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Does Australia need an annual wealth tax? (And why do we now apply one only to pensioners)

TTPI - Working Paper 3/2016
March 2016

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Abstract

This paper argues that given the current hybrid income-expenditure tax system in Australia (hybrid IT/ET) a wealth tax could make sense as a way of ironing out disparities in the tax treatment of different assets. A wealth tax could be designed to approximate a comprehensive income tax (CIT) outcome by combining a wage tax with imputed asset income (deeming), or it could fall more lightly. We already have a harsh wealth tax in the welfare system, the asset test; the issue arises as to why we would confine wealth taxation to the not-so-well-off. If we move the income tax to an ET of, e.g., a consumption tax (CT) type a wealth tax might still make good sense, although the implied rate may be lower than under the wage tax as the CT taxes some part of economic rents. However if we move towards explicit taxation of economic rents using, say, the rate of return allowance (RRA) or its cash-flow counterpart, the Z-tax, a wealth tax may be less needed, as such rents comprise two-thirds the total return on capital.

Keywords: Annual wealth tax, deeming, economic rents, alternative minimum tax, rate of return allowance, expenditure tax, cash-flow tax, Z-tax, income tax

**I wish to thank Professor Miranda Stewart, Director TTPI for extensive comments on the draft. All remaining errors are of course my own. I can be contacted at david.ingles@anu.edu.au*

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SUMMARY

In this paper I make the argument that an annual wealth tax (also known as a net worth tax) could be a useful way to tax capital incomes. We do not tax capital incomes well at the moment in Australia; indeed, two-thirds of the potential income is excluded. Much of the extra revenue would flow from housing.

However wealth tax proposals such as that proposed by Piketty (2014) are not well thought through. A major problem is 'stacking', where wealth tax interacts with existing taxes on capital income. Stacking can be avoided by abolishing existing capital income taxes and converting the income tax to either a pre-paid or post-paid expenditure tax (ET) – that is to a wage tax or a consumption tax.

Wealth tax would then be paid on top of the wage or consumption tax. The wealth tax would either have its own rate structure (at rates up to 3 per cent, which is half of the expected 'normal' return to capital) or utilising deeming (presumptive income) at say 6 per cent per annum. Deeming integrates the wealth tax into the income tax rate structure, as deemed capital income can be added to wage income and tax paid at relevant marginal rates. Alternatively we can retain existing capital income taxes and rebate them from the wealth tax due. This converts the wealth tax to an alternative minimum tax (AMT) on capital income, similar to proposals for a 'Buffet tax'. This is how the Australian pension asset test works except that it is an AMT set against all income of the pensioner, not just asset income.

Taxing assets has been found to be more effective in the social security context than taxing incomes; hence the revival of the assets test in the 1980s. However the current assets test has many inconsistencies and very high implicit wealth tax rates. Moving to a unified deeming system would make much more sense.

Would taxing assets be more effective in the context of large fortunes – that is, outside the pension means test applications? The wealth tax runs up against severe problems of discovery and valuation, given (inter alia) the availability of offshore tax shelters, trusts and the like. Academics have made proposals to address these issues, but it is questionable how far they succeed. International co-operation might be required.

Options to tax capital incomes more comprehensively raise issues about whether we really need a wealth tax. For example the rate of return allowance (RRA) suggested by the UK

Mirrlees Review (2010) taxes most of the return to capital, probably in the order of two-thirds of it. It can also be applied to owner-occupied housing, including imputed rent. This may be a workable route to reform, although it raises some similar issues about discovery and valuation. In Ingles (2015b) I suggest a cash-flow alternative to the RRA which I call the Z-tax (ZT), and which holds out the promise of more administrative feasibility. In the context of such taxes wealth taxation might be confined to the welfare system.

Taxes on value appear to be inferior to taxes on transactions or to taxes on value when valuation events like death occur. That is why many academics have preferred gift and bequest taxes to wealth taxes, although such taxes do not sit easily in either an income tax or expenditure tax framework and for that reason are not explored here. By contrast the Z-tax exploits valuation events but in a hybrid income-expenditure tax framework. I argue that we should prefer this sort of 'vertical' hybrid to the horizontal hybrid we now have and which is very distortionary of saving and investment choices. Combining a wealth tax with a wage tax or consumption tax is another sort of vertical hybrid.

We already have a wealth tax in the welfare system, called the asset test; this was abolished in the 1970s and then re-imposed in the 1980s as a way of addressing the rise of so-called 'income rigging' under the income test. Since income rigging is just another word for tax minimisation, the issue arises as to why we would confine wealth taxation to the not-so-well-off. However it must be conceded that politically, wealth taxation is much more widely accepted when it is used to claw back welfare benefits.

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1. INTRODUCTION

Tax practitioners have a generally dim view of wealth taxation. Annual wealth taxes raise relatively little money and have been phased out in a number of countries. They interact with existing taxes on capital income to produce unpredictable outcomes in terms of effective tax rates on different assets. Nor does wealth taxation have a clear conceptual underpinning in the context of the comprehensive income tax ideal. Chatalova and Evans (2013, 434) note that of the traditional tax bases of income, expenditure and wealth, 'the latter is by far the least used in the tax systems of both developed and developing countries', with many developed countries retreating in whole or part from wealth taxation (436). These authors advise that countries can generally live without wealth taxes.

This paper argues that this pessimism may be unwarranted and that many of the problems with wealth taxation are due to poor design and lack of political will. It also argues that very substantial revenue is potentially available from wealth taxation. However it would be very difficult, politically, to unlock this.

This view of wealth taxes sees them as buttressing the comprehensive income tax (CIT) and as a possible substitute for tax on capital income, implying a wide base and moderate rates. An alternative view sees wealth tax as applying only to high net worth individuals (e.g. Tanzi 2012, Miller 2016). I do not explore this option. Instead I explore the wealth tax as an indirect means to achieve outcomes approximating the CIT.

Grudnoff (2016) has recently suggested that capital gains should be taxed on homes above a $2 million value. Rather than relying on home sales, a wealth tax can be a presumptive tax on capital gains as the deemed or implicit rate of return on housing wealth would include both imputed income and likely capital gains.

There are three major categories of wealth tax– 'taxes on the holding or stock of wealth, on the transfer of wealth, and on wealth appreciation' (Chatalova and Evans 2013, 436). There are also separate taxes on land. This paper is mainly concerned with the first of these; it takes the view that a wealth tax could be an efficient proxy for a tax on capital income and if this income were taxed effectively, there would be little additional case for taxes on wealth transfers. Also taxes on wealth appreciation (capital gains) are more appropriately thought of as part of the income base, while taxes on land raise separate issues since they are often capitalised into a lower land price. I do not deal with them here. I define an annual wealth tax as a tax on an individual's or a household's *net worth* – i.e. assets less borrowings.

Transfer taxes are more common than wealth taxes because uncovering wealth is easier when the wealth transfer takes place since the legal documents tied to the transfer stipulate entitlement and value (Chatalova and Evans 2013, 443). However transfer taxes impose their own set of issues (see e.g. Meade 1978) and fit uneasily in either an income tax or an expenditure tax framework.

I will argue that a wealth tax could be a useful means of implementing a CIT, possibly using the device of deeming (i.e. presumptive income) as has historically been used in social security means testing. Deeming income allows the wealth tax to be integrated with the normal income tax rate structure by the simple device of adding deemed income to wage income.

Presumptive income approaches have a number of drawbacks, discussed later. However there is the very interesting possibility that we can get around these drawbacks by combining a tax like the rate of return allowance – RRA (which taxes part of returns above a designated risk-free rate) with a wealth tax which falls only on the risk-free return. This would be an alternative means of implementing a CIT without some of the problems that bedevil practical implementation of a CIT. However I concede that there would be a new set of implementation problems around a wealth tax itself, as well as the RRA. It would be a matter of judgement which of these was greater.

There are serious questions about whether we really wish to adhere to the CIT ideal (Ingles 2015b). For example if we taxed economic rents using a tax such as the RRA, this might be thought to sufficiently weigh on capital income. In this context the wealth tax might be confined to the welfare system, although here improvements are needed, in particular through the wider use of deeming and the abolition of the separate assets test (Ingles and Stewart 2015).

If we taxed capital more lightly, as under the various ET options then there does seem to be a case for an impost on wealth which might target higher wealth holders in particular. However I do not advocate heavier wealth taxation than that implied by the CIT benchmark. If we actually taxed real income from capital – instead of pretending to, as we do now - that would go a substantial way to ironing out unneeded disparities in access to resources.

If wealth is taxed consistently it is hard to see a residual case for taxes on wealth transfers. Transfer taxes can act as a check on the dynastic transmittal of inequality, but proper taxation of capital incomes will restrict the opportunity to accumulate large fortunes on a tax concessional basis. That said, asset valuation can be more tractable at the time of gift or bequest, and various tax inquiries such as Henry (Treasury 2010) have been supportive of bequest taxation. However such a tax is unlikely to raise more than 1 per cent of total tax revenue (Flynn and Stewart 2014, 12).

A wealth tax has been seen, in the past, as exacerbating the distortions caused by the income tax's disparate treatment of savings. However it can be integrated with the personal income tax either by using it as a form of *alternative minimum tax* (AMT) on capital income (existing taxes on capital would be deducted from the wealth tax bill – see Ingles 2015a), or by the use of deemed (potential or hypothecated) income as a tax base, with actual asset income to be disregarded. For example in Australia we might deem asset income to be 6 per cent per annum (the Netherlands uses a 4 per cent rate). Deeming can also be used as an AMT by including actual capital income or deemed income, whichever was higher.

A transformation of the tax system along these lines provides a means of increasing the overall equity and efficiency of the tax system. A wealth tax operating as an AMT would be a serious alternative to the 'Buffet rule' that has been advocated (Grudnoff 2015) as a means of making the rich pay at least some tax (the ALP is interested in this idea), and could obviate the need for changes to e.g., negative gearing and capital gains tax. Indeed in its most comprehensive form such a tax could entirely remove the need to tax capital income at the level of the income tax.

The Buffet rule[1] is a form of alternative minimum tax which defines income more comprehensively that in the current income tax rules. For example, negative gearing losses might be disallowed. But rather than patch up the tax system for the top 1 per cent, it would appear preferable to have a principled reform of the tax base. While mooted changes to negative gearing and capital gains tax are a step in the right direction, a wealth tax is a much more comprehensive approach to this end. In particular it could start to come to grips with the tax bias favouring owner housing.

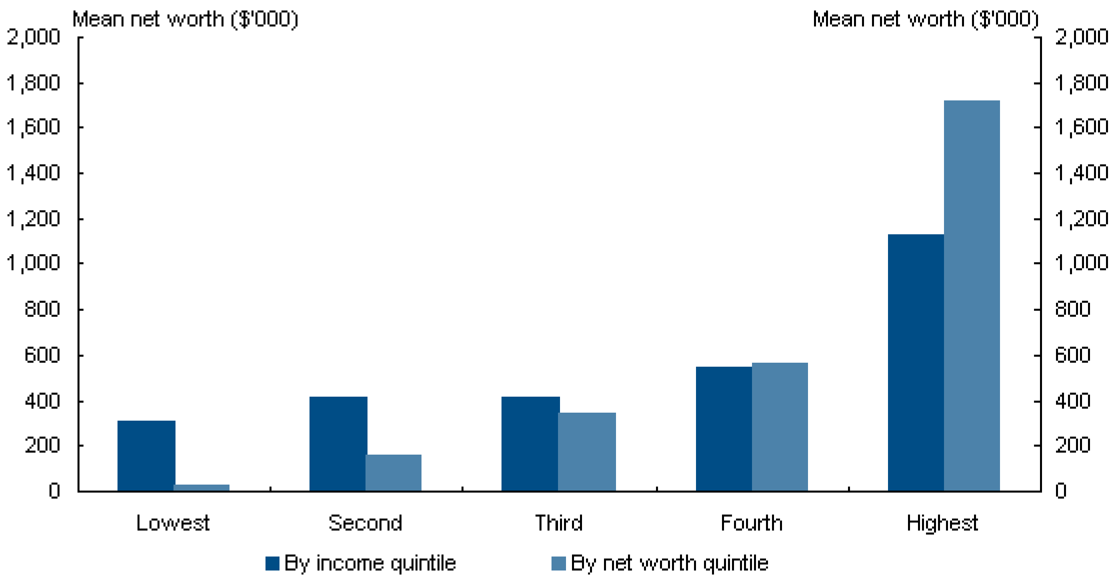
[1] The Buffet rule would impose a minimum tax rate of 30 per cent on the rich, using a more comprehensive tax base than the current income tax.

2. THE DISTRIBUTION OF WEALTH

We now have a lot of information on the wealth distribution. Wealth is much more unevenly distributed than income in Australia, as it is in most other countries. However – in contrast to Piketty's (2014) overseas findings - there appears to be no current tendency for the wealth distribution to worsen in this country.

The ABS has presented findings about household wealth and wealth distribution in Australia compiled from the Survey of Income and Housing (SIH). Updated information is available from the ABS 2009-10 and 2011-12 surveys but the distribution is only slightly changed over the last decade so the earlier figures reproduced in the Henry report still give a good indication of the wealth distribution.

Figure 1: Net worth of households by income and net worth quintiles, 2005-06



Source Treasury 2008a, chart 3.7, p. 182

In 2011-12, as in 2005-06, households in the highest net worth quintile (20 per cent of the population) held more than 60 per cent of the total net worth of all households, while a further 21 per cent was held by households in the 4th quintile. By contrast, the lowest 3 quintiles between them held only 18 per cent of total net worth.

Some researchers use the Household Income and Labour Dynamics (HILDA) longitudinal survey in preference to the ABS cross-section one, although the results of the two are quite similar. In 2002, 2006 and 2010 the HILDA survey included direct questions on wealth. The Gini coefficient can take a value between 0 and 1. A value of 0 implies that wealth is absolutely equally distributed. A value of 1 implies that all the wealth is held by one household. Wilkins (2013) found that wealth is more unequally distributed than income, with a raw Gini coefficient of .61. A value of .61 is pretty unequal but not out of line with wealth distributions in other OECD countries. This compares with a Gini of .34 for (unequivalised) household disposable incomes.

The wealthiest decile (tenth) of households own 45 per cent of all assets whereas the least wealthy decile have negative net worth. In general, wealth is correlated with age, with the 55-64 group being the wealthiest, although within age cohorts, wealth is also found to be very unequally distributed.

The 2010 HILDA figures show a wealth Gini falling from .62 to .61 between 2002 and 2010 (Wilkins 2013, 74). The fact that this ratio is stable or falling is not a reason for complacency; advanced economies around the world are exhibiting a growing wealth concentration and according to Piketty there are features of the modern global economic structure which are conducive of growing wealth inequality. Perhaps the issue is not whether the share of the top quintile is growing but whether it is already too high.[2] There are also issues with rising inequality between the old and the young, relating in part to difficulties in getting on the housing ladder (Daley and Wood 2014, 12-20).

Further information on the wealth distribution is provided in Table 1 below, from the ABS Survey of Income and Housing publication. Note that net worth includes housing wealth; indeed, this contributes almost half (44 per cent) the total. Any mortgage is subtracted from the value of the home to give net housing wealth. The average wealth for all households is $728,100 but this includes a range of values as low as $31,200 for the lowest quintile and $2.215 million for the highest.

The table compares 2005-06 and 2011-12. We could have gone back to 2003 but in fact the earlier date makes no difference; the distribution of income and wealth has been relatively stable over the decade. Incomes and wealth have risen strongly but the quintiles shares are virtually unchanged.

However the Grattan institute have found that over the last decade, older households have captured most of the growth in Australia's wealth: 'In part the wealth of generations has

[2] There are problems in estimating the share of the very wealthy as they may not respond to surveys, or perhaps not accurately. Top quintile shares may therefore be underestimates.

diverged because of the boom in housing prices.' While some of the young will ultimately benefit from inheriting, this means that wealth dispersion may become greater in the future as inheritances typically benefit those who are already wealthy (Daley and Wood 2014 p2).

Table 1: Household net worth and income, 2005-06 and 2011-12

Mean value 2005-06 and 2011-12	Household net worth ($1000)		Gross household income per week $		Equivalised (a) household income $pw	
1st quintile	27.4	31.2	282	393	255	346
2nd	160.6	191.2	623	857	414	581
3rd	341.7	437.9	1048	1450	565	792
4th	564.3	766.5	1596	2240	746	1057
5th	1720.7	2215.0	2974	4297	1239	1814
All quintiles	562.9	728.1	1305	1847	644	918
Share of aggregate	per cent		per cent		per cent	
1st quintile	1.0	0.9	4.3	4.3	7.9	7.5
2nd	5.7	5.2	9.5	9.3	12.9	12.6
3rd	12.1	12.0	16.1	15.7	17.6	17.3
4th	20.0	21.0	24.5	24.3	23.2	23.0
5th	61.1	60.8	45.6	46.5	38.5	39.5

Source: extracted from ABS Household wealth and wealth distribution, 6554.0, Table 1. (a) Equivalised income means that gross income is adjusted for family size and composition.

The table shows that the lowest quintiles had a higher share of total income than they did of wealth, and this share was further raised by equivalising household size. The tax transfer system goes to a good deal of effort to reduce inequality in income shares, and by international standards is highly redistributive (Stewart et al. 2015). For some reason this redistributive effort is not at all applied to wealth except in the pension system.

3. THE CASE FOR TAXING WEALTH

Arguments for a wealth tax have been many and varied. They include (from Rudnick and Gordon 1996, 3-5):

- A tax on income alone does not take into account the claim on overall resources or the non-monetary benefits that wealth confers
- A wealth tax may add to the overall progressivity of the tax system without the need to increase marginal income tax rates
- A wealth tax could improve tax administration, providing income to collect income and property taxes
- While not a substitute for an accruals system of capital gains taxation, it could capture some additional revenue from appreciated assets
- Major concentrations of wealth held by a small number of people can have unfortunate political and social side effects.

A wealth tax is a direct way to address the distribution of wealth. It is a tax levied as a proportion of a taxpayer's net worth (assets less liabilities), typically at a rate of around 1-2 per cent. Although such rates seem low, they are a large fraction of the total expected return to asset investment, which in Australia is typically around 5-6 per cent a year in real terms. Hence a wealth tax of 2 per cent is equivalent to an income tax of around 33 per cent levied on real asset income.

I do not here advocate a wealth tax as a means of redressing wealth inequalities, although I do point out that such inequalities would be substantially reduced if capital income were properly taxed.

In the past two decades annual taxes on wealth have been largely abandoned in Europe (Villios 2013, 8). Part of the problem with wealth tax is that they are perceived to have adverse impacts on economic performance and incentives to save. A lot of these problems arise from stacking wealth taxes on top of income taxes which are inconsistent in their treatment of capital incomes, and a wealth tax adds to these inconsistencies. If a wealth tax were combined with a consistent tax treatment of capital, such as an ET in any of its forms, or if it is used as an AMT, these problems would appear to be substantially addressed.

Australia's assets at end-June 2014 were around $12.5 trillion. Netting out foreign liabilities, this falls to $10 trillion (Lowe 2015). The estimated real yield at say 5 per cent per annum is $500 billion, and estimated tax revenue at say 35 per cent average marginal rate is $185 billion. We net out current taxes on assets (excluding property taxes), which I estimate at

$60 billion (mainly from corporate tax - Ingles 2015b), suggesting a potential revenue gain of $125 billion. This figure assumes that housing and superannuation wealth would be included – obviously a heroic assumption.

This gain is around 6 per cent of GDP. In contrast no OECD country has raised more than 2.5 per cent of GDP from wealth and transfer taxes in any one year (Chatalova and Evans 2013, 443). So it must be regarded as a highly theoretical estimate given that great difficulties would be encountered in actually raising the revenue.

This wealth tax revenue could be used to compensate the bulk of taxpayers and welfare beneficiaries. Mathematically we can afford to compensate or over-compensate all households with net household assets less than the average of $730,000 (probably $800,000 currently). Rises in pension and allowance rates are required, if housing were included, in order to compensate asset rich but income poor pensioner households.

There would need to be provision for tax to be deferred for those who are asset-rich but whose annual cash flows were insufficient to pay taxes due – mainly pensioners in expensive homes. On application, tax could be deferred until sale of the property with an interest rate at or around the long-term bond rate.[3]

As Richardson and Denniss (2014) note, the distribution of wealth in Australia, like that in other countries, is much more unequal than the distribution of income. And whereas tax transfer policies substantially ameliorate the uneven distribution of market incomes, no such policies impact the wealth distribution except indirectly. Indeed the current very light taxation of many forms of capital income documented in Ingles 2015b directly contributes to the maldistribution of wealth.

A wealth tax was proposed in the prestigious Meade Report (1978) for the UK Institute for Fiscal Studies, although this was in the context of their preference for a direct expenditure tax. However the more recent Mirrlees Committee was not persuaded, although it did look favorably on wealth transfer taxes (Mirrlees et al 2011). Their recommendation for a rate of return allowance (RRA), including for owner housing, would however substantially address disparities in the tax treatment of asset incomes.

3.1. Piketty's wealth tax

A wealth tax is one of the policy recommendations of Thomas Piketty in 'Capital in the Twenty-First Century' (2014), which is concerned with rising inequality. He suggests a

[3] See Dennis and Swann (2014) for one such proposal.

comprehensive international agreement to establish a progressive tax on individual wealth, defined to include every kind of asset, while noting that such a tax is a ‘utopian idea’ (p515). He views a wealth tax as part of an ideal tax system alongside income and inheritance taxes.

An international agreement accomplishes two things. First, it can help to address capital flight, whereby rich individuals simply move domicile to avoid the wealth tax. Second, it enables information sharing between countries, so that is becomes more difficult to hold capital in offshore accounts which are undiscoverable for the domestic taxing authorities. Compulsory reporting is meant to simplify administration and remove the need for self-assessment (p521).

Piketty’s view is that income is not a well-defined concept for wealthy individuals and only a direct tax on capital can gauge the taxable capacity of the wealthy (p525). His anecdotal evidence suggests that billionaires earning real returns of 6-7 per cent declare only a fraction – perhaps a hundredth - of this in income, while ‘leaving the remainder of one’s fortune to accumulate in a family trust or other ad hoc legal entity created for the sole purpose of managing a fortune of this magnitude...If some people are taxed on the basis of declared incomes that are only 1 per cent of their economic incomes, or even 10 per cent, then nothing is accomplished by taxing that income at a rate of 50 per cent or even 98 per cent’ (p525-6).

One way to deal with this issue is to deem income from wealth at say 5 per cent a year and include that income in the income tax - which is an approach Piketty views as problematic (p526). The other way is the wealth tax.

In Piketty’s idea, wealth below one million euros would be either untaxed (p517) or taxed at 0.1 per cent up to €200,000 and 0.5 per cent up to €1 million (p529); wealth between one million and €5 million would be taxed at 1 per cent, and wealth above €5 million at 2 per cent. He appears to contemplate the wealth tax subsuming taxes on capital like the property tax, with the advantage that the wealth tax allows a deduction for debt and a progressive rate. However he also contemplates wealth taxes on the largest fortunes of 5 or even 10 per cent (p517) which are confiscatory taxes.

In Piketty’s view the failures of existing wealth taxes are due to politics – they are riddled with exemption: ‘many asset classes are left out, while others are assessed at arbitrary values having nothing to do with their market value. That is why several countries have moved to eliminate such taxes' (2013 pp517-518).

Piketty's wealth tax is meant to be a modest supplement to other revenue streams – his tax yields estimated revenue of 2 per cent of national income - 'still nothing to sneeze at … the goal is to stop the indefinite increase of inequality of wealth and second to impose effective regulation…' (p518). Hence it is really a millionaires' cum billionaire's tax, although there could be a low rate on all wealth in the nature of a compulsory reporting system.

The truth is that Piketty's ideas on wealth tax while interesting have not been systematically thought through, although he is right to address issues of international information sharing and regular revaluation, among other issues. In particular there are potentially severe problems with interactions with the income tax and inheritance taxes, where these exist.

3.2. Zucman views

Zucman is an associate of Piketty with publications detailing his estimates of hidden capital income for both individuals and corporations (Zucman 2014, 2015). I do not deal here with his findings about corporate use of tax havens leading to effective reductions in the corporation tax rate, but with his findings on wealthy individuals using such havens. He makes the case for a world financial registry, making it possible to both fix loopholes in the corporate tax and make personal tax evasion much more difficult (2014 p122). Such a register would facilitate the wealth tax proposed by Piketty, although there are major issues of compliance, transparency, privacy and the like.

Zucman notes that 'a large fraction of the world's equities might not initially be attributable to and well-identified beneficial owner. Equities are largely held through intertwined financial intermediaries, like investment funds, pension funds and the like'. There is current work to create a global system of legal entity identification (2014 p137). Zucman estimates that 8 per cent of the global financial wealth of households or around $8 trillion is held in tax havens, but other estimates are generally larger as Zucman only captures financial wealth and disregards real assets. 'The world's offshore assets are large enough to significantly affect measures of the inequality of wealth' and 'Wealthy individuals increasingly use shell companies, trusts, holdings and foundations as nominal owners of assets' (2014 p140). This warns us that collecting a wealth tax might not be simple: 'there is a fundamental problem that many assets cannot easily be traced to their real owners, so even the automatic sharing of bank information [as now provided for in some cases] may bump into problems of financial opacity' (2014 p144).

3.3. Other recent suggestions

Miller (2016) has proposed a comprehensive mark-to-market (accruals) tax for the very highest (0.1 per cent) wealth and income taxpayers, with a threshold over US$20 million. Publicly traded securities would be subject to tax on their annual accrued gains under this system. Nontraded assets would be taxed on realisation but using an equalisation formula so that the implicit tax weight would approximate an accruals result. The proposal is meant to address the ability of the rich to avoid income tax on appreciated assets by holding them and never selling, which is a feature of a realisation–based capital gains tax. The proposal is meant to be superior to a wealth tax by avoiding double tax (income tax and wealth tax) on some but only the wealth tax on others (2016 p8-9) – an issue addressed by my AMT proposal.

Gergen (2016) proposed a flat annual tax on the market value of publicly traded securities paid by the issuer, perhaps in the order of 0.8 per cent of the value. The tax is said to cover around 65 per cent of the wealth owned by US households and non-profits, or about 75-80 per cent if owner-housing and consumer durables are excluded. There is also a complementary tax on other capital, based on book value. He argues that 'the two taxes eliminate the need for tax rules designed to measure business enterprise income and investment income, including the rules on realization, recognition, capitalization, depreciation and tax accounting' (2016, p3). These taxes on imputed income complement taxes on labour income or, ideally, consumption. The taxes on capital are meant to raise the same revenue as current taxes on capital including the corporation tax. This tax system has similarities to the deeming system I discuss in the text.

Kleinbard (2015) has proposed a comprehensive Business Enterprise Income Tax (BEIT) having two features. First, only business income in excess of a Cost of Capital Allowance (COCA) is taxed at the enterprise level – in effect, a tax on economic rents. Second, the risk-free part of enterprise returns is taxed at the individual level using an imputation system – in effect a wealth tax. Gergen explicitly adopts this second part of the Kleinbard system in his tax proposal, which leaving out the first part. However Kleinbard, like Gergen, does not propose to tax owner housing; in the US the fight is about abolishing existing tax subsidies for mortgage interest so housing is a step too far. However I note that there are property taxes in the US.

3.4. *Impact on tax progressivity*

Because of the maldistribution of wealth, even a proportionate tax on wealth increases the progressivity of the tax system. Also a broad based, low rate tax potentially raises considerable revenue. In the US it has been suggested by Shakow and Shuldiner (1998) that current revenue from the income and corporate tax could be raised with a proportionate wage tax of 18 per cent and a wealth tax of 1.5 per cent, after allowing some low income exemption (this gives an implied deeming rate of 8.3 per cent). Shakow and Shuldiner (1998) argue that such a system would not entail any loss of progressivity compared to the current US system. The loss of progressivity in the flat rate income tax rate structure (with personal exemptions) is compensated by the progressivity of taxing wealth, even with a flat tax rate.

In Australia, the tax rates would necessarily be higher since our government accounts for a larger share of GDP. But nonetheless, these US results suggest that a combination of a wage tax or CT and wealth taxation could provide the basis for a simpler and fairer system than what we now have.

Graetz (2007) has proposed getting rid of the income tax for most US taxpayers and substituting a VAT with a small income tax for the well-off. It would not be difficult to substitute the wealth tax for the residual income tax, and might be a more effective path to reform. However there may be constitutional obstacles to wealth taxation in the US.

3.5. *Efficiency*

A wage tax or CT combined with a comprehensive wealth tax achieves what I have elsewhere (Ingles 2015b) called a ‘vertical hybrid’ tax system where income and expenditure tax principles are combined in such a way that all assets are treated similarly. This contrasts with the current ‘horizontal hybrid’ of income and expenditure tax bases which is known to be very distorting of savings and investment choices. Under the current horizontal hybrid some assets receive income tax treatment and some assets an ET treatment.

We presently combine CIT treatment of some assets with ET or better treatment of others, like superannuation and owner-housing. A vertical hybrid could raise the same revenue as the current (so-called) income tax system with far less distortion. If desired it could still be concessional compared to a CIT – for example the current revenue from capital income taxation could be raised with a wealth tax rate of around 0.6 per cent (as compared with a CIT-equivalent rate of around 1-3 per cent in steps).

With a neutral treatment of savings, inter-asset distortions are removed and the potential efficiency of the income tax (absent progressivity) starts to approach the efficiency of the GST. Often, efficiency (i.e. tax revenue relative to economic distortion) is put forward as the core argument for expanding the GST. (See Treasury 2015 and 2010b for some discussion of relative tax efficiency.) However I note that recent political debate has suggested – based on Treasury modelling - that once compensation measures are included, the efficiency gains from a GST tax mix change are relatively modest.

A wealth tax can be levied as an alternative minimum tax (AMT) on capital income. Under the AMT/wealth tax approach, efficient (neutral) treatment of savings is achieved if the AMT is binding; whereas it is not achieved if the income tax (IT) is binding. (By 'binding', I mean that tax paid by the individual is in practice computed by reference to this particular tax.) This creates an argument for a relatively broad wealth tax so that most taxpayers are not subject in practice to the IT. Thus issues endemic to the CIT such as the appropriate adjustment for inflation and lock-in of capital gains are completely sidestepped as a wealth tax or deeming rates are set to take account of the expected *real* yields from assets. It also creates a system where – if fully comprehensive - existing tax expenditures on housing and superannuation would come to be relatively unimportant.

The greater the tax breaks on savings, the more the IT starts to look like an ET. In the pension deeming approach the IT is converted into a wage tax (a form of ET) by disregarding asset incomes and only taking account of deemed income. The combination of an ET and a wealth tax can be configured to be conceptually similar to a fully comprehensive IT except that capital income is not actually measured; it is imputed via a wealth tax or deeming tax rate. I discuss some problems with imputation below.

4. General issues with wealth taxation

4.1. Problems with a wealth tax and some solutions

Wealth taxes have a poor history as revenue raisers. Partly this is due, as noted earlier, to political pressures leading to poor design or poor valuation, with numerous thresholds or exemptions.[4] Partly it is due to the tax clashing – stacking - with existing taxes on capital

[4] See for example Denk (2012). In extant wealth tax, many forms of property are undervalued.

income, thus exacerbating the effective tax rate problems documented by Henry (Treasury 2010b).[5] Partly it is due to the possibility of avoiding the tax by shifting domicile or the use of entities such as private trusts.

The domicile problem, whereby wealthy individuals simply move their address, is addressed by Picketty in his suggestion for an internationally harmonised tax. I do not believe that shifting domicile would be a big issue if an Australia wealth tax were carefully designed as a method of ironing out effective tax rate disparities. It would be more of an issue if the tax rate were to become higher than the CIT equivalent.

The clash or 'stacking' problem where a wealth tax interacts with normal taxes on capital income can be got around by rebating from a wealth tax any taxes on capital income. In this way a wealth tax would become a form of AMT on capital income. This is similar to the current operation of the pension assets test although that test – illogically - operates as an AMT on all income, not just capital income. The US already operates an AMT on personal income.[6]

If it were not sought to achieve a CIT outcome wealth tax or deeming rates could be less– e.g. we might contemplate a top wealth tax rate of 2 per cent or a deeming rate of 4 per cent. Lower rates would also be appropriate if some part of economic rents were already taxed as is possible under some form of ET. Because such a policy would be very redistributive it would need to be phased in over a long period to avoid disruption. Asset prices would be impacted, particularly for housing.

A wealth tax is normally regarded as a 'left' policy idea. The approach suggested here is meant to be neutral insofar as any left-right view can be accommodated by parameter changes.

Taking asset income out of the income tax base converts it to an expenditure tax (ET), in the form the Meade Committee called an 'Income Tax with Savings Yield Remitted (ITSYR).[7] The key feature of an ET is that the real yield on savings is equal to the underlying real yield on the investments they finance – i.e. there is no intertemporal tax wedge. This result can be achieved by an income tax which exempts capital income or by

[5] Treasury 2010b. Denk (2012) documents these problems with the Norwegian wealth tax

[6] This is because rich people were paying little or no income tax. Instead of the logical solution of fixing the tax base, the US legislature introduced an alternative base with fewer holes. There are now proposals to introduce yet another AMT under the 'Buffett rule'.

[7] The equivalence with an expenditure tax is explained in Meade (1978) and Ingles (2015b).

a consumption tax of either the direct or indirect type. Adding a wealth tax converts the ET partly or fully to a CIT, depending on a wealth tax rate.

For example, the left might wish a wealth tax rate to be relatively high, sufficient perhaps to approximate a CIT outcome. A CIT outcome, with a 50 per cent top tax rate, allows the wealthy to consume half the real yield from their wealth. Those of conservative disposition might modify the rate structure to approach an expenditure tax outcome except for the very rich. The proposed structure is flexible enough to accommodate either result; the key feature is that irrespective of the net outcome the tax treatment of all types of savings and investment would be neutral.

This approach to tax design also allows for ETs of different type to be sensibly included in the tax mix. For example the ET component can comprise an indirect consumption tax (value added tax or GST) and/or a progressive consumption tax (e.g. a cash-flow tax or progressive value added tax like the Bradford X-tax).

Kerin and Findlay (2015) suggest that the efficiency cost of the income tax, which raises \$165 billion, is \$24 billion – 15 per cent of its revenue. The Treasury indicates a cost of 20 per cent. If this could be halved the gain to the economy is \$15 billion per annum. Much of the efficiency cost of the income tax relates to its hybrid treatment of capital income, which is obviated by the ‘vertical hybrid’ suggested here.

The other action to improve the income tax is to fix up fringe benefits and work-related deductions and remove the host of tax expenditures and special rebates which clutter it. The other differences are the proportional nature of the GST (which could be replicated under an IT, albeit with the same compensation issues) and the intertemporal distortion caused by an IT relative to an ET. However, the intertemporal distortion is the subject of much debate.

A key issue here is the elasticity of savings with respect to the real interest rate. There is little persuasive evidence of such elasticity. Treasury (2015b) appears not to regard the intertemporal distortion as a big issue (pp 58-60), although the Henry Report (Treasury 2010a, 2010b and 2010c) thought it justified concessional treatment of superannuation savings. The bottom line is that it is wrong to simply associate big impact tax reform with an expanded GST. That said, there are arguments for making the GST more neutral in regards to its base and it would sit easily within the hybrid IT/ET suggested here.

4.2. The valuation issue

Valuation has always been held to be an important obstacle to implementing a practical wealth tax (see e.g. Rudnick and Gordon 1996 p 9-10). Whether wealth can be valued with sufficient consistency is a moot point. In France, Greece, Norway and Switzerland 'practical experience has not been encouraging' (Mirrlees 2011, p. 347). One suspects that some of the difficulties with assessing assets in the European countries specified are political rather than technical in nature; certainly that is the French and Norwegian experience (Denk 2012). These political challenges would, of course, arise in most country contexts in different ways.

Mirrlees (2011) argued that 'many forms of wealth are difficult or impractical to value, from personal effects and durable goods to future pension rights – not to mention 'human capital'.' However, valuation problems may be overstated. Australian experience with the pensions asset test shows that a wealth tax (a term I use to connote either deeming or a wealth tax), at least as it pertains to the less wealthy, is quite practicable. About 75 per cent of the potential tax base is relatively easily valued, being shares, cash or real property. Real property can be re-valued regularly using widely available regional house price indexes.

In their 1994 Review of the pensions' income and assets test, Ageing Agendas argued that in relation to means testing, 'assets generally provide the best basis for assessing a pensioner's capacity for self-support. An assets based approach offers greater simplicity, predictability and less intrusion than one based on income…' (Barber et al. 1994).

Countries administering wealth taxes have not found them particularly difficult to administer but there is some suspicion that this is because they do not strive for accurate valuations. Smith (1993, p.165) argues that the 'administrative challenges of a net wealth tax are likely to be overcome only through the use of generous exemptions and simplified rules for the valuation of many types of properties'. A particular issue is the valuation of private companies.

In Norway, there are distortions caused by the undervaluation of owner-occupied and rental housing and business property in the base of the wealth tax. These undervaluations remove over half the tax base (Denk 2012, Figure 5). It can be questioned as to whether these are features intrinsic to a wealth tax.

The Dutch system gets over the problem of valuing private companies by not including them in the deeming regime but rather taxing their income yield (Cnossen and Bovenberg 2000). This would seem like a sensible course. In essence the scheme would be that if the asset can be valued a deeming regime applies; if an asset cannot be easily valued then it should be subject to existing income tax treatment including full taxation of realised gains. Most small business capital gains concessions could be abolished (Ingles 2009 and Evans et al. 2015).

Trusts, particularly discretionary trusts, pose a particular problem as it can be hard to attribute their value to specific individuals. One option is to tax trusts as stand-alone entities, using an assumed average tax rate of say 35 per cent, and credit this tax to trust beneficiaries as a form of franking credit. Another is to tax trust wealth as if it were owned by the controlling individual(s).

4.3. Compliance burdens

In aggregate the compliance burden under a wealth tax or deeming may be less than under the current capital income tax system, but would nonetheless be substantial. Part of the tax collection can be done by withholding, with most taxpayers on the 34 per cent marginal tax rate. Banks would withhold from cash accounts; corporations could withhold from dividend payouts based on their share market valuation at the relevant point in time.[8] Superannuation funds could withhold at the same rate.

For taxpayers on other than the 34 per cent rate there would necessarily be an end-of-year reconciliation. For assets outside the withholding system the taxpayer would need to estimate their annual tax liability and request a variation in their Pay-As-You-Go (PAYG) withholding. It is already possible to have PAYG withholding amounts varied if, for example, the taxpayer has a negatively geared property. Use of variation of PAYG instalments would need to become more widespread.

Share and cash investments are easily valued annually while real property could be valued annually using regional property price indexes. State Valuer-Generals already provide unimproved property valuations (UCVs) for rates purposes and it would not be difficult to change the valuation basis to reflect an improved basis as UCVs are calculated by working

[8] In some cases the withheld amount would be greater than the dividend. Corporations would need to pay this out of their cash reserves; the same applies to corporations not paying a dividend with franking credits being an offset.

backwards from sales data. Household goods, cars, boats, valuable antiques, artworks and the like could be valued based on insured values. This will provide some disincentive to insure, however, and there might therefore be a case for a general exempt threshold for household items (e.g. the first $20-30,000 might not be taxable). A threshold for personal use assets (which usually decline in value) is provided already in the capital gains tax. There would need to be some mechanism to pick up egregious valuation errors (or fraud) exposed on sale or death. This could take the form of a retrospective adjustment.

Another difficulty is that a deeming/ wealth tax regime can call for large cash payments at times when cash flow might not be commensurately large. A possible solution is to allow taxpayers who plead inability to pay to accumulate debts on which interest accrues at the ordinary cost of government funds plus a slight penalty (the bond rate plus one or two per cent). These debts could be secured against the asset being deemed – in most cases that would be the owner-occupied home, as it is homeowners who would have most difficultly under deeming in terms of cash flow.

A final difficulty is that it can be hard to tax legal entities such as trusts at an appropriate rate, since beneficiaries of the trust may not share the same marginal tax rates. However I note that these difficulties are surmounted in the social security system. That said, taxation of the very wealthy may involve whole new orders of difficulty.

Cash flow to pay tax is less of an issue if it is not sought to replicate a CIT outcome or if the wealth tax or deeming regime supplements an ET of the CFCT or RRA type, because the required deeming rates are lower.

4.4. Problems with presumptive taxes on capital

Deeming, like a wealth tax, imposes a sort of rough justice. It advantages those who can achieve returns above the deeming rate, and disadvantages those whose returns are lower. According to Cnossen and Bovenberg (2000, p6):

> 'Taxing capital income on a presumptive basis violates ability-to-pay measured in terms of income. Firstly, under a presumptive capital income tax, the government exempts above normal returns that originate in superior investment insight and information advantages. These additional returns, which are attributable to the application of labor and other investor-specific production factors, escape tax. This is in contrast to above-normal returns due to superior entrepreneurial skills applied in businesses. These returns are taxed…
>
> Secondly, under a presumptive capital income tax, the government does not share in the good and bad luck of investors. This violates the ability-to-pay criterion and may also harm efficiency. In particular, if private risk pooling is inefficient, the government

> may be better equipped to pool investment risks, for example because of its ability to share risks across generations through public debt policy. By stepping back as insurance agent, the government foregoes the insurance premium, i.e., the tax on the risk premium.'

Deeming is fair *ex ante* but not necessarily *ex post*. If your share portfolio falls 50 per cent in a year, your deemed income is still, say, 6 per cent of the starting value. The same applies if it increases in value by 50 per cent. People would have to accept the rough justice implicit in this – just as they did for many years in the pension system and still do. But note that this disadvantage is only short-term. Over time the lucky or skilled investor accumulates more assets and pays more tax on these and visa–versa for the unlucky investor. Note also that a large part of capital income is reasonably stable. For example dividends have historically comprised over half the total returns to shares, and dividend income is much more stable than share valuation. A similar comment applies to rental returns from property.

A wage tax with deeming is still a better way of taxing capital incomes than what we do now. However the *ex-ante* nature of deeming leads me to conclude that it not as good as a system which actually measures *ex post* returns like some forms of RRA. But an ET with deeming could still be a sensible reform. The CT or RRA could tax abnormal returns[9] and the deeming regime normal returns. This lead to the interesting possibility that this tax combination could approach an 'ideal' CIT more closely than the CIT itself.

5. Deeming in the income tax system as a form of wealth tax

A wealth tax can be fully integrated with the income tax by using deeming: that is, by assuming an asset will yield on average a certain percentage yield. This assumed yield is then added to wage income to give taxable income, and the normal progressive rate scale is applied to this. Thus deeming is an alternative, and probably a better alternative, to a progressive wealth tax structure.

The equivalence of wealth taxation and deeming is easily illustrated. Suppose an asset yields 6 per cent per annum in real terms. An indexed CIT at 33 per cent would reduce the asset yield to 4 per cent. The same effect could be had if the asset yield was not taxed but

[9] Mirrlees' RRA would tax returns above the risk-free rate, but the uplift factor could as easily be the 'normal' rate of return which is higher than the risk-free rate. It is not entirely clear how much rents are taxed by a CT; my best estimate is one-third (Ingles 2015b). Taxed rents mainly arise through the use of gearing.

a 2 per cent wealth tax levied instead. Hence a wage tax plus a wealth tax can be made roughly equivalent to a CIT albeit that there are complexities caused by having separate rate structures. A wage tax plus deeming avoids such complexities as only one rate structure – that of the income tax - need be applied.

Deeming is useful for taxing assets which provide real benefits for their owners but nonetheless escape tax (e.g., owner-occupied housing or holiday homes) or indefinitely defer tax (e.g., geared property investments). In particular, it addresses the issue of tax deferral under the capital gains tax.

Deeming for the income tax can be combined with the AMT approach, although the AMT would be restricted to capital income. Capital income would be actual or deemed, whichever is the greater, and this would be added to wage income. This creates better integration with the progressive income tax rate structure.

This integration feature can be highly desirable. For example, with a $25,000 annual personal income tax threshold (as recommended by the Henry Review) a person with no wage income could hold assets of up to $416,672 (6 per cent deeming) or $833,345 (3 per cent deeming) and pay no tax. If their wage income is $25,000 they pay tax of $8,750 or $4,375 respectively at those asset levels (if the tax rate is 35 per cent).

Deeming of ordinary income from wealth – as opposed to pension means testing - was first suggested in Australia by Daryl Dixon in 1985 (Dixon 1985). He appears to have been partly inspired by the example of deeming in the pre-70s pension merged means test. However this was a rediscovery of an old suggestion, as the idea had previously popped up in the UK in 1974 (Fleming and Little 1974). John Head was much taken with Dixon's idea and promoted it in a collection of tax essays in 1997 (Head and Krever 1997). Head noted of deeming that:

> 'if the familiar range of real and financial assets can be valued consistently and with sufficient accuracy, capital income taxation, as we know it, could simply be abolished…such a procedure, which has already been trialled at low income and wealth levels, would accordingly be extended up the income and wealth scale where it more properly belongs'. (Head 1997 in Head and Krever 1997, p. 60)

Deeming was proposed in New Zealand in the 2001 Tax Review (McLeod review – see Burman and White 2010) as an alternative to the traditional capital gains tax, and has been adopted in the Netherlands as a means of taxing some capital incomes with a 4 per cent deeming rate (Cnossen and Bovenberg 2000).

In New Zealand it was proposed that, as an alternative to introducing a capital gains tax, 4 per cent of net worth be added to income annually, and taxed at the individual's marginal rate. This was assessed at the time to be the risk-free return on capital, based on the long-term bond rate. Deeming was to be extended to owner-occupied housing in the original proposal, but this element was later dropped due to community opposition. Ultimately the whole proposal was dropped. However it was looked at again in 2010 as part of the Report of the Victoria University Tax Working Group. The majority supported detailed consideration of deeming for property investments (Victoria University of Wellington Tax Working Group 2010, p. 11). This is in a context where New Zealand only taxes short-term capital gains.

The risk-free return method based on bond yields has disadvantages since the bond rate fluctuates and is the product of inflation as well as the nominal bond rate. It would be more appropriate to use a deeming rate based on the historical real return on investments.

Deeming is already used in the social security means test system to impute an income from financial assets (at around 3.25 per cent - see further Ingles and Stewart 2015). This was the approach adopted in the pension means test prior to the 1970s under the merged means test, under which capital was assumed (deemed) to have an annuity value of 10 per cent per annum. This deemed income was added to other (non-asset) income to calculate 'means as assessed', and the means test taper was then applied.

5.1. What are appropriate deeming rates?

The annual real return from capital in Australia has historically been over 6 per cent per annum. Equities in Australia have historically yielded 7 per cent real but may not achieve this in the future. Cash has yielded 1-2 per cent and bonds slightly more. Property has yielded some 6 per cent (ABN/AMRO and RBS 2008). Investment returns in property can be raised (on average) by employing some degree of gearing. So the aggregate returns to investors in property are likely to be closer to 8 per cent or more. But equity returns to individual investors may be less than 7 per cent because of costs. The Treasury assume a net 4 per cent real yield in their superannuation projections.

Super funds having a mix of growth and other assets yield over 5 per cent gross but 4 per cent after costs. The Future Fund, with its lower costs, is targeting returns of between 4.5 and 5.5 per cent in real terms[10].

It would be possible to refine the deeming regime by having different rates applying to different forms of investments, although arguably the different yields reflect different degrees of risk and it may not be appropriate to fully discriminate between assets in this manner.

Bank deposits typically earn much less than shares, in real terms, and this could be reflected in different deeming rates. Bank accounts could attract a deeming rate of say 1-2 per cent; bonds could be deemed at 2-3 per cent. This bank deeming rate should not vary with rises and falls in interest rates, as does the current pension deeming rate (see below). What we are concerned with is the real long run average return on the asset class, not the short-run nominal return.

For housing deeming might initially be restricted by utilising a high threshold and/or a low deeming rate; ideally this concessionality should diminish over time so that housing ultimately ceased to be a tax favoured investment.

5.2. How much revenue could be generated by the deeming of asset incomes?

In general, the revenue implications of deeming are similar to those for annual wealth taxation. A 5 per cent deeming rate applied to aggregate investments of $10 trillion would yield up to $190 billion per annum, assuming housing and superannuation wealth were included.[11] I subtract the cost of current Commonwealth taxes on capital of approximately $60 billion[12] leaving net revenue of up to $130 billion per annum. This could finance a $10,000 reduction in the average income tax bill - with rises in the tax threshold and equivalent rises in pension and allowance rates being sufficient to offset the new tax for most households with average levels of net assets.[13] This revenue estimate is comparable to, but higher than, the cost of current tax expenditures in the income tax system, the

[10] 'The fund's mandate is to target a return of at least CPI +4.5 to +5.5% per annum over the long term via acceptable but not excessive risk': http://www.businessinsider.com.au/australias-future-fund-went-bargain-hunting-in-the-september-quarter-2015-10

[11] I assume an average marginal tax rate of 35 per cent. This may be conservative, given the fact that most wealth is held by a minority of the population who would tend to face high marginal rates.

[12] Net business income is not included here as this would be treated as ordinary income under the deeming proposal.

[13] $730k in 2012 – probably nearer to $800k now. The median house is worth around $550,000. Deemed at 5 per cent, this amounts to $22,500 income and a tax bill of approx. $8,000 for a wage earner on a 35 per cent marginal rate. For many home owners their home equity would be much less than $550,000, with a corresponding reduction in their overall tax bill.

largest of which relate to superannuation and housing. Part of the difference is that I am implicitly including accruing capital gains (and imputed rent) in the deeming system.

5.3. Integrating deeming or wealth taxation with the general tax system

Options for taxing wealth need to be integrated with the approach taken to taxing asset incomes more generally. If we tax wages only, the potential wealth tax base is the whole of the normal expected return on assets. If we tax economic rents then the residual tax base - in terms of the CIT benchmark - becomes the risk-free or safe return, which is around 2 per cent pa in real terms and could be taxed – if at all - at a low wealth tax rate of around 0.7 to 1 per cent. Alternatively it could be taxed using deemed income using a 2 per cent deeming factor. But arguably, with a tax on economic rent like the RRA, we may not want to tax wealth at all.

However with consumption tax of the direct or indirect type probably only one-quarter to one-third of the total return to capital is taxed (Ingles 2015b) and a wealth tax could be a useful adjunct. For example, if we had an ET such as a cash flow consumption tax (CFCT) and wanted to approximate a comprehensive income tax outcome the top wealth tax rate could be 2.5 per cent or equivalently the deeming rate could be 4 to 5 per cent.

If we were to end taxation of capital income entirely (by converting the income tax to an income tax with savings yield remission – ITSYR, also called a wage tax) the top rate of wealth tax could be as high as 3 per cent or the deeming rate 6 per cent. Alternatively we could combine a light taxation of capital for the less wealthy with a full CIT for the wealthiest, implying a relatively high exemption in a wealth tax structure. So there are a lot of options in wealth taxation depending on what outcome we actually seek to achieve.

If wealth were taxed broadly and integrated with the income tax we could abolish separate social security means tests and claw-back pensions and allowances by a simple system of income tax surcharges. This option is canvassed in Ingles (2001). At the moment the income tax base is so full of holes that this option is not sustainable.

All the problems of ‘income rigging’ which bedevilled the pension income tests in the late 1970s and led to the asset test are present in our current income tax. But we, strangely, take a much more relaxed view of ‘tax planning’ than we do of ‘income rigging’.

6. Wage tax with a wealth tax

The wage tax with a wealth tax differs only slightly from the wage tax with deeming, and has a lot of the same advantages and disadvantages. The main difference is that the two taxes are not integrated with regard to the rate structure, an integration which deeming achieves automatically. However this can be an advantage if we are not concerned to replicate the CIT, but rather accept that expenditure taxation is appropriate for those with modest levels of assets and taxation of capital income is appropriate only for those who are quite well off.

The highest rate might apply to large fortunes, with lesser rates at various thresholds. We might arrive at a 3-step rate scale being 1 per cent on say net worth over $1 million, 2 per cent above $2 million and 3 per cent above $3 million. These steps are meant only to be illustrative. Obviously a wealth tax option yields less revenue than the deeming option as it leaves a large part of wealth as having an ET treatment only.

7. Combining an Expenditure Tax with an annual wealth tax or deeming

The wealth tax shares the disadvantage of deeming, that it discriminates against those who receive relatively low returns on their assets and in favour of those who receive high returns. One way to get around this is to combine a wealth tax not with a wage tax but with a form of ET, such as a Consumption Tax (CT) or the RRA. The CT ensures that we are taxing some of the above-normal returns; the role of a wealth tax is then to tax the 'normal' component of capital return, and this is pretty much the same for all savers.

In Ingles (2015b) I take the view that the appropriate tax on capital income falls somewhere between the CIT and the wage tax, but should not be higher than the CIT. This rules out ideas like tax surcharges on capital income.[14] Where I consider a wealth tax as a substitute for capital income taxation this restricts the range of wealth tax rates that might sensibly be imposed to those which replicate a CIT outcome. I could also be a sensible option to simply abolish the income tax and combine a value added tax (GST[15]) or progressive value added tax (X-tax) with a wealth tax.

If the value added tax were at a flat rate it would need to be supplemented with cash payments to low income earners to preserve progressivity.

[14] The Whitlam government briefly introduced such a surcharge, but it exacerbated the sorts of issues in capital income taxation documented in the Henry report. Overseas the more common idea is to tax capital income more lightly using a scheduled approach. In Australia we discriminate against capital income in the social security means test, in relation to the work bonus for pensioners.

[15] The GST might incorporate universal cash payments – demogrants – to maintain progressivity. Exemptions could then be removed, allowing a cash-flow form of this tax as canvassed by Henry.

If we combine deeming with a CT, the appropriate deeming rate is a bit less than 6 per cent as some part – perhaps a quarter - of the real yield from assets is already taxed, it being in the nature of above-normal returns. For this tax combination to be fully effective it needs to apply to housing and personal use assets, both on the CT side and the wealth tax side. Imputed rent needs to be included in the CT base. People might find this hard to understand.

Deeming or wealth taxes are of doubtful relevance under a RRA or Z-tax system which, if it is sufficiently comprehensive, already includes a large part of the return to capital (I estimated it to include about two thirds of the total return to capital). If we combine deeming with the RRA or ZT system we are already taxing returns above the risk-free rate and so we need only deem at that rate to achieve a CIT outcome; in the order of 2 per cent in real terms.

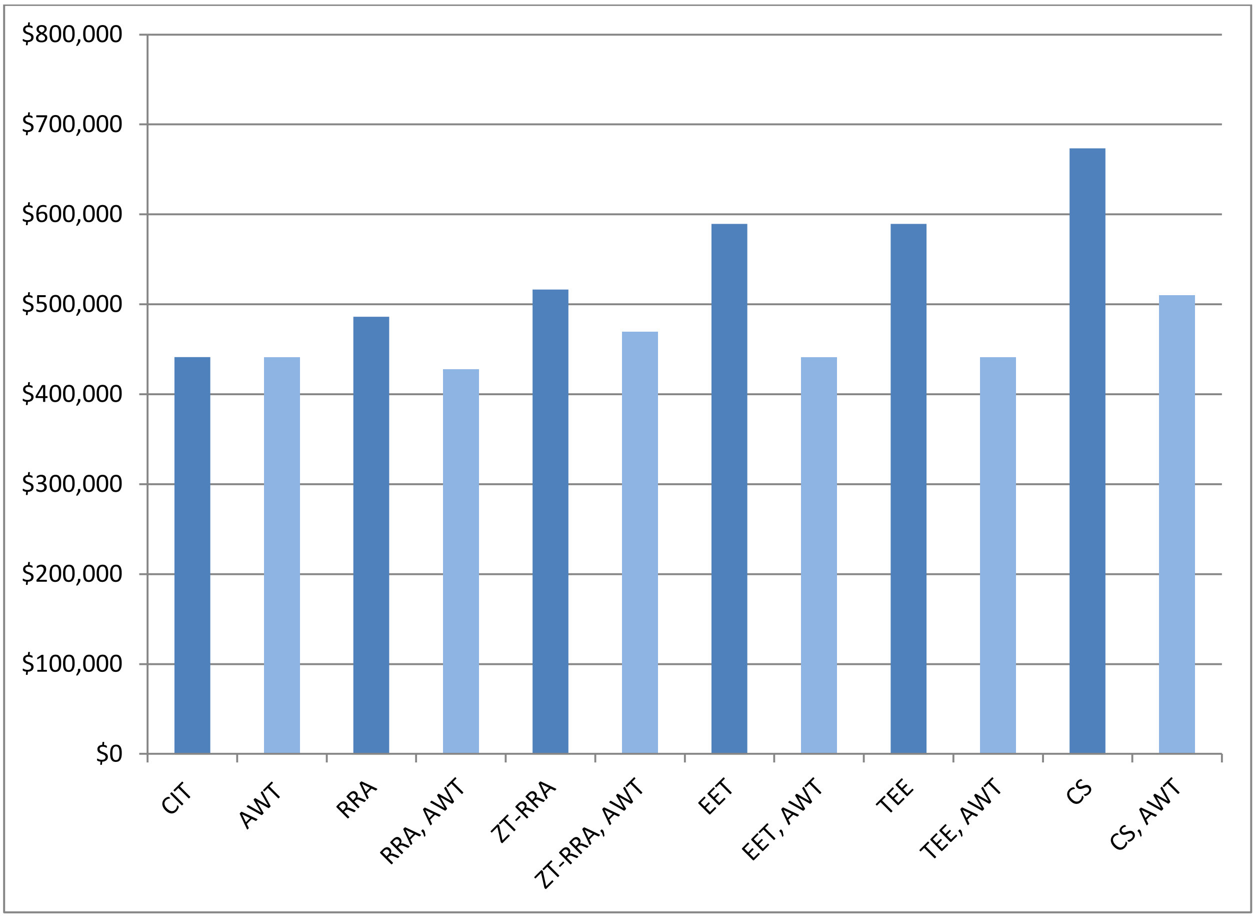
Why would we introduce an RRA system and then comprehensively undermine it by adding on a deeming regime? The answer lies in the greater neutrality that can be achieved under RRA than under a CIT. However RRA combined with a wealth tax might make more sense, as the implicit aim is to tax the capital incomes of the un-wealthy lightly (the tax being confined to economic rents) but to tax something approaching comprehensive income at higher levels of wealth. However the implied rates of wealth tax are still very low, reaching only 1 per cent at the top bracket.

8. Modelling the combination of annual wealth tax (AWT) with various tax bases

Chart 2 below models net retirement lump sum outcomes under various tax bases, and compares these with the outcomes achieved when these are combined with wealth taxes at a CIT-comparable rate (this being 1.4 per cent in the case of the AWT, the EET and the TEE as well as the current system (CS), and 0.7 per cent in the case of the RRA and ZT-RRA[16]). These wealth tax rates are identical to a deeming regime of 4 per cent (and 2 per cent in the case of the RRA and ZT-RRA), given the assumed linear tax rate of 35 per cent.

[16] The ZT works by allowing savings to be allocated to ZT accounts in which they can accumulate tax free until there are drawdowns for the purpose of consumption. Tax is payable in full on drawdown but is offset by tax credits which reflect the amount of tax paid when the savings were originally made. These tax credits are carried forward at either of the inflation rate (ZT –income tax), the bond rate (ZT-RRA) or the normal return on savings (ZT-ET). In the case of the ZT-IT savings receive an indexed income tax treatment in the short term but the longer tax is deferred, the more the tax acts like an ET. Hence the ZT is a vertical hybrid.

Chart 2: Net lump sums at AWOTE before and after wealth tax, 4 per cent real returns, various tax systems

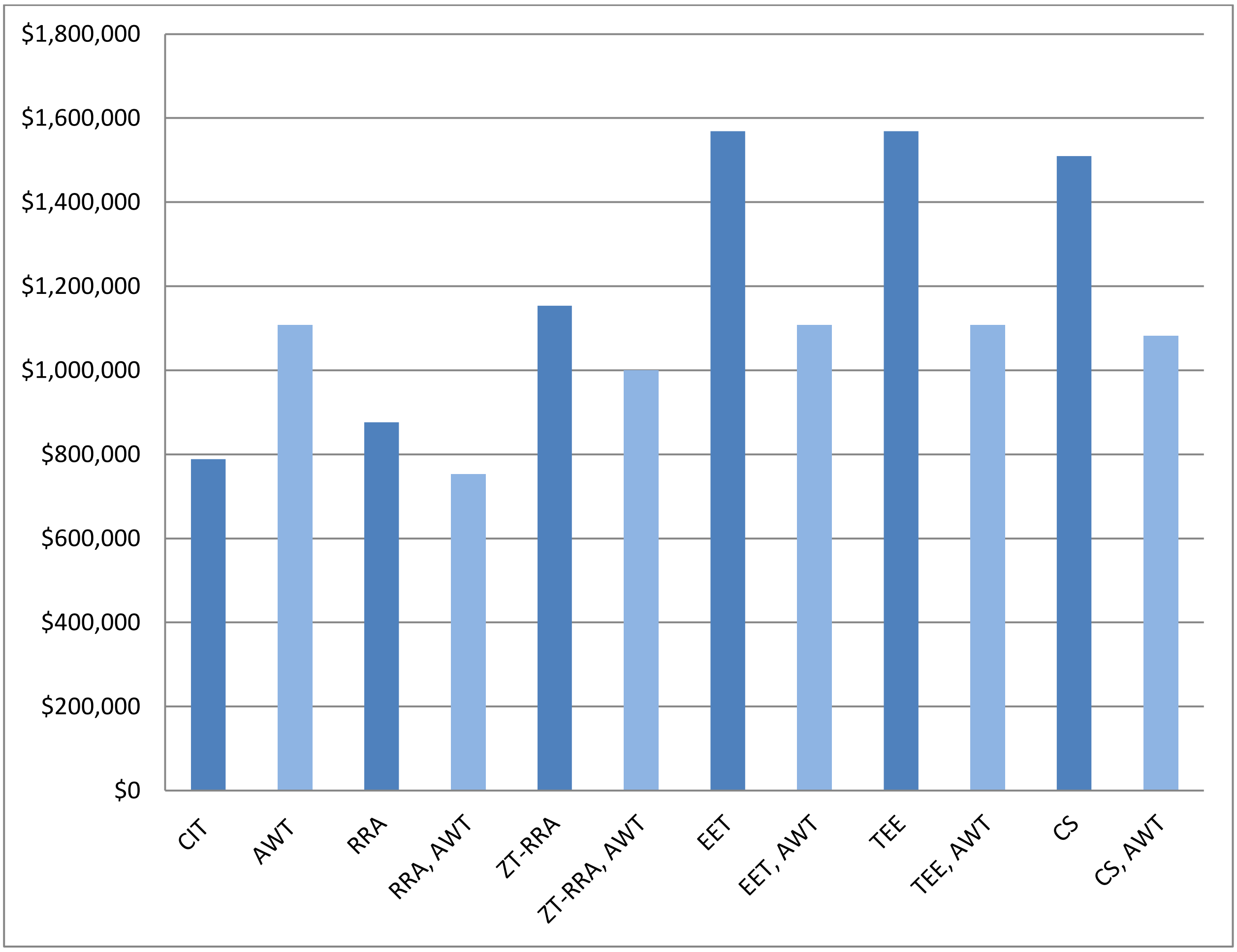


Notes: AWOTE average weekly ordinary time earnings, Superannuation Guarantee contributions only. CIT: comprehensive income tax (indexed base), AWT: annual wealth tax, RRA: rate of return allowance with the risk-free rate exempt, ZT-RRA: Z-tax with uplift at the risk-free rate, EET: CFCT or post-paid expenditure tax, TEE: wage tax or pre-paid expenditure tax, CS: current superannuation tax system. These net lump sums all assume a 4 per cent real rate of return and a 40 year accumulation.

The period modelled is 40 years of saving and the rate of return assumption is 4 per cent real per annum – the rate used by the Treasury in its retirement modelling. Significantly, all the outcomes are roughly comparable except perhaps the current system, which is generous even when combined with a wealth tax. The first 2 bars compare a theoretically ideal indexed CIT with a wealth tax; this outcome is identical under the assumptions used. TEE and EET are forms of expenditure tax, being pre-paid and post-paid respectively – also known as a wage tax and a consumption tax.

It can be seen that in each case the impact of the wealth tax is to reduce the net return to a saver; in the case of EET and TEE this reduction is quite marked, and brings the net result back to a CIT outcome. The CIT and the AWT are identical under the assumptions used. To test the sensitivity of these results I also modelled an 8 per cent real return, which might be the return available to a very skilled or aggressive investor (chart 3).

Chart 3: net lump sums at AWOTE before and after wealth tax, 8 per cent real returns



Notes: see notes to chart 2. These bars show net lump sums under an 8 per cent real rate of return.

This chart shows that the AWT does compress returns markedly. It is more generous to the skilled investor than the CIT, which is a predictable result given our discussion on problems with a presumptive return approach. The RRA with wealth tax has a similar outcome to the CIT, as also predicted, and the ZT is more generous than the RRA which reflects the increased value of tax deferral under higher rate of return assumptions. The EET and TEE outcomes after wealth taxation are similar to wealth taxation alone, showing that these tax systems do not effectively tax economic rents. The generosity of the current superannuation tax system is markedly reduced under wealth taxation but is still comparable to wealth taxation alone – that is, it's still generous under this 8 per cent return scenario.

The charts show that it is possible to achieve a theoretically ideal CIT outcome using a RRA plus a wealth tax. There are reasons to believe that this might be easier than trying to achieve a CIT directly (Ingles 2015b). No other tax combination involving an AWT achieves a CIT result. However there it can be asked if a CIT is really what we want to achieve in capital income taxation; if we could impose a tax weight on capital akin to the RRA (which catches around two-thirds of capital returns) this might be thought enough. Either the RRA itself or the ZT-IT (not shown in this modelling) can produce such an outcome.

9. Recent pension asset test changes: A harsh wealth tax

Currently we apply a wealth tax to welfare recipients, in the form of the assets test (which is an AMT on all income, not just capital income), and the Government is doubling the implicit wealth tax rate.[17] Recent Inquiries seek to widen its scope by extending the use of deeming and including some part of housing wealth.[18]

The combination of an AMT/wealth tax plus deeming is the approach currently used in the pension asset test[19]; deeming (alone) is the approach favoured by both Henry and Shepherd (2014a and 2014b) for the welfare system (as also advocated in Ingles and Stewart 2015).

The Government's recently legislated asset test changes raise the effective deeming rate for those with assets above the new thresholds to 15.6 per cent (this calculation takes account of the 50 per cent pension taper). Augmenting the deeming regime now applying to financial assets[20] – that is, imputing an annual income at a fixed rate of say 6 per cent - is a much better option, and could probably save as much.

Deeming has been already partly restored in the income test, as it covers the full range of financial assets at rates of 1.75 per cent initially and then 3.25 per cent. As deeming is quite

[17] See Morrison (2015)

[18] Treasury (2010a, 2010b and 2010c) and Shepherd (2014b). ACOSS (2015) argued for tightening the pension asset test as an alternative to scaling back pension indexation. The Government has partly adopted this approach.

[19] The asset test operates as an AMT on all of a pensioner's income, not just asset income. This is in inefficient arrangement, and this is one reason we advocate a deeming approach to pensioner's wealth.

[20] Financial investments subject to deeming include: bank, building society and credit union accounts; cash; term deposits; cheque accounts; friendly society bonds; managed investments; assets held in superannuation and rollover funds held if you are of Age Pension age; listed shares and securities; loans and debentures; shares in unlisted public companies; Gold, silver or platinum bullion.

a flexible instrument, the question then arises as to why we should have a separate asset test at all.

The Government's changes to asset test taper rates deliver benefits at the low end but are quite draconian at the top end. In 2017 the assets free areas will rise from $202,000 to $250,000 for single home owners and from $286,500 to $375,000 for couple home owners. Pensioners who do not own their own home benefit from an increase in their threshold to $200,000 more than homeowner pensioners. However, the asset test taper doubles, from $1.50 per fortnight ($38 a year) per $1,000 to $3 ($78 per year) per $1,000. The effect is to reduce the asset cut-out point where pension ceases; for example a home-owner couple will see their pension cease at assets of $823,000 compared to over $1.1 million currently.

On a superficial view these seem like reasonable changes, saving an estimated $2.4 billion over the 3-year Budget forecast. However when we look at the changes in detail, they do not make for sensible policy. The wealth tax on pensioners sees a simultaneous base narrowing and tax rate increase – usually a poor combination.

Restoring the old taper of $3 per $1,000 implies a wealth tax rate of 7.8 per cent ($78 per $1,000) on wealth above the new thresholds. These are very high marginal rates in a context where, with real returns of around 5 per cent on many investments, the assets test confiscates the whole of the real return so that income from savings is very heavily taxed at an effective rate around 160 per cent. A home-owner couple with $823,000 in savings might not have a higher living standard than one with $375,000 unless they run down their asset fairly quickly.

For the conservative investor the situation is even worse. Risk free rates from saving in term deposits or similar forms of investment are only slightly higher than the rate of inflation, while the cost of an indexed annuity is such that a $1 million lump sum will only buy the (indexed) married rate of pension - a return of 3.3 per cent in real terms.

The tighter means test can promote risky behaviour. Recent press reports have suggested that pensioners are already thinking of ways to run down their assets and get back on the full pension. Keeping a too-big house, or up-sizing, is one suggestion. Another is to spend monies on lifestyle, like cruises.

Superannuation tax concessions can help offset the disincentive to save inherent in the pension mean test but once pension age is achieved, there is an incentive to run down savings or convert them into untaxed forms. A system based on offsetting distortions make little sense.

In the welfare system the Henry Tax Review and Shepherd (National Committee of Audit) have both argued that the separate asset test should be replaced by a general regime of deeming.

At the moment pensioners are assessed under both the income test and the asset test, and whichever test gives the lower rate is applied. This allows considerable scope for sophisticated pension planning. Deeming, by contrast, allows a pensioner to have either modest income or modest assets, but not both. Deeming fully integrates the pension wealth tax with the pension income test, so it doesn't unfairly advantage those who maximise their entitlements under both tests simultaneously as the current system allows. The wider base under deeming is the reason it can raise as much revenue at an effective wealth tax rate less than half that proposed by the Government.

The arguments for higher wealth taxes on the pensioner population – by means testing housing for example, or raising the implicit wealth tax rate[21] – need to be considered in the context of the generally inconsistent treatment of assets in the income tax system. Reform on the tax front would automatically impact on wealthy pensioners since part – up to half - of their pension is clawed back through the income tax.[22]

Ideally deeming would include housing; separate rental assistance schemes would however be phased out. This need not be a savings measure; on the contrary it could finance rises in base pension rates roughly equivalent to the rental subsidies provided by state housing authorities for low income tenants, but would be greater than existing payments for Commonwealth Rent Assistance. Different treatment of renters and home owners in the pension asset test (like the thresholds) would logically cease. Note that this proposal makes sense even if restricted to the pension asset test, but even more sense if applied to the whole of the taxpaying population.

[21] As is already in process, with the wealth tax rate to become in effect 7.8 per cent in 2017

[22] This clawback could be made more effective by changes to the very generous senior Australians and pensioners' tax offset, or SAPTO.

The one good reason for restricting wealth taxation to the pension system is that the implicit wealth tax (the asset test and deeming) can be levied by reducing the pension paid; people do not need to write out cheques.

As an alternative to deeming, the pension asset test could be restructured as an alternative minimum tax on asset income only – as compared to the current test which is an AMT on total income including any wages. The recommended wealth tax rate would be much less than the current 7.8 per cent; e.g. it could be 3 per cent which corresponds to a real rate of return of 6 per cent and a 50 per cent taper.

10. Conclusions

10.1. Deeming

The idea of deeming has potential application far beyond the pension asset test. It could be applied as the main method of taxing capital income, in which form it doubles as a form of annual wealth tax. To make the tax base truly comprehensive, deeming could also be extended to owner-occupied housing. However, I would suggest that the deeming rate for such housing be initially concessional as it is politically impossible to move away from the current tax preferences for such housing too quickly.

Deeming raises enough additional tax revenue that it would fund large increases in the base rate of pension and large cuts to income tax. These changes in the parameters of the tax/transfer system would redistribute from those with large housing equity to those with none (renters), or those who were buying a house but had not accumulated substantial equity. Overall the scheme would make the tax/transfer system considerably simpler and fairer. Obviously this is an extremely redistributive proposal which might need to implemented in phases. But it does provide a coherent vision to which tax reformers concerned with equity might aspire.

Ingles (2015b) canvasses alternative approaches to the comprehensive taxation of capital income. All these have plusses and minuses. Deeming needs to be considered alongside these alternatives as a practicable means of implementing tax on capital income.

However, while deeming or wealth tax approaches are superior to what we have now, we should ideally aim for a tax system which measures capital income rather than imputes it. The CT and other options such as RRA can combine with modest forms of deeming or wealth taxation to achieve this outcome. Such options could also flow back to the pension income test, allowing this test to be fully integrated into the general tax system. In this scenario the pension means test would be abolished and replaced by a system of tax surcharges (under a comprehensive tax base) allied with source withholding.

10.2. Annual wealth taxation

A wealth tax, like deeming, is a serious contender for tax reform but its place in the overall system depends very much on the other elements adopted within the system. The CFCT is an elegant solution to many of the problems that bedevil the CIT. The X-tax or ‘flat’ tax – both forms of progressive value-added tax - are similarly elegant. The problem with these taxes is that they exempt most of the return to capital, and I have argued in a companion paper (Ingles 2015b) that there are good reasons we should attempt to tax at least part of this.

By combining either of these forms of ET with an annual wealth tax or deeming the result is a (quasi) comprehensive income tax which is may be administratively feasible than the ‘ideal’ CIT.

A wealth tax is levied in some countries and has been of declining importance in the tax mix. Many academics regard it as complicated, arbitrary and hard to levy in conjunction with an income tax, and as having limited revenue potential. These criticisms are based on a misconception of the proper role of a wealth tax. If used instead of, rather than in addition to, ordinary capital income taxation or used as an AMT it avoids the stacking problem, and can have a much more serious rate structure.

If economic rents were to be taxed along the lines of the RRT or the Z-tax[23] the case for separate wealth taxation becomes much less, as these taxes are levied on the bulk of the real yield to capital.

If capital income were properly taxed, there would appear to be little reason to further discriminate against capital by levying taxes on bequests or wealth transfers. Although such taxes have some advantages over a wealth tax (notably that property can be valued on transfer) they give rise to a host of problems (e.g. they fall very heavily if deaths in the family are not widely spaced[24]) and are extremely unpopular even amongst those who are

[23] The Z-tax is a cash-flow alternative to the RRA; see Ingles (2015b).

[24] The Meade Committee (1978) sought to address this by proposing an age-gap annual wealth accessions tax. This and other transfer tax proposals in Meade would be complicated and hard for the public to understand.

never likely to pay them.[25] One of the roles of transfer taxation is to compensate for deficiencies in the tax treatment of capital income; it seems preferable to address these directly.

I note that this view is contrary to that of the Mirrlees review, who thought that annual wealth tax would be hard to administer and would impact (undesirably) on the return to life-cycle savings (Mirrlees 2011, p347). Mirrlees preferred to tax wealth transfers using a lifetime receipts (donee) basis, but noted the many practical difficulties and the public antipathy to this form of taxation. Since bequest motives figure prominently in people's motivation for saving and investing, there is not a great deal of difference in how these two forms of taxation impact savings incentives[26].

It is inherent in wealth and wealth transfer taxation that the public do not like any tax which requires them to write a cheque to the tax authority, particularly when the cheques are unsupported by cash flows. Taxes based on automatic (and hidden) payments cause far less public antipathy. This is a fact that idealistic tax reformers need to bear in mind, and which – together with its marked redistributive impact - make the deeming/ wealth tax proposal an extremely difficult one politically. Probably there is more realistic potential for reforming capital income taxation in the sorts of rent (RRA) or cash flow taxes (Z-tax) canvassed in Ingles (2015b). But that does not mean that we should not consider wealth taxation as a serious option in tax reform.

[25] On this point see Boadway et al. (2010).

[26] Economists like to point to 'unintended' bequests as a fit subject for taxation. How do we determine the extent to which they are really unintended?

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List of abbreviations

AMT	Alternative Minimum Tax
AWT	Annual Wealth tax on net worth
CFCT	Cash Flow Consumption Tax
CIT	Comprehensive Income Tax
CT	Consumption Tax
ET	Expenditure Tax
GDP	Gross Domestic Product
GST	Goods and Services Tax
IT	Income Tax
ITSYR	Income Tax with Savings Yield Remission
NCOA	National Commission of audit
RRA	Rate of Return Allowance
SIH	Survey of Income and Housing
TE	Tax Expenditure
VAT	Value Added Tax (known in Australia as GST)
X-tax	Bradford proposal for a progressive VAT
Z-tax	Ingles' proposal for a cash-flow tax based in part on the RRA