



Australian
National
University

Wealth inequality and the tax system

Tax and Transfer Policy Institute

Robert Breunig and Kristen Sobeck

Tax and Transfer Policy Institute, Crawford School of Public Policy

The Australian National University

Canberra ACT 0200 Australia

www.anu.edu.au

CRICOS Provider No. 00120C



1. Introduction

A society in which people can save and become wealthy is a healthy and prosperous society. Wealth allows individuals to sustain living standards in retirement, smooth consumption over their lifetime, and prepare for unexpected life events. Wealth also provides capital for business investment, which contributes to productivity growth and increases living standards of the broader population. When wealth accumulation differs across the population, it also leads to wealth inequality. But when does wealth inequality become a government policy concern? To answer this question, it is important to identify the sources of wealth.

At the simplest level, wealth arises from two sources: income from savings¹ and inheritance. When individuals earn money, they pay tax. After paying tax, they decide between consuming all of the remaining money or consuming some and saving the rest. Some differences in wealth arise from individuals' choices about how much to save and how much to consume. These choices reflect different attitudes towards risk and different preferences about current and future consumption. In general, wealth inequality that arises from differences in preferences should not concern government. Redistributing this type of wealth would create inefficiencies by encouraging people to make decisions that differ from what their own preferences would lead them to do.² For simplicity, in this report, this type of wealth accumulation is referred to as equitable wealth accumulation.

Inherited wealth is of much greater policy concern. Inherited wealth is usually transferred between family generations over time, inter vivos or at the time of death. A core principle of fairness in our society is that all individuals should have an equal opportunity of success. Two people of equal ability, who work equally hard, should have an equal chance of success. If one of them inherits a large amount of money and this creates a large difference in the opportunities for success, basic fairness is undermined. The idea that birthright conferred advantage on some, to the detriment of others, was violently rejected by the French Revolution and led to the demise of monarchies throughout Europe from the 18th to the 20th century. In this report, this type of wealth accumulation is referred to as inequitable wealth accumulation.

¹ Savings can take various forms, including: owner-occupied housing, superannuation, investment properties, savings accounts, shares, income from trusts, and other high-value personal assets (art, jewellery).

² There may however, be socially unacceptable levels of wealth – defined based on a society's notions of fairness and values – that may still result in Government redistribution, even if those levels of wealth are accumulated as a result of differences in preferences.



Once people save, they have to determine the vehicle through which to save. Some people may embrace risky investments with a small chance of a very large return. Others may be more conservative and put their money in an interest-bearing account where the return is small, but low risk. It is important that government policy abstain from interfering with preferences about risk and risky investments; these lead to innovation and entrepreneurship. This is one of the justifications for having a small, flat-rate tax on all forms of income from savings. It also suggests that there is nothing unfair about different people receiving different returns to savings. Different returns reflect different risk appetites and preferences; when higher returns reflect this greater risk, they also represent equitable wealth accumulation.

In some circumstances however, government policy can alter the return on investment by favouring savings in specific forms of assets and/or directing public funds to those assets. From an equity standpoint, if all individuals benefited equally from government subsidized investment, such policies might be unobjectionable. In practice however, this is not the case, and government policies confer disproportionate financial benefits on certain groups, relative to others. Importantly, these financial benefits compound over time in the form of wealth. These types of gains represent inequitable wealth accumulation and are also of policy concern.

This set of observations leads to some basic principles about the kind of wealth inequality that should and should not be addressed by government policy:

1. Wealth inequality that comes from hard work, parsimony, and individual differences in preferences is not of policy concern (equitable wealth accumulation).
2. Wealth inequality that arises from birthright (or other forms of luck), which often further entrenches advantage and privilege in society, is of policy concern (inequitable wealth accumulation).
3. Wealth inequality engendered by government policy, which favours some assets relative to others, is of policy concern (inequitable wealth accumulation).

In what follows, section two discusses the economic theory of optimal taxation of savings and wealth. It also reviews the taxation of savings in Australia and the ways in which it contributes to wealth inequality. Section three illustrates interactions between the tax system that contribute to the types of inequitable wealth accumulation that policymakers should aim to redress. Policy recommendations are also provided to redress these challenges and create a more efficient, sustainable, and equitable tax system.



2. How should wealth be taxed? How is it taxed in Australia?

It can often be difficult to distinguish between “equitable” and “inequitable” wealth accumulation, especially since they may often be intertwined. For this reason, it may not be easy or possible to subject these different types of wealth to different types of taxes. Subjecting wealth to a low rate of tax presents a compromise which, on average, attempts to tax the inequitable wealth but not tax the equitable wealth. Wealth taxes can, however, be difficult to implement.

As a result, an alternative means to tax wealth is to tax the income from savings (as opposed to the value, or stock, of wealth). Taxing wealth and taxing income from savings are roughly equivalent—one taxes the stock and the other the flow. Moreover, as discussed more extensively in Varela et al. (2020), the transitional and administrative costs associated with changing to a system that taxes the stock of wealth are substantial, since the Australian system is largely based on taxing income. As a result, since taxing income from savings and taxing wealth can be designed in an equivalent manner, a more appropriate approach to tax wealth in the Australian context is by taxing the income from savings.³

Ideally, in recognition of savings’ contribution to economic growth, savings would be taxed at one relatively low rate, applied consistently across all forms of savings. The application of one common rate would ensure that individuals invest in assets that best correspond to their preferences for risk, return and liquidity. Since savings usually originate from post-tax income from employment, a low rate recognises the previous tax paid. A low rate also incentivizes savings more than a high tax rate since the impact of taxes on savings accumulates over time (Varela, et al., 2020).

In a pre-tax (or no tax) world, wealth accumulation arises from an individual’s initial level of savings combined with her choice of savings portfolio. The greater her initial level of savings, the greater the income generated by it, and the larger the level of wealth created. This effect arises from compounding. High-income individuals, on average, accumulate more wealth because they save a greater amount of money. The composition of a savings portfolio is influenced by individuals’ preferences for risk, return and liquidity. In general, these preferences determine the speed at which wealth accumulates. Over a sufficient time period, investments with a high return can accelerate wealth accumulation, however,

³Taxing income from savings and taxing the stock of wealth can be designed in an equivalent manner. In order for this to be the case, all forms of wealth need to be taxed, including the imputed income flows from property assets. In practice, the introduction of a wealth tax, would disproportionately benefit older individuals (since the wealth tax would have been in existence for a smaller share of their lifetime). However, this generational benefit would erode over time as individuals age. Similar generational arguments would apply to the introduction of a broad-based property tax.



they often carry more risk (so may be more volatile), particularly in the short term. Assets with lower returns are usually less risky and often more liquid; they also contribute to wealth accumulation, but generally at a slower pace. In a pre-tax world, over a long period, individuals who invest more savings in assets with a higher return will have greater levels of wealth compared to those who invest a smaller amount of money in assets with a lower return.

Tax design can distort savings decisions because it creates a wedge between the pre-tax (or no tax) and post-tax return on investment. This might matter less if the same magnitude of wedge existed across all forms of savings, as the theoretical literature suggests. In practice however, the Australian tax system taxes different forms of savings quite differently. Some forms of savings are taxed upon purchase of the asset (e.g. real estate), while other forms are taxed when they are sold (e.g. shares). Some forms of savings are taxed annually (e.g. income from a savings account), while others are taxed using multiple taxes imposed at different points in time (e.g. investment real estate).

Complex tax arrangements, which apply to different forms of savings, complicate tax rate comparisons. As an illustration, Table 1 summarizes the tax treatment of different asset classes. In the case of “other property”, at least six different taxes apply to the investment. These taxes apply to different tax bases and are imposed at different points in time. To facilitate comparison of tax rates on different forms of savings, we calculate marginal effective tax rates (METRs) for a variety of asset types. METRs calculate the net impact of the tax system and show the share of the pre-tax return on investment paid in tax. For example, if an investment makes a 3 percent return in the absence of taxes, but only makes a 1.5 percent return after taxes are paid, the METR equals 50 percent. Importantly, METRs provide an indication of the extent to which the tax system favours one form of savings relative to others.

Table 1. Tax treatment of different asset classes.

Asset Class	Tax treatment
Own home	Taxed through stamp duty, council rates and GST. Receives exemptions for capital gains and pension means tests.
Other property	Similar to own home, other property is liable for stamp duty, council rates, GST. Other property is also subject to: land taxes, taxes on rental earnings and capital gains tax. Negative gearing can confer some tax advantages.
Superannuation	Most contributions are taxed at a flat rate of 15% on pre-tax income. Earnings on investments within superannuation are taxed at a concessional rate. In the pension phase, withdrawals from superannuation (e.g. account-based pension) are untaxed. The tax treatment of annuities will depend on whether they are purchased through superannuation.
Own business	Non-incorporated businesses are taxed through the personal income tax. If individuals opt to incorporate their business, they are subject to the appropriate corporate income tax rate.
Home contents and vehicles	Taxed through the GST. Typically exempt from capital gains tax.
Bank accounts, term deposits and bonds	Taxed through personal income tax.
Shares	Capital gains taxed upon sale through the personal income tax. Dividends taxed through the personal income tax, with imputation credits provided to remove the impact of corporate taxes.
Trusts	Distributions from trusts are taxed through the personal income tax. However, the distribution of dividends can lower the effective tax rate paid.
Gifts and inheritances	Untaxed

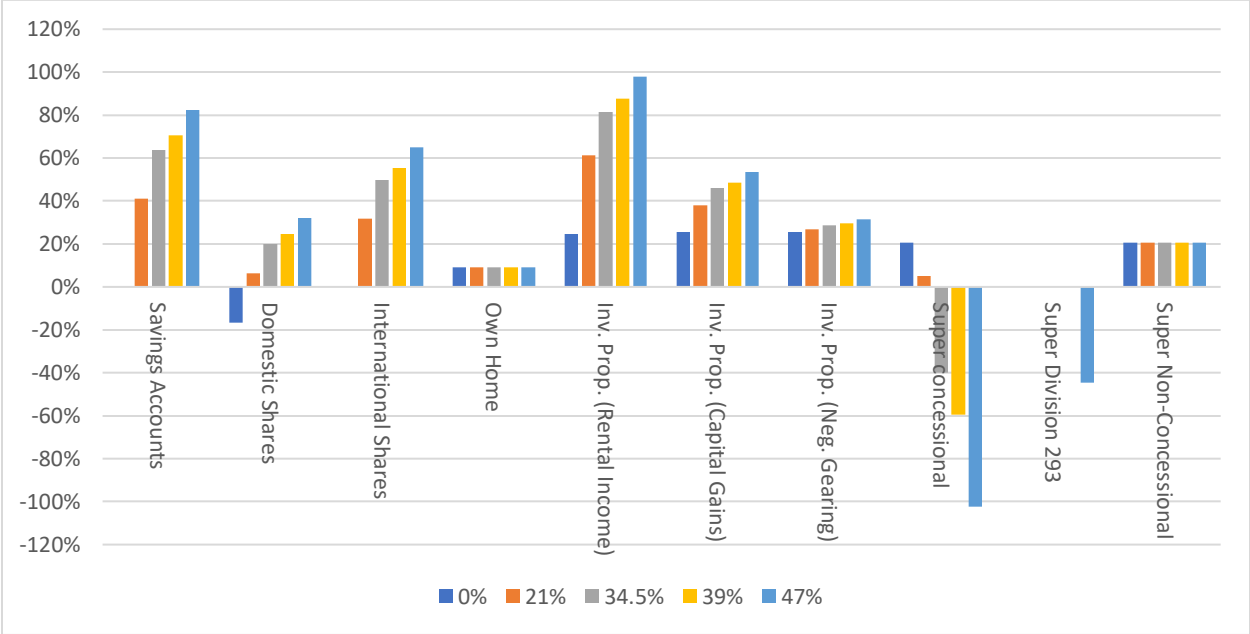
Source: Adapted and reproduced from Varela et al. (2020).

Figure 1 shows the METRs across different forms of savings across a 20-year investment period. Two main trends emerge from the figure. First, the METRs vary considerably by asset type. Some forms of savings, such as rental income from an investment property, are taxed quite heavily, while others, such as concessional superannuation, are subsidised for high income earners. Second, some forms of savings, such as owner-



occupied housing and non-concessional superannuation, do not vary by marginal income tax rate; this occurs because the taxes imposed on these assets are either a lump sum on purchase (stamp duty), unlinked to personal income tax (in the case of owner-occupied housing), or an annual flat tax rate (in the case of non-concessional superannuation). By contrast, forms of savings linked to the personal income tax system vary by marginal income tax rate.

Figure 1. METRs of major Australian asset classes over a 20-year horizon.



Notes: The figure assumes a constant real pre-tax rate of return of 3 percent, 2 percent annual inflation, personal income tax rates applicable in the 2017-18 year (inclusive of the Medicare levy), stamp duty of 4 percent on property transactions, earnings within superannuation taxed at 10 percent⁴ and a land tax equal to 0.4 percent per annum on investment properties. Domestic shares are assumed to make half of the return through capital gains and half through dividends. The negatively geared investment property uses a -30 percent gearing ratio. Council rates and GST are excluded. For more details on the methodology and interpretation, see Varela et al. (2020).

Source: Reproduced from Varela et al. (2020).

The assumptions imposed on the calculations can also change the METRs. For example, a shorter investment period would reduce the METR on a savings account, while it would increase the METR on owner-occupied housing (stamp duty is distributed over a smaller

⁴ The tax rate on earnings within superannuation is 15% in the accumulation phase. However, a lower tax rate applies to capital gains (10%), earnings in the pension phase (0%) and franked dividends (15% minus the corporate tax rate). A rate of 10% is used in the calculations and is designed to be conservative. Australia’s Future Tax System Review (2009), colloquially known as the Henry Review, suggests a figure of 7-8% while a calculation based on ATO Tax Statistics 2015-16 Super Funds Summary Tables suggests a figure close to 5%.

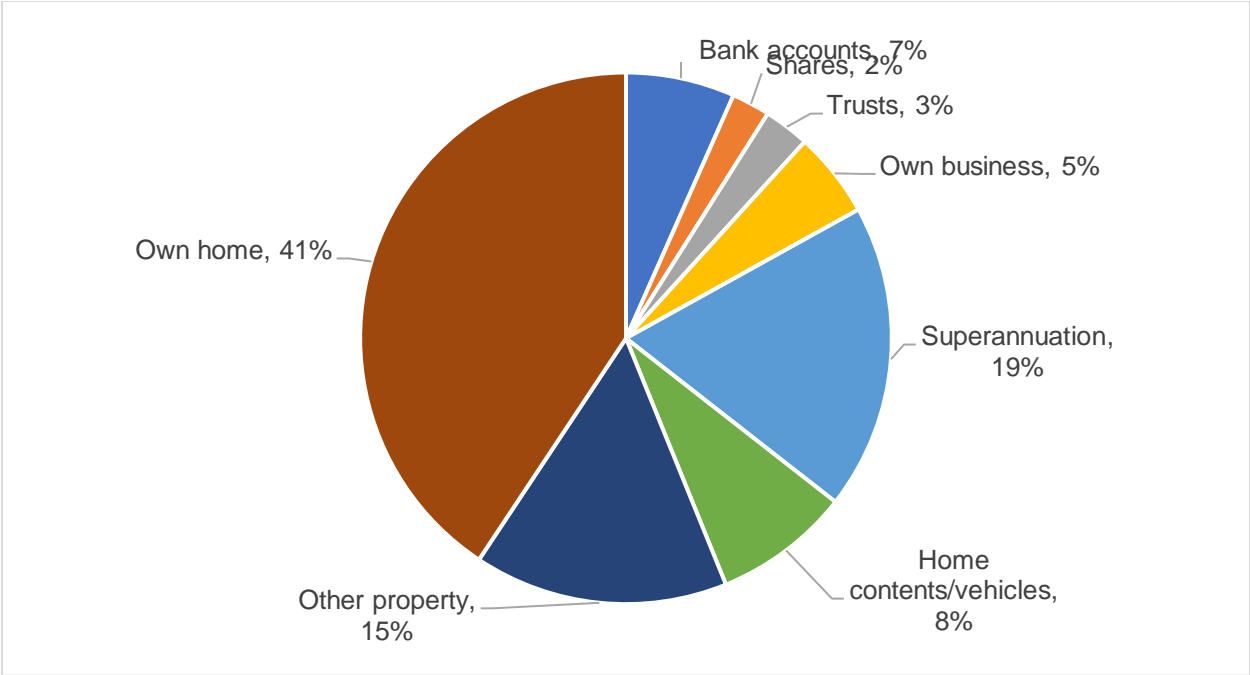


number of years). Higher inflation would increase all METRs, except owner-occupied housing, since a higher level of inflation increases the amount of tax payable.

These differences in METRs are important since the literature on the impact of the composition of savings portfolios is clear: taxpayers alter portfolio composition in favour of preferentially taxed assets (see appendix A in Varela et al. 2020, for a review of this literature). At a macroeconomic level, it is also expected that asset prices respond to tax treatment to equalize post-tax returns. High house prices in Australia at least partially reflect the preferential tax treatment.

Figure 2 illustrates the impact of these differences on savings. Consistent with the low METRs associated with owner-occupied housing and superannuation (presented in Figure 1), Australians disproportionately invest their savings in these two assets. Misallocation of investment, engendered by preferential taxation, results in an inefficient allocation of capital. Instead of investment decisions being driven by individuals' preferences for risk, return and liquidity, they are partially influenced by tax minimisation. The next section reviews how different METRs and other aspects of the tax system's design interact to create inequitable wealth accumulation. It then provides cameos of different households to illustrate these effects.

Figure 2. Shares of asset types held by Australian households, 2019 - 20



Source: ABS Household Income and Wealth, Cat. No. 6523.0



3. How does the tax system engender inequitable wealth accumulation?

This section describes how three interactions in the tax system contribute to inequitable wealth accumulation and wealth inequality:

1. Owner-occupied housing capital gains tax exemption coupled with the absence of an inheritance tax
2. The absence of a broad-based property tax
3. The capital gains discount coupled with negative gearing

While there may be other aspects of the tax system that contribute to wealth inequality, such as the use of trusts, we leave discussion of other aspects for future work.

Owner-occupied housing capital gains tax exemption coupled with the absence of an inheritance tax

Capital gains tax applies when an asset is sold. If an asset is held for more than 12 months, capital gains tax applies to 50 percent of the value of appreciation (or loss) accumulated between the date of purchase and sale; this is referred to as the capital gains discount. If an asset is held for fewer than 12 months, the capital gains discount does not apply. Owner-occupied housing is exempt from capital gains tax. This is consistent with the practice of other countries in the OECD; the majority fully exempt owner-occupied housing (OECD, 2022).

These practices are often (debatably) justified on several grounds. First, they are employed to encourage homeownership. The success of this intention is questionable. In the face of housing supply constraints, excess demand for real estate exacerbates issues of housing affordability, rather than contributing to homeownership. Inflation is often used as another economic justification. Inflation erodes the real value of capital gains since the tax is applied to nominal values. In the absence of indexation, inflation increases the effective tax rate on an investment. Fully exempting owner-occupied housing from capital gains taxation is one, extreme, way of eliminating this effect.

Capital gains exemptions applied to owner-occupied housing are also justified as a means to reduce lock-in effects. Lock-in effects discourage the sale of assets that have appreciated over time. In a review of the literature however, Burman (2009) suggests that



“... on balance, the empirical evidence from the US [where capital gains tax applies to housing] suggests that lock-in is much less of a problem in practice than economists and tax practitioners would imagine. And, as noted, it is likely to be even less acute in Australia since capital gains carry over at death.” Moreover, high stamp duties create their own lock-in effect which counteracts any positive impacts of the capital gains exemption.

The impact of the capital gains tax exemption creates a gap in the wealth accumulation between individuals who invest in owner-occupied housing and those who do not, as all other capital investments are subject to capital gains. Coupled with the lack of an inheritance tax, the difference in the wealth accumulation of different households is even greater. The impact of this interaction is illustrated through three high-income households described below.

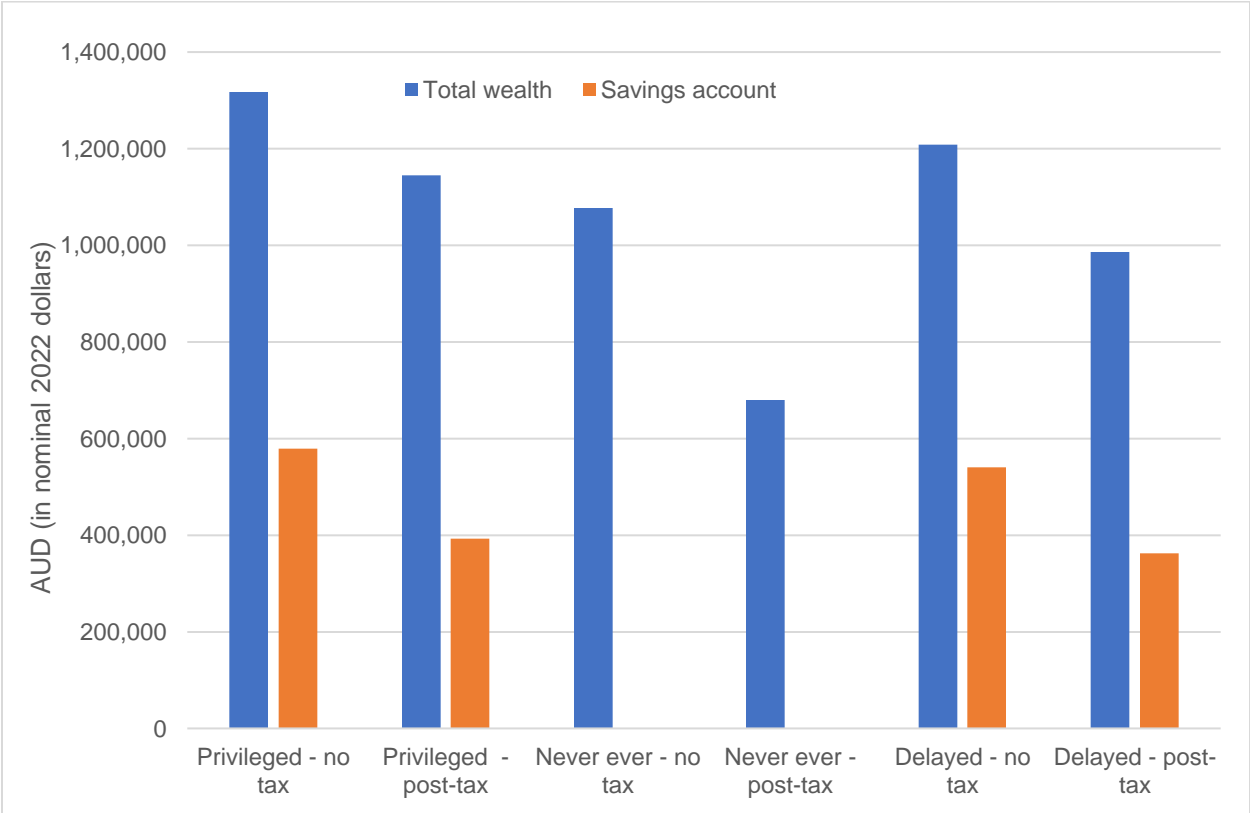
- In 2000-01, Patrick and Patricia both earned \$60,000 per year, nearly placing them at the bottom of the highest income tax bracket (47c), which started from \$60,001. The couple saves 10 percent of their post-tax income in an interest bearing savings account. Patricia’s parents gifted the difference between the couple’s savings and the 20% deposit on a house in 2000-01, allowing them to purchase a home. Patricia and Patrick are referred to as privileged homeowners. They are privileged by nature of luck; Patricia was lucky to have been born to parents who saved. It is this luck which has enabled the couple to enter the housing market sooner than they otherwise would have been able to, ensuring their wealth accumulates longer inside a tax-exempt asset.
- Danielle and Daniel are delayed (future) homeowners. They are the same age as Patricia and Patrick, have the same earnings, and identical savings behaviour. By contrast, neither of their parents could contribute to their deposit to purchase a home. Danielle and Daniel will continue to save in a savings account until they reach the 20% home deposit. They will eventually own a home; it will just take them longer to enter the housing market than Patricia and Patrick.
- Nicolas and Nicole are never ever homeowners. They are identical to Patricia and Patrick. They received a gift from Nicole’s parents that amounted to the same value as that given to Patricia and Patrick. However, Nicolas and Nicole never want to own their own home; they want to travel the world. They opt to save in shares that offer the same return on investment as owner-occupied housing.

Figure 3 estimates the total wealth levels of the three couples after a 21 year period both with and without the income tax system. “Total wealth” amounts to the level of savings in



each couple’s savings account and their home equity (if they own a home). Home equity is initially small as outstanding debt exceeds the initial home deposit. Paying down a mortgage and house price growth both increase home equity. “Savings account” refers to the amount of wealth each couple would have accumulated if they had invested their entire savings in a savings account, rather than purchase a home (or investing in shares).

Figure 3. Levels of wealth by household type, 2000-01 to 2021-22



Notes: Estimates are based on wealth accumulation from the 2000 – 01 to 2021 - 22 financial years. “Total wealth” captures the value of owner-occupied housing and cash in a savings account for the privileged and delayed couple. For the never-ever couple, “total wealth” captures wealth from shares that earn the same return as owner-occupied housing and accrue entirely in the form of capital gains (i.e. no dividends); the income tax calculation assumes the asset was sold in 2022 and CGT applied. “Savings account” refers to the total wealth level accumulated by a couple if they had invested their savings exclusively in a savings account, instead of in owner-occupied housing. The value of housing used is based on the national median value of a dwelling in 2000-01 published by the ABS. Increases in home equity are extrapolated using average nominal dwelling and land growth published by the RBA; this growth amounted to nearly 500 percent between 2000-01 and 2021-22. Home equity calculations assume a 30 year repayment period, a 20 percent deposit and a fixed interest rate of 2.9% for the duration of the loan; for simplicity (and to minimise sources of variation) the rate is fixed. For simplicity, payment of stamp duty is disregarded. Sources: Authors’ calculations using data from the ABS Housing costs and occupancy (2019 -20); ABS Consumer price index (housing group); Reserve Bank of Australia (RBA) dwelling and land growth estimates; RBA retail deposit and investment rates; ABS Ordinary time earnings for full-time adults.



Several important findings emerge from Figure 3. First, the tax system attenuates the magnitude of wealth accumulated by all couples. This emerges through several channels. Progressive income taxation, applied to labour income, reduces all couples' disposable income; this reduces the amount available to save (relative to the no income tax case) thereby lessening the associated compounding effects. In the case of the delayed and privileged couples, progressive income taxation also applies to the interest earned from the savings they accumulate in their savings account on an annual (accrual) basis. The lower level of post-tax wealth observed for Nicolas and Nicole (relative to the no-tax wealth) is attributable to the imposition of capital gains tax when their shares are sold at the end of the 21 year period.

Figure 3 also illustrates that the level of wealth accumulated by Patrick and Patricia always exceeds that of the other two couples. This occurs as a result of the gift received from Patricia's parents and the couple's choice to invest the money in a tax-exempt asset. Since investment in owner-occupied housing is untaxed, wealth accumulates at a faster rate relative to other taxed investments. The wealth accumulation benefits associated with owner-occupied housing are most apparent by comparing the post-tax wealth of the privileged couple with that realized by the never ever couple. Even though both couples received the same financial gift from their parents, and the shares purchased by Nicolas and Nicole had the same return on investment as owner-occupied housing, the level of post-tax wealth of the never-ever couple is much lower. The lower wealth observed for the never ever couple emerges because of capital gains taxation. It also emerges as a result of the difference in the base for wealth accumulation; while Patrick and Patricia earn a return based on the market value of their home, Nicolas and Nicole only earn a return based on the value of the savings they invested in the share market.⁵

The delayed couple also has less post-tax wealth than the privileged couple, but still more wealth than the never ever couple. The lower levels of wealth accumulated by the delayed couple are a result of delayed homeownership. First, Danielle and Daniel need additional time to save enough to equal the contribution made by Patricia's parents. Since house prices have risen faster than incomes (OECD, 2022; Daley & Coates, 2018), the divergence between income and house price inflation has increased the time required to save for a first-home deposit; it has also increased expenditure on housing. Importantly, for Danielle and Daniel, the income tax system, through these two channels, further prolonged the period required to save enough to reach the 20 percent deposit to purchase a home.

⁵Nicolas and Nicole could leverage their share market portfolio and reinvest in the share market. Banks are, however, more likely to impose tighter borrowing constraints, relative to a real estate investment.



The difference in wealth accumulated by both homeownership couples is a conservative estimate. Patrick and Patricia purchased their home when house prices were lower. As a result, their mortgage repayments are lower than those of Daniel and Danielle and their household disposable income is higher every year. Higher disposable income can be consumed or saved. If the privileged homeowners saved more, the gap between the couples' wealth accumulation would widen. The couple will also finish re-paying their mortgage earlier than Daniel and Danielle, further contributing to their savings (and the associated compound growth of those savings). Finally, if Patrick and Patricia invested any of their savings in other tax-preferred forms of savings and/or forms of savings with a higher return, the gap would also widen.

Figure 3 also provides estimates of the wealth that would have been accumulated if both couples had opted to retain their savings in a savings account, rather than invest in a home. The gap in accumulated wealth between those who purchase a home versus those who opt to save in a savings account is quite large, owing to the lower return on investment (interest rate), relative to owner-occupied housing, and income taxation. Income tax applies to interest earned on savings on an annual basis (on accrual).

In summary, this section compared the wealth accumulation of three couples. Two couples differed in terms of the form of asset in which they chose to invest (privileged and never ever). Two couples differed in terms of their receipt of an inheritance (privileged and delayed). The cameos revealed that the receipt of an inheritance or inter vivos gift impacts wealth accumulation. However, the extent to which an inheritance accelerates wealth accumulation, relative to other couples, depends on how it is invested. Investing in owner-occupied housing confers large wealth benefits. These benefits arise from the sizeable returns observed over the past 21 years, the preferential tax treatment afforded to owner-occupied housing, and the compounding gains associated therewith.⁶ Untaxed intergenerational transfers accelerate offspring entry into the untaxed owner-occupied housing market and the associated wealth gains.

While simple cameos are illustrative of some of the factors at play, when the effects are applied to the broader population, several additional factors exacerbate wealth inequality:

- The couples used in the cameos are high-income and are likely to have similar savings rates. Saving rates, however, differ across the income distribution. Low-wealth low-income households save less. Lower savings, coupled with high house price growth,

⁶While the cameo uses historical returns, differences in investment returns have endured over long periods.



extends the duration of time required to save for a deposit; in some cases, it precludes home-ownership entirely.

- Low-income families are often liquidity constrained. As a result, they're more likely to hold their very limited savings in easily accessible forms, such as savings accounts. These forms of savings often have low returns. In addition, as illustrated in Figure 1, they are also more heavily taxed relative to other forms of (less liquid) savings. This liquidity tax prevents low-income household investment in forms of savings with a higher return, constraining wealth accumulation. As illustrated in Figure 3, using savings accounts substantially limits opportunities for wealth accumulation. It's important to note that investments with a higher post-tax return, relative to a savings account, needn't necessarily be riskier. For example, by investing in a mutual fund with an identical return⁷ and holding it for more than 12 months, the individual would receive a higher post-tax return, relative to a savings account, by nature of the preferential tax treatment afforded to capital gains.
- Wealthier individuals are more likely to receive an inheritance; when they do, the value of the inheritance is higher than average. Data from HILDA shows that the wealthiest 20 percent of individuals (in a given age bracket) receive about 38 percent of the value of all inheritances (in that age bracket); by contrast, the poorest 20 percent only receive 8 percent (Wood, et al., 2019). The concentration of intergenerational wealth transferred to high wealth children will further widen wealth inequality.

The absence of a broad-based property tax

In the absence of taxing owner-occupied housing, a broad-based property tax could also help mitigate growth in wealth inequality. A broad-based property tax would apply to all forms of landholding. Ideally, it would apply to the unimproved value of land, as opposed to the value of the home or home improvements, since taxing capital improvements discourages property maintenance.

In practice, recurrent property taxes are levied by the states and territories in the form of land taxes and general rates. With the exception of the ACT, general rates are considered to more closely align with the definition of user fees for public services (i.e. street cleaning, rubbish removal, etc.) rather than a property tax. Land taxes levied by the states are a property tax, however, the tax base is quite narrow as it only applies to investment

⁷ This statement is conditional on an identical return. The calculation could diverge if the average rate of return on the two assets differs.



properties (owner-occupied housing is exempt). As a result, in practice, a broad-based property tax does not exist, except in the ACT.

The absence of a broad-based property tax accelerates wealth accumulation among those who own real estate, thereby contributing to wealth inequality. House prices increase due to capital improvements, including personal labour on improvements, which are within the remit of control of a homeowner. They also increase for a range of reasons outside of homeowners' control, such as: low interest rates, changing demographics, and housing supply constraints, among other factors. Positive externalities engendered by public investments, such as improvements in transportation infrastructure and other neighbourhood amenities such as high-quality schools, are another contributing factor that result in higher house prices.

Importantly, windfall gains, in the form of higher asset prices, generated by positive externalities financed through public funds contributed by Australian taxpayers nationally, accrue entirely to private homeowners. For example, evaluations of the bus rapid transit (BRT) network estimates that property values increased by 1.64% for each 100 meters closer to a bus stop in Brisbane (Zhang, et al., 2020). House price increases were also higher for homes within 400 meters of a bus stop in Sydney (Mulley & Tsai, 2016). Similarly, during the light-rail construction phase in Sydney, properties within 0 – 400 meters of a light-rail stop sold for 3.1% more than those within 400 – 800 meters (Abidoye, et al., 2021). Breunig et al. (2019) also show that developing a playground in a nearby green space (within 300 meters) increases the value of the average property by nearly five percent. Limited government land release policies also contribute to increased asset prices (Daley & Coates, 2018). A broad-based property tax is an efficient and equitable means of reappropriating the benefits of public investments, realized by private owners, and reinvesting them for public benefit.

Turning to the privileged homeowners, Patricia and Patrick, a broad-based annual property tax would indirectly tax the untaxed capital gains accrued by the couple since the value of the property (and the corresponding property tax) would increase each year. In addition, since they would pay this tax from their higher disposable household income, the reduction in disposable income available for savings would lessen the wealth accumulation of the couple. Meanwhile, the delayed homeowners, Daniel and Danielle, only pay the property tax once they enter the property market.

Renters, like Nicolas and Nicole, never have to pay property tax. If renters bear some of the economic incidence of the tax, through higher rental prices, they may pay some of the tax indirectly. In Australia, this would however, be much less likely. Investment properties



are already subject to a recurrent land tax. If a broad-based property tax was introduced on all property, it would broaden the tax base, potentially allowing for lower rates of taxation and/or elimination of the separate land tax on investment properties altogether. In other words, the introduction of a broad-based property tax would likely improve conditions for renters. For those who hold assets but have only small income flows, governments could implement reverse mortgage programs, as they currently do for those unable to pay their council rates.

The capital gains discount coupled with negative gearing

For assets against which capital gains tax applies, such as investment real estate, the capital gains taxation scheme confers two benefits. First, taxation on realisation (e.g. when the asset is sold), rather than on an accruals basis (e.g. annually on the income generated), allows taxpayers to defer tax payment and re-invest the income, tax-free. For example, if \$100 is invested in a bank account and earns a 5% return, the \$5 return is taxed in the same financial year it is earned at an individual's marginal income tax rate. If, for example, the marginal income tax rate was 50%, the individual could re-invest \$102.50. By contrast, if \$100 is invested in shares and earns a 5% return, the individual can re-invest \$105 if she doesn't sell the asset. As a result, the effective tax rate is lower for the individual who invested in shares and reduces further the longer the asset is held.

A second benefit of the capital gains tax design is that investors can choose the optimal time to sell their assets, potentially benefiting from a lower marginal income tax rate, such as when they retire. Indeed, individuals over 65 are more likely to sell assets than younger individuals (though, there may be many reasons that individuals may desire to liquidate their assets as they age) (Daley & Wood, 2016). The benefits in timing also help explain the overrepresentation of other real estate in the savings portfolio of Australian households (Figure 2). The ability to time capital gains realization incentivizes investors to shift their portfolios to long-duration investments with less recurrent net income and greater capital gains.

A third benefit conferred on those who invest in assets that accrue capital gains arises from its combination with negative gearing. Gearing refers to borrowing money to invest. When the financial returns exceed the cost of borrowing, the investor makes a profit. Such an investment is referred to as positively geared. By contrast, if the costs exceed the financial returns in a financial year, the investor makes a loss; this investment is negatively geared (Tax and Transfer Policy Institute, 2019). Profits and losses are taxed at an individual's marginal income tax rate. Investment losses are deducted from total



assessable income, which encompasses income from employment (labour income) and investment income (capital income).

Under comprehensive income taxation, the ability to deduct investment losses from labour income is consistent because *all* forms of income are taxed at marginal income tax rates. In practice however, Australia's system is not a pure comprehensive income tax system. It is a hybrid system that combines elements of a comprehensive income tax system with a modular approach. Under the hybrid approach, some forms of income are taxed at progressive marginal income tax rates, while others are taxed at a lower and flat rate. This hybrid system facilitates opportunities for tax arbitrage, particularly when combined with the capital gains discount.

Turning to the privileged homeowners, Patricia and Patrick eventually accumulate enough wealth (through home equity and savings) to purchase an investment real estate property. This real estate property will subsequently earn the same pre-tax return on investment as the owner-occupied property. The couple decides to rent out the property and will receive rental income that will be taxed at their marginal income tax rates. Progressive taxation of rental income is consistent with the practice of most OECD countries (OECD, 2022). Since the rental income is taxed, they are also permitted to deduct the associated costs of financing (mortgage interest repayments) and maintaining the property from their assessable income.

The privileged couple is likely to make a net loss on the property for several years. This is because the interest payments on a loan represent a larger share of the mortgage when repayments begin. They can deduct the loss from their total assessable income, which includes their labour income. Since they are in the highest income tax bracket, deductions are valuable and reduce the amount of tax payable by 47c per dollar. Second, since they can choose when to sell their investment property, they can opt to sell it once they retire.

Selling the property when they retire is beneficial for two reasons: the effective tax rate will be much smaller the longer the property is held (since capital gains are taxed on realisation) and in retirement they will not have labour income (or have less of it) putting them within the tax free threshold or a much lower income tax bracket. They are also more likely to be in a much lower income tax bracket since income drawn-down from superannuation for retirement is tax-exempt. In other words, negative gearing allows individuals to minimise tax paid today as well as in the future when they sell the asset. The delayed couple, Danielle and Daniel, are also able to undertake the same tax minimisation strategy as Patrick and Patricia. It will take them longer to acquire the



investment property however, since they purchased their owner-occupied home at a later point in time.

4. How could tax policies be improved to redress inequitable wealth accumulation and wealth inequality?

The lack of an inheritance tax engenders a divide in wealth accumulation between those who receive an inheritance and those who do not. A larger wealth divide arises between the wealth of those who enter the housing market and those who cannot. This is in part because those who cannot enter the housing market tend to be lower income individuals with limited forms of savings. The types of savings in which low-income individuals hold their savings tend to be liquid forms, with a low return, that is taxed like labour income. In other words, savings tax settings are regressive and disproportionately favour the rich to the detriment of the poor (Varela, et al., 2020). The silver lining is that while tax settings contribute to wealth inequality they can also be changed to reduce it. Specific changes to the tax system will influence investment decisions that over the longer run will attenuate the magnitude of wealth inequality. Some of these changes are described below.

Consistent taxation of savings

Since the inconsistent taxation of different forms of savings is an important driver of wealth inequality, more consistent taxation of savings would help redress it. A dual income tax (DIT) is one way to achieve consistent taxation of savings. A DIT applies a separate and (usually) flat rate of tax on all forms of capital income. Meanwhile all labour income is subject to a progressive rate schedule.

A DIT would eliminate the incentive to invest in certain forms of assets, relative to others, for tax purposes alone. The incentive to split income across individuals or over time would also be eliminated as the same flat tax rate would apply to all individuals at all points in time. Shifting to a DIT would also be more equitable as it would tax income from assets at the same rate, irrespective of the type of asset (as the current system does). Finally, stamp duties could be removed and the tax advantage associated with negative gearing would be redressed by ringfencing capital deductions from capital income.

The extensive tax base of a DIT would also permit the tax rate to be set at a relatively low level. Varela et al. (2020) estimate that a revenue neutral DIT rate could be levied at 6.2%, assuming the average nominal return on assets was 5 percent. This rate includes the



taxation of owner-occupied housing, which could be achieved by taxing imputed rent or by levying a broad-based property tax. If owner occupied housing remained excluded, all capital income could be taxed at 10.2% to ensure revenue neutrality or an appropriately priced land tax could be combined with the 6.2% rate on all other forms of savings.

[Inheritance tax](#)

An inheritance tax, which would also include taxation of inter vivos gifts, would also limit wealth accumulation and reduce wealth inequality between those in receipt of an inheritance and those who are not (or in receipt of a much lower value inheritance). Inheritance taxes are imposed in the majority of OECD countries (OECD, 2021). However, exemption thresholds vary substantially across countries. In addition, over time, the size of the tax base, subject to inheritance taxation, has declined across the OECD (OECD, 2021).

One important drawback of inheritance taxes are that they encourage the use of tax minimisation strategies. These strategies, which include the use of trusts, particularly relevant in the Australian context, imply that such a tax may not be borne by the wealthiest families, but rather, families in the middle of the wealth distribution. While tax avoidance could be minimised if an inheritance tax was set at a low rate, the political viability of introducing one is questionable. The benefits of doing so, particularly given the use of trusts, are also debateable, especially when more efficient options are available.

Australian households hold the majority of wealth in real estate and superannuation. In the case of real estate, a more efficient option of targeting inherited wealth, including that held within trusts, would be through a broad-based property tax imposed annually throughout all property owners' lifetimes. Similarly, taxation of inherited wealth received from a decedent's superannuation could be better achieved through improvements in the taxation of superannuation during all superannuants' lifetimes. Both of these reforms are discussed in greater detail below.

[Introducing a federal and broad-based property tax](#)

Introducing a federal land tax and/or substantively changing property taxation in all states would be an efficient and equitable way to change wealth accumulation and reduce wealth inequality. A broad-based property tax that applied to all property at a low rate could reduce wealth accumulation through several channels:



- A broad-based property tax based on the unimproved value is a simpler way of taxing the tax-exempt capital gains on owner-occupied housing. Indeed, the capital gains tax exemption currently applied to owner-occupied housing could be retained with a properly designed property tax.
- A broad-based property tax would reduce the disposable incomes of owner-occupied property owners. In turn, this would reduce their income available for savings (and the associated compounding effects that contribute to wealth accumulation).
- A broad-based property tax, set at a low rate, could be introduced alongside the elimination of state land taxes (but not general rates) in a revenue neutral way. Such a policy change would actually improve the net financial position of investment property owners for whom the current cost of land tax would exceed a broad-based property tax (because the current land tax has a very narrow tax base and higher rates). Such a policy change has the added benefit of not adversely impacting renters (indeed, such a policy could positively impact renters).

Rose and Breunig (2022) show that a federal property tax set at 0.1% of unimproved land values (excluding government and rural land) imposed over 33 years would eliminate public debt associated with COVID-19. For example, on a property with an unimproved land value of \$1,000,000, this amounts to an annual property tax of \$1000.

Improve the taxation of superannuation

Superannuation is taxed at a lower rate than labour income because it is held for a much longer period of time (and the impact of taxation compounds over time). However, since the superannuation guarantee is calculated based on a flat percent of earnings, individuals with higher earnings accumulate more superannuation; they also more greatly benefit from the concessional tax treatment accorded to it. As emphasised throughout this report, the gains from concessional tax treatment compound over time accelerating wealth accumulation of those who can access them.

Several policy options would improve the taxation of superannuation to create a more equitable system that reduces wealth inequality. Moving from a flat 15% tax rate on superannuation contributions to a system where the tax payable is based on an individual's marginal income tax rate less a flat discount (at least 5 to 15 percent) is one policy option. This would attenuate the compounding impact of wealth accumulation over time.⁸ Lowering the annual concessional contributions cap is another consideration which would reduce access to concessional taxation of superannuation.

⁸ It would also eliminate the need to retain Division 293 taxation.



Since the impact of taxation on an investment increases over time (Varela, et al., 2020), ideally superannuation would be taxed at a low rate when individuals enter the labour market in their teens or 20s and the rate would increase as they age. This is not how the system is designed; the greatest tax benefits – in terms of both the rate⁹ and the concessional contribution caps – are accorded to those closest to retirement, completely antithetical to one of the underlying rationales for taxing superannuation at a low rate.

In theory, these well-intended contribution caps, as well as matching policies such as the government co-contribution program, were designed to allow low and middle income individuals, or those with disrupted labour force participation patterns (disproportionately women), to catch-up and boost their superannuation balances. In practice however, research shows that those who disproportionately took advantage of changes in the contribution caps were those for whom they were least intended: high-income individuals who were predominantly men (Coates, 2018; Chan, et al., 2022). The government co-contribution policies also have relatively low take-up among eligible low and middle individuals (less than 10 per cent in 2015 – 16) (Sobeck & Breunig, 2020).

To this end, three specific proposals would align the taxation of superannuation with the dual goal of minimizing the cumulative impact of tax and creating a more progressive system:

- Lowering the superannuation tax rates for younger Australians (since their contributions are held for the longest period).
- Removing catch-up provisions, which allow concessional contribution caps to be rolled over to future years (and disproportionately benefit older Australians).
- Taxing earnings received within superannuation during the retirement phase at the same rate as earnings received during the accumulation phase. Currently, the system places the smallest tax rate on assets held for the shortest amount of time.

⁹ The rate is preferential closer to retirement since individuals' incomes tend to increase as they age, and the concessional tax rate is of greater value to individuals in the highest income bracket. The concessional contribution caps further magnify the savings benefits afforded to this privileged group.



Bibliography

Abidoye, R. B., Fam, F., Oshodi, O. S. & Oyetunji, A. K., 2021. Impact of light rail line on residential property values – a case of Sydney, Australia. *International Journal of Housing Markets and Analysis*, 15(3), pp. 691-708.

Breunig, R., Hasan, S. & Whiteoak, K., 2019. Impact of Playgrounds on Property Prices: Evidence from Australia. *Landscape and Urban Planning*, Volume 190.

Burman, L. E., 2009. Taxing Capital Gains in Australia: Assessment and Recommendations. In: *Australian Business Tax Reform in Retrospect and Prospect*. Sydney: Thomson Reuters.

Chan, M. K., Morris, T., Polidano, C. & Vu, H., 2022. Income and saving responses to tax incentives for private retirement savings. *Journal of Public Economics*, Volume 206.

Coates, B., 2018. *What's the best way to close the gender gap in retirement incomes?*, Melbourne: Grattan Institute.

Daley, J. & Coates, B., 2018. *Housing Affordability: Re-Imagining the Australian Dream*, Melbourne: Grattan Institute.

Daley, J. & Wood, D., 2016. *Hot Property: Negative Gearing and Capital Gains Tax*, Melbourne: Grattan Institute.

Mulley, C. & Tsai, C.-H. (., 2016. When and how much does new transport infrastructure add to property values? Evidence from the bus rapid transit system in Sydney, Australia. *Transport Policy*, Volume 51, pp. 15-23.

OECD, 2018. *Taxation of Household Savings*, Paris: OECD.

OECD, 2021. *Inheritance Taxation in OECD Countries*, Paris: OECD.

OECD, 2022. *Housing Taxation in OECD Countries*, Paris : OECD.

Rose, T. & Breunig, R., 2022. *Paying Back Australia's COVID-19 Debt*, s.l.: Tax and Transfer Policy Institute.



Sobeck, K. & Breunig, R., 2020. *The impact of government funded retirement contributions (matching) on the retirement savings behaviour of low and middle income individuals*, s.l.: Commonwealth Treasury, as part of the Retirement Income Review.

Tax and Transfer Policy Institute, 2019. *Australia's Tax Policy: What is Negative Gearing?*. [Online]
Available at: <https://taxpolicy.crawford.anu.edu.au/taxpolicy-publications/tax-facts>

Varela, P., Breunig, R. & Sobeck, K., 2020. *The Taxation of Savings in Australia: Theory, Current Practice and Future Policy Directions*, Canberra: Tax and Transfer Policy Institute.

Wood, D., Griffiths, K. & Emslie, O., 2019. *Generation Gap: Ensuring a Fair Go for Younger Australians*, Melbourne: Grattan Institute.

Zhang, M., Yen, B. T., Mulley, C. & Sipe, N., 2020. An investigation of the open-system Bus Rapid Transit (BRT) network and property values: The case of Brisbane, Australia. *Transportation Research Part A: Policy and Practice*, Volume 134, pp. 16-34.