of CGT. Capital gains tax should be applied to real rather than nominal gains. As noted earlier, the abolition of indexation as part of the Ralph reforms has increased the CGT burden for individuals where the rate of inflation is more than twice the rate of return on the asset. This could be expected to increase the CGT burden in a low asset return/high inflation environment. This also potentially creates perverse incentives for government due to the interaction between inflation and CGT revenue. As Alan Greenspan has noted, 'it's really wrong to tax a part of a gain in assets which are attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So, for the government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate.'[51]

Conclusion

The taxation of capital gains raises little revenue but inflicts significant costs on the Australian economy. Even among ardent supporters, there is little argument that CGT is a poor revenue-raiser. At best, CGT is seen as an anti-avoidance measure. Yet CGT is itself readily avoided through the deferred realisation of capital gains. This lock-in effect immobilises the capital stock, denying capital to emerging uses with potentially higher rates of return. The excess of burden of the tax weighs on economic activity more generally. Despite being motivated by a comprehensive view of the income tax base, CGT actually violates principles of horizontal equity by imposing an additional tax burden on saving out of after-tax income. Taxing the capital gain on the disposal of an asset adds to the taxes already applied to the yield on that asset.

Despite failing all the criteria of a good tax, there is nonetheless considerable hostility among many commentators to the existing concessional treatment of capital gains on the part of individuals and funds. There is also support among some commentators for extending the capital gains tax to the family home, which they regard as good economics but bad politics. In reality, it is bad economics too. The opposition to the concessional treatment of capital gains is rooted in the economics of the 1920s and 1930s, not modern tax theory and practice. Australia's pre-Ralph CGT was internationally anomalous in seeking to tax capital gains at the same rate as ordinary income. The optimal tax literature generally rejects the idea that capital should be taxed, but even

where a case for taxing capital can be made, there is no support for the notion that income derived from capital should be taxed at the same rate as income derived from labour.

The support among many commentators for extending the CGT sits uneasily with the widespread support for alleviating the tax burden on saving, including the concessional tax treatment of superannuation. This largely stems from the failure to recognise capital gains as a genuine form of saving. Much is made of the distortions arising from the different tax treatment extended to different forms of saving in Australia. The focus for reducing these distortions should be easing the tax burden on other forms of saving rather than increasing the tax burden on capital gains. It is no accident that the preferred saving vehicle for many Australians is one of the few assets protected from CGT and other taxes—the family home. The magnitude of so-called 'tax expenditures' on housing is an induced behavioural response to the structure of the tax system more generally.

There is a widespread belief that the principal residence exemption and the concessional treatment of capital gains adds to demand for housing and puts upward pressure on house prices. Yet the supply-side implications of CGT for housing are almost always ignored in public debate. The notion that Australia overinvests in housing is belied by a growing national shortage of housing stock that is placing upward pressure on house prices and rents. The idea that investment in housing is somehow 'unproductive' should be condemned as offensive to the many Australians who increasingly struggle to find affordable accommodation. Removal of the principal residence exemption and the concessional treatment of capital gains would have adverse consequences for housing supply. Like stamp duty, CGT serves as a transactions tax that would lower turnover in the housing stock and result in a less efficient allocation of that stock. Abolition of the principal residence exemption would establish the tax deductibility of mortgage interest payments, giving Australians an incentive to increase their borrowings to offset taxes on ordinary income. This increased leverage would increase the demand for housing, adding to upward pressure on house prices and rents. Deductibility of mortgage interest would also offset the revenue raised by a CGT on owner-occupied housing.

The opposition to the concessional treatment of capital gains on the part of many commentators reflects hostility to what is perceived to be 'easy' or 'unearned' gain through speculation. This stems from the failure to recognise the critical role that speculation plays in the efficient allocation of capital and business formation, which in turn drive long-run productivity growth and growth in real wages. Capital gains are the return to entrepreneurial risk-taking, just as capital losses are the price paid for entrepreneurial error. The tax system should reward rather than penalise entrepreneurship and risk-taking, with a view to expanding the tax base and reaping more revenue than is ever likely to be collected by taxing capital gains at the same rate as ordinary income.

Reform of capital gains needs to be reconciled with demands for reform of the tax system more generally. Yet the evidence suggests that easing the burden of CGT would come at little static cost to the revenue and with potential for substantial dynamic revenue gains from the alleviation of lock-in effects, dead-weight losses, and the compliance and collection costs that CGT imposes on the economy. The much stronger growth in CGT payable on the part of individuals and funds compared to companies between the introduction of the Ralph reforms and 2006–07 highlights these potential revenue gains. Rather than winding back the Ralph reforms, the focus should be on extending the current concessional treatment of capital gains in conjunction with broader reforms aimed at easing the overall tax burden on capital. A low flat rate of tax on capital gains would reduce lock-in and tax clientele effects, which reduce revenue collected as well as being harmful to economic efficiency. Minimum holding periods for qualifying for concessional tax treatment should be abolished to increase capital agility. Inflation indexation should also be reinstated to ensure that the Ralph reforms continue to provide relief from CGT in a low return/high inflation environment.

The evidence suggests that easing the burden of CGT would come at little static cost to the revenue and with potential for substantial dynamic revenue gains.

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