76. TAX No 3.

ON THE DRY SIDE

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People who would not wish to be called socialists are calling for capital gains taxation, some want some form of death or inheritance duty and a few even see virtue in wealth taxes. Increasingly people who have capital are seeing, or becoming reconciled to capital taxes replacing high rates of income tax.

Unlike consumption taxes neither capital gains nor wealth taxes yield enough revenue to make a good hole in our overloaded income tax.While most OECD nations tax both wealth and capital gains none get much of its revenue from them and no two OECD nations get a very high proportion of its revenue from them and no two OECD nations seem to agree on the best form for them to take. They appear to be inordinately difficult to administer. Before saddling ourselves with unnecessary problems we should decide just what, if anything, we want of the taxes and endeavour to concentrate on those ends with the minnimum of untoward side effects.

While we can't have an efficient and equitable system without capital taxes neither will we have a perfect system with them. To have even a better system, the new taxes will need to function rather better than our present income tax. Both in Australia and overseas the record of capital taxes is not encouraging.

An efficient tax is one with a low cost relative to yield. Cost includes the department's cost, the taxpayers' cost and economic cost caused by misallocation of resources, including diversion of resources from work to leisure.

Apart from revenue and the bloody minded pursuit of ideology there are four things a government might want from a capital tax. It might want to introduce a greater degree of progressivity into the tax system, that is to enhance so called verticle equity; it may wish to introduce a greater degree of equity between people with the same living standards, that is more horizontal equity; it might want to avoid economic distortions caused by income or consumption taxes alone; and it may wish to protect either of its two main taxes from avoidance.

In the company of an income tax a capital gains tax might serve all four ends. Since it will in the main attack people with more than average spending power, in a rough and ready way it will increase verticle equity, and could in some part substitute for progressivity in the income and comsumption taxes.

Living standards are no less if spending power is derived from realised capital gains than from income and a capital gains tax could contribute to horizontal equity. The problem is equity with who's income, since the present income tax act taxes incomes unequally.

Wage earners pay tax on real earnings and have little opportunity to avoid tax although many evade a bit. Holders of financial assets pay tax on nominal earnings which may be real losses and they too have little chance to avoid it.(A $1000 deposit earning 5% looses value because it earns less than inflation but still attracts at least fifteen dollars tax, if owned by a taxpayer whose income exceeds the tax threshold.)

Holders of real assets not suffering the ravages of inflation also pay tax only on real earnings.

What is more real assets often yield untaxed rewards. Houses, cars and works of art without producing money income benefit their owners. If an asset should increase in real value while it is enjoyed, the owner does doubly well. Here is the real case on equity grounds for a capital gains tax,- taxing all those capital gains which politicians tell us would never be taxed. If capital gains are to be taxed equally with earnings derived from financial assets then all nominal gains must be taxed as income. A truly confiscatory tax, but no worse than that imposed on interest earning deposit holders now.

The most important justification for capital gains tax are, to prevent economic distortion, and to protect the income tax from rewards taken as capital gain in place of income. It is a well established tax ruse to develop property, including goodwill, with normal tax deductable wages, fuel, wear and tear, and materials used in the normal course of business, and then to sell the added value If the property has earned income, and been held for more than a year, the tax payer is usually sitting pretty. However his advantage is inequitable and resources have been attracted away from activities which would have been chosen in a more neutral tax environment.

If the financial markets are to work properly to finance Australian industrial development with Australian capital then we don't need laws limiting foreign ownership but equal treatment of housing and financial assets. The easier way for a government to do this is for it to tax householders' capital gains but a better way might be if it taxed earnings derived from financial assets only to the extent which they exceed inflation.

A new capital gains tax, taxing only real gains and allowing real losses would improve equity and economic neutrality but such a complex tax would be the devil to administer. If on the other hand 26AAA were extended to tax all gains but in diminishing proportions over ten years, taxing the entire gain when the asset is realised in year one, nine tenths in year two etc., 26(a) could be set aside, housing would not be quite so favoured beside financial assets the income tax base would be largely protected and both verticle and horizontal equity would be increased.

I see no objection founded in the principles of equity or economic neutrality to either inheritance taxes or taxes levied on those items of property which are not intended to earn taxable income. However it is doubtful whether these taxes can be administered to produce their intended outcomes. Death duty altogether too easy to avoid to be a fair tax. Unfortunately we must live with taxes as they work in practice and not as they are intended to work.

Our tax system, though still much less than perfect could be greatly improved by a broad based comsumption tax, by taxing an approximation of real capital gains and by removing special privileges from the income tax act.