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THE TAX AUSTRALIA HAS TO HAVE

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INTRODUCTION

Modern tax systems have a mix of taxes, with individuals being taxed in any of three broad ways: on what they earn (income tax); on what they spend (consumption tax); and on what they salt away and give away (taxes on wealth, either annually or intermittently, and inheritance and gift taxes). Australia is a rarity amongst the modern developed economies of the world because it has no general taxes on the accumulated wealth of individuals. People pay no tax annually on their wealth; nor do they pay any tax on their estate when they die; nor is any tax paid on gifts or inheritances. Consequently, the outstanding characteristic of Australia's tax system is that it is based on a very narrow range of sources of tax, which are taxed relatively heavily. Therefore, while wealth taxes are the taxes Australia does not have, a need to broaden the tax base and make the tax system fairer might mean that, in future, some general taxes on accumulated wealth become taxes which Australia has to have.

The focus in this discussion is on the role of wealth taxes in general, and annual net wealth taxes in particular, in a tax system. The key criteria for judging tax systems or tax measures are equity and efficiency. In practice these two key criteria often conflict, so that in developing a system of taxes there are trade-offs between equity and efficiency objectives. Other important criteria for judging taxes or tax systems are administration and revenue aspects of taxes.

In the rest of this discussion, first the principles of taxation are outlined, then the nature of various taxes on wealth is explained. The incidence of taxes on capital and possible effects on efficiency are explored. Then the arguments relating to taxes on wealth are canvassed. The argument is presented that annual net wealth taxes would improve Australia's tax system - as also would death, inheritance and gift taxes. This is not a popular line of argument. But, as the saying goes, a popular economist, like a popular tax-collector, is obviously someone who is not doing his or her job.

PRINCIPLES OF TAXATION

The main principles of taxation are that the burden of tax should be shared fairly between different people in society; that taxes should not interfere with business decisions in a way which causes the economy to operate less efficiently than it would without the tax or under an alternative tax system; the tax system should be understandable and not too costly to administer; and finally, it should raise sufficient money to fund government policies. trying to achieve all of these objectives at the same time is difficult as they conflict. For instance, all interference by taxes with economic choices and decisions involve efficiency costs.

Compromises and trade-offs between satisfying these principles of taxation and meeting political imperatives, is central to the art of polities. In the light of well-established principles of taxation, in the 1950s the British economist Lord Kaldor proposed his ideal tax system. It had a single tax return and moderate levels of tax on income, realised capital gains, an annual tax on property, a tax on personal expenditure and a gift tax payable by those who get the presents.

The criteria used for the assessment of a tax structure have been a matter of debate since at least the time of Adam Smith. Smith (1776) proposed four maxims with regard to taxes in general, and these he summarised as follows.

> All nations have endeavoured, to the best of their judgement, to render their taxes as equal as they could contrive; as certain, as convenient to the contributor, both in the time and in the mode of payment, and, in proportion to the revenue which they brought to the prince, as little burdensome to the people (1970, Vol.2, p.309).

The criteria that nowadays are generally seen as being important features of a tax system are based on those originally expounded by Adam Smith. They include:

(i) The distribution of the tax burden should be equitable between individuals and social groups (Kaldor 1964, p.203).

(ii) Taxes should be chosen so as to minimise interference with economic decisions because such interferences impose efficiency costs and these costs should be minimised (Musgrave 1984, p.225).

(iii) The tax structure should facilitate the use of fiscal policy for the pursuance and achievement of stabilisation and growth objectives (Musgrave 1984, p.225).

(iv) The tax system should permit fair and non-arbitrary administration and it should be understandable to the taxpayer (Musgrave 1984, p.225).

(v) Administration and compliance costs should be as low as possible (Musgrave 1984, p.225).

(vi) The tax system should provide adequate revenue (Musgrave 1989, p.216).

The efficiency objective of taxation holds that tax administration and compliance costs should be kept as low as possible, and that the 'excess burden' or efficiency cost of a tax, should be minimised. The essence of this major objective of taxation can be found in Adam Smith's fourth and final maxim of taxation. He wrote,

> Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury and the state. A tax may either take out or keep out of the pockets of the

> people a great deal more than it brings to into the public treasury, in the four following ways. First, the levying of it may require a great deal of officers, whose salaries may eat up the greater part of the produce of the tax, and whose perquisites may impose another additional tax upon people. Secondly, it may obstruct the industry of the people, and discourage them from applying to certain branches of business which might give maintenance and employment to great multitudes. While it obliges people to pay, it may thus diminish, or perhaps destroy, some of the funds which might enable them more easily to do so. Thirdly, by the forfeitures and other penalties which those unfortunate individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from employment of their capitals.........Fourthly, by subjecting the people to the frequent visits and the odious examination of the tax-gatherers, it may expose them to much unnecessary trouble, vexation and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to the expense at which every man would be willing to redeem himself from it (1970, Vol.2, pp. 308-9).

Another generally accepted axiom of taxation is that people should be taxed according to their ability to pay. This is the fairness or equity principle. Fairness in taxation comes in two directions: horizontal and vertical. Horizontal fairness requires that people in similar circumstances are treated similarly. Vertical fairness requires that better-off people pay more tax than those who are worse-off. The argument for taxing people's wealth rests in part on the notion that tax based on people's ability-to-pay is the key component of a fair tax system, and income or consumption taxes do not fully capture the entire increase in people's well-being or ability-to-pay over a period.

Adam Smith (1776) clearly defined the 'ability to pay' principle in the first of his four maxims of taxation:

> The subjects of every state ought to contribute towards the support of the government, as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state. The expense of government to the individuals of a great nation is like the expense of management to the joint tenants of a great estate, who are all obliged to contribute in proportion to their respective interests in the estate. In the observation or neglect of this maxim consists what is called the equality or inequality of taxation (1970, Vol.2, p.307).

Kaldor commented on the difficulty in implementing the ability to pay principle as follows:

> It is not possible to give any precise definition to notions such as 'taxable capacity' or 'ability to pay'. But that does not mean that these notions themselves are of questionable validity. They very clearly mean something, even though if one wants to quantify them with precision one always comes up against difficulties........It is clear that different individuals' taxable capacities differ and we should aim at a system which distributes the burden of taxation in a manner that is as close as possible to this concept of ability to pay, or taxable capacity (1964, Vol.1, pp.205-6).

There are two further, related notions here. First ,wealth bestows intangible benefits such as security, status, borrowing power, political influence, and more material benefits such as scope to reduce the rate of income tax paid. Second, there is the idea that income earned from property is achieved with less effort and is usually of a more permanent nature than income earned by hard work. Therefore the addition to ability-to-pay from benefits accrued relatively easily (i.e.without any sacrifice of leisure, which itself is a valued benefit) from owning property is greater than the addition to ability-to-pay from benefits which accrue from the sweat of personal exertion. Thus income from wealth is an eminently more taxable part of ability-to-pay than is the main source of tax revenue in Australia, which is tax on personal income from effort.

Vertical equity has been seen in terms of equal sacrifice, or equal loss in social welfare, since the time of the writings of John Stuart Mill (1848). He discerned:

> As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all, which, it must be observed, is the mode by which least sacrifice is occasioned on the whole...... Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice. It means apportioning the contribution of each person towards the expenses of the government so that he shall feel neither more or less inconvenience from his share of the payment than every other person experiences from his (1973, p.804).

This notion of equal sacrifice has been interpreted in practice as relating to a loss of income through the payment of taxes. If the marginal utility of income schedule (the level of welfare as a function of income) was the same for all taxpayers, then the equal sacrifice principle would call for people with different incomes to pay different amounts of tax.

A comprehensive system of taxation has to include the entire accretion to the wealth of an individual over time, regardless of the nature of such accretion. That is, all income should be included whether it accrues in the form of money, imputed income (for example the rent from owner occupied housing), or appreciation in the value of assets. Income then equals the increase in net worth (saving) plus consumption during the measurement period. This definition of income is widely attributed to R M Haig (1921) and H C Simons (1938), and is known as the 'Haig-Simons' formula for calculating personal income over a measurement period. Cited in Simons (1965, p.61), Haig originally asserted that 'Income is the money value of the net accretion to one's economic power between two points in time'. Simons (1938) went further to argue:

> Personal income connotes, broadly, the exercise of control over the use of society's scarce resources. It has to do not with sensations, services, or goods, but rather with rights which command prices (or to which prices may be imputed). Its calculation implies estimate (a) of the amount by which the value of a person's store of property rights would have increased, as between the beginning and end of the period, if he had consumed (destroyed) nothing, or (b) of the value of rights which he might have exercised in consumption without altering the value of his store of rights. In other words, it implies estimate of consumption and accumulation. Consumption as a quantity denotes the value of rights exercised in a certain way (in destruction of economic goods); accumulation denotes the change in ownership of valuable rights as between the beginning and end of a period.........Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in the value of the store of property rights between the beginning and end of the period in question. In other words, it is merely the result obtained by adding consumption during the period to 'wealth' at the end of the period and then subtracting 'wealth' at the beginning (1965, pp.49-50).

Another important part of tax equity is the benefit principle. This principle holds that people should be taxed according to the benefit people receive from the provision of public services. While the benefits of public services go to the general public irrespective of wealth ownership, in addition, property owners gain from increases in the value of property which arise from the provision of public services. Benefits of this type are also received by way of the protection of property, which is one of the functions of the state. It can be argued that property owners receive a disproportionate share of the benefits from the provision of public services, and therefore a tax on property can be justified according to the benefit principle of taxation. Presumably, the above reasons are the basis for the system of land tax in Australia. The

taxation of land is done with vertical fairness in mind as well, exempting owners of land below certain threshold values.

The Nature of Taxes on Wealth

The forms of tax which can be regarded as general taxes on the accumulated wealth of individuals are annual net wealth taxes, death taxes, gift taxes and inheritance taxes. The nature of annual wealth and death, inheritance and gift taxes are fundamentally different. Death taxes and inheritance taxes are collected only once a lifetime, and gift taxes intermittently. Reference was made to this distinction and its implications in the study carried out by the OECD:

> An annual net wealth tax, seen as a regular supplement to income tax, can be expected to take account on a continuing basis of the advantages (and hence the additional taxable capacity) conferred by wealth. Death taxes, supported by a gift tax, supplement income tax by catching wealth, in general, once a generation, even if doing so with less reliability than an annual net wealth tax because of the greater possibilities of escaping the tax by higher consumption (Sandford 1988a, p.16).

Saunders drew attention to the difference between annual taxation of wealth and taxes on inheritances, estates and gifts, when he expressed the view that these two types of taxes should be seen as complementary to each other rather than as substitutes.

> A criticism often levied against an annual wealth tax is that it does not distinguish between inherited and accumulated wealth. This serves to emphasise that there are many different arguments for taxing wealth, some relevant to wealth transfer taxation, and some relevant to the annual net wealth tax, and it is therefore not appropriate to view alternative wealth taxes as substitutes...... It is important to re-emphasise that these two forms of wealth taxation have different objectives and they should not be regarded as tax substitutes (1983, pp. 408-10).

A distinction is necessary between taxes on wealth which tax the income earnt by capital, and those which tax the capital itself. Capital taxes are levied on a capital base but are intended to be paid from the income derived from that capital and not from the capital itself. By contrast, taxes on capital in the strict sense are intended to be paid from capital and not from the income it generates (Groenewegen 1990, p.189). As Pigou (1928), one of the founders of modern welfare economics noted.

> According to it (popular opinion), while all other taxes are paid, at least in part, out of economies in consumption, death duties, being taxes on capital, are necessarily

> paid wholly 'out of capital'. This is a gross confusion.......It stems from a failure to distinguish between object of assessment and source of tax payment. The object of assessment is the channel through which the source of tax payment is reached; it is not identical with it. For commodity taxes everybody recognises this. Nobody maintains that a tax assessed on beer is necessarily paid out of beer or even out of resources which would have otherwise have become beer. The position is essentially the same with income and capital (1947, p.139).

The rate of tax and the definition of the tax base will determine whether an annual net wealth tax can be classed as a 'capital tax' or a 'tax on capital'. However, owing to the low rates that are applied in practice in the countries which impose an annual wealth tax, it is generally designed to be paid from the income from capital, rather than from capital itself. Therefore an annual net wealth tax may generally be seen as a 'capital tax' rather than a 'tax on capital'. The other main class of personal wealth tax are taxes imposed on the wealth of individuals at death, and inheritance taxes and gift duties, all of which are paid once a generation rather than on an annual basis. This second class of wealth tax may, in some instances, act as a form of 'tax on capital'.

A capital gains tax has existed at the federal level since 1985, but since capital gains are a form of income derived from capital, this is an income tax rather than a capital tax. Sandford (1988) made clear this distinction:

> It can be argued that a tax on capital gains should not be regarded as a tax on capital at all, since capital taxes, like death taxes and annual net wealth taxes, are levied on a stock of assets at a point of time, whereas a capital gains tax is levied on the appreciation of assets over a period of time and is thus more akin in many respects to an income tax than to a capital tax (1988a, p.13).

A further distinction is that wealth taxes may be imposed on property, payable by the owner, in which case they are an impersonal, or *in rem* type of tax. Alternatively tax can be levied on the combined property holdings of a person, or on his or her net wealth, and thus is of a personal nature (Musgrave 1984, p.459). Taxes on people are superior to taxes on things because the ability to pay criterion is better satisfied.

The taxation of estates may also be considered as an alternative to a tax on capital income during the recipient's lifetime, in order to counter any perceived disincentive effects that a tax on capital income would have on saving and investment. Fiedler (1983, p.48) commented that 'it is possible to regard a tax which is due on the transfer of wealth as being equivalent to the present

value of taxes due under an annual wealth tax, if the tax is based on the donee rather than the donor, that is, if it were an accessions tax'.

The taxation of capital in Australia is currently restricted to the taxation of specific property or land value through local government rates, State land taxes, and taxes on the transfer of property and capital. According to Groenewegen (1990, p.188) these amounted to nine percent of national tax revenue in 1987-88. The prominence of local rates in the taxation of capital, and their role in financing local government, was described by Groenewegen (1985):

> In fact, local rates are the only tax revenue source of local government. This is justified by long standing tradition (local rates on property values as a source for financing local public works date back to the late middle ages in Britain). It also conforms to normative criteria of tax assignment which accord local government tax control over an immobile tax base (land and real estate) to prevent transfer of tax burdens across boundaries. As long as local government exists and needs an independent tax revenue source local rating is the only real candidate for this task. (1985, p.215).

He went on to say:

> Although local rates do not raise a large proportion of national tax revenue, they form a substantial part of aggregate property or wealth taxation (half on the definition used in the tax classification ..., more than three-quarters if financial and capital transaction taxes are excluded). With land taxes (an even less important revenue source), rates are therefore the mainstay of Australia's wealth tax system and explain Australia's high ranking in property taxation among OECD countries, a paradoxical situation when Australia has no general property taxes whatsoever (1985, p.216).

Early federal land tax was eroded in the 1920's by the first Country Party federal treasurer, Earl Page, and was abolished in 1953, by Arthur Fadden, another Country Party treasurer (Groenewegen 1985, p.214). However land tax has survived as a tax instrument of state governments, but it represents only a minor and dwindling proportion of state governments' revenue (Groenewegen 1990, p.198). In nearly all cases, the tax is levied largely on urban land of relatively high value, but not on the ordinary residential block.

Inheritance taxes are based partly on the proposition that in a capitalist society, people have the right to keep what they earn in a competitive market, given 'equal positions at the starting barrier'. The traditional liberal case for taxing unearned wealth from transfers by gift or bequest is generally attributed to John Stuart Mill (1848). He asserted:

> With respect to the large fortunes acquired by gift or inheritance, the power of bequeathing is one of those privileges of property which are fit subjects for regulation on grounds of general expediency.. ....I conceive that inheritances and legacies, exceeding a certain amount, are highly proper subjects for taxation..........The principle of graduation (as it is called), that is of levying a larger percentage on a larger sum, though its application to general taxation would be in my opinion objectionable, seems to me both just and expedient as applied to legacy and inheritance duties (1973, p.809).

Some of the benefits and the privileges of ownership are created and protected by society and by the law during a person's life. The 'right of a dead hand to dispose of property' is also creation of the law. Therefore, the community has the right to interfere in the processes of inheritance, and reclaim some of what it helped create and protect during the life of the generous departed. A gift duty is a necessary complement to death duties and inheritance taxes.

Reducing inequalities in terms of inherited wealth by the implementation of an inheritance tax, or annual wealth tax for that matter, can go some way towards improving the equality of opportunity for all the potential sources of much needed human capital. In so doing a tax on inheritance would also enhance the competitiveness of the hitherto less privileged members of society in the development and application of their potential abilities, with consequent overall benefits to an economy due to a greater overall quality and quantity of human capital. Economic efficiency gains would follow. John Stuart Mill (1848) took this standpoint when he remarked:

> Many, indeed, fail with greater efforts than those with which others succeed, not from difference of merits, but difference of opportunities; but if all were done which it would be in the power of a good government to do, by instruction and by legislation, to diminish this inequality of opportunities, the differences of fortune arising from people's own earnings could not justly give umbrage (1973, p.808).

Bird (1980) agreed:

> The distribution of assets in a country at any point in time, for example, is largely the outcome of historical accident, as condoned by the state and frozen in law. The result of this pattern in the distribution of initial wealth is that many of those most successful in life stand not on their own feet but on the shoulders of their fathers - a result hardly in accordance with the commonly accepted idea that one function of the state is to provide approximately equal access to economic opportunity for its citizens....In these terms, one role of the state is to improve the fairness of the

lottery of life: and one way to do so is through direct taxation of inherited wealth (1980, p.36).

Incidence of Taxes on Wealth

A popular misconception is that where a tax is imposed is where a tax is paid. There is a difference between the person who is told that they have to pay some types of tax, and the people who really pay it. This question of who eventually really pays a tax is called the incidence of a tax. In many cases tax is paid by other people, not by the owners of business which may bear the initial charge. The burden of the tax may be passed on to either employees who receive lower wages, or consumers who pay higher prices. The same applies to a consumption tax: it does not matter which side of the counter it is imposed, the incidence of it is shared by those people who buy the product, and those people involved in making it and selling it. The incidenceof a tax is not necessarily borne where the tax is first imposed, but is spread amongst people throughout the economy. It is difficult to know who actually pays a tax. Only one thing is certain: all taxes are eventually paid by individuals.

Ricardo (1817) distinguished between reductions in consumption and savings as the source of tax payment:

> All taxes either fall on capital or revenue. If they encroach on capital, they must proportionably diminish that fund by whose extent the extent of the productive industry of the country must always be regulated; and if they fall on revenue, they must either lessen accumulation, or force the contributors to pay the amount of the tax, by making a corresponding diminution of their former unproductive consumption of the necessities and luxuries of life......Taxes are not necessarily taxes on capital because they are laid on capital, nor on income because they are laid on income (1969, p.95).

A tax on factor income, according to the partial equilibrium approach, will reduce the return to the taxed factor, thus burdening the suppliers of the factor, and raise the price of products in which the factor is used. Hence both the earnings and expenditure side of household accounts are affected, but it is not possible to predict the distribution of expenditures by householders on products in which the taxed factor enters. Shoup (1970, p.364) concluded that the effect of a net wealth tax on the incomes of co-factors and to consumers of capital intensive products is probably small, and distributed randomly by income class.

Assuming perfect capital markets and using partial equilibrium analysis it can be shown that a tax on capital income will be borne primarily by the recipients of capital income, and as a result the tax will tend to be progressive. However once market imperfections are accounted for, and

a longer-run view is taken, the incidence of a tax on capital income in an open economy will also partly fall on co-factors of production such as labour, if the stock of capital in an economy is reduced in response to the tax and productivity of labour falls. Also, consumers may bear some of the burden of a tax on capital income through the shifting of part of the tax in the form of higher prices.

Stiglitz (1988) explained this shifting of part of the burden from capital to labour in terms of a reduction in the demand for labour. In the longer run the distribution of the tax burden will depend on the resulting effects on factor supplies, rates of return, and economic growth. The burden that is borne by labour will be the larger the more elastic is the supply of capital relative to that of labour. Depending on the structure of an annual net wealth tax and the nature of the economy in which it is implemented, the incidence of this tax, as an example of a tax on capital income, would be expected to follow the above mentioned patterns.

Stiglitz (1988, p.431) also emphasised an important distinction between the short and long run incidence of a tax on capital income. In particular, these effects depend on whether an economy is open or closed. In the context of an open economy, the rate of return before tax would have to adjust sufficiently to offset a tax on capital income, otherwise investors would withdraw funds and invest in another country. In this case Stiglitz concluded that such a tax would be borne by other factors because effectively, the supply schedule for capital is infinitely elastic.

Musgrave (1984, p.473) provided an alternative view of the incidence of taxes on capital income in the case of a tax on real property. This view attempts to account for market imperfections by differentiating between different types of assets. First, a tax on land will be borne entirely by the owners of land since the supply of it is completely inelastic, and so the distribution of the burden will tend to be progressive in line with the above discussion. Second, where the tax is levied on commercial structures it may in part be eventually borne by consumers as businesses pass on part of the tax, to whatever extent they can, and consequently the distribution of this part of the burden may be regressive. Third, the taxation of housing introduces further complications to the analysis of the burden of a tax on real property. Although housing is an investment item, it can also be viewed as a durable consumer good, in which case part of the tax is absorbed by either actual or imputed rent, and is therefore distributed in line with consumption. As expenditure on housing falls as incomes rise, the distribution of this part of the tax burden will be regressive. Further, Musgrave (1984, p.474) claimed that due to market imperfections the burden of a tax on rental housing may be passed on to tenants.

Shoup (1970) examined the incidence of an annual net wealth tax in the setting of an open economy. This analysis included consideration of key aspects such as the status of a country in relation to the net movement of capital, variations in the coverage of types of individuals who are included in the tax base, and the nature of investment in regard to risk. He said:

> Partial equilibrium analysis for an open economy suggests that if a small capital importing country imposes a net-worth tax on a source basis, domestic capital that is internationally mobile will migrate and foreign capital will cease to flow in, until the rate of return in the taxing country has risen by enough to cover the tax. No new investment will be made in the country, whether to replace depreciated assets or to expand, until the tax has been fully shifted, in part forward to consumers, in part laterally to co-factors (1970, p.359).

Bird (1980) agreed:

> Any tax on capital may in theory induce sufficient internationally mobile domestic capital to migrate (and foreign capital to stay out) until the overall rate of return on capital has risen by enough to offset the tax - in other words, until the tax has been shifted to consumers or less mobile factors of production (1980, p.37).

In the case of risk capital, Shoup noted that the supply schedule may be relatively elastic, so that the potential savings available for risky ventures 'may then turn into consumption, or may be directed into more risk free areas of investment. This process would drive down the pre-tax returns to capital in these risk free areas of investment, and correspondingly increase the rate of return to risk capital. Thus according to Shoup, part of the burden of a net worth tax is passed to consumers of, and co-factors producing, products made in risky businesses, as well as owners of capital in risk free areas of investment.

Sandford (1988) drew attention to the possible effects of a partial tax on capital, in this case an annual net wealth tax, in respect to the possible exemption of farm-land. He asserted:

> Governments may seek to reduce the possible harmful effects of capital taxation by exempting (or partially exempting by valuation concession) particular productive assets like agricultural land and private businesses; but in so far as the market reacts to these exemptions by pushing up the price of these assets so as to equalise net of tax returns on different forms of investment, the incidence of the tax is felt across the whole field of capital investment. In these circumstances the main effect of exemption is to give existing owners a once and for all capital gain (1988a, p.20).

The incidence of a tax on capital income will be probably progressive because capital income as a proportion of total income rises with increasing income. However, capital income can be a high proportion of income at the bottom end of the income scale due to the high percentage of retirees in this group, and consequently the tax will be regressive at the lower end of the income scale (Musgrave 1984, p.470).

EFFICIENCY EFFECTS OF TAXES ON CAPITAL AND WEALTH

A tax system ought not have the effect of making people worse off by making resource use less efficient than it could be with a different but equally fair tax system. However, it is virtually impossible to know what the effects of a tax on wealth will be on efficiency, once all the effects have worked through the economy, because it is virtually impossible to establish who actually bears the burden of a tax which affects the accumulation of wealth, and to what extent.

Wealth taxes cause a cost to efficiency by changing the choice people face between consumption in the present and in the future, or by affecting the choices they make between products, and between work and leisure. These changes in choices are called substitution effects. A tax which affects income only but does not have substitution affects, does not cause efficiency costs because resource use does not change.

A wealth tax affects the choice people face between work and leisure. There are two effects: people are worse off so they will work harder to maintain income, and, alternatively the income from working, and therefore the income given up by not working, is less, so people will work less. The balance of these two effects is uncertain, but there is not likely to be a great effect either way. Similarly, as with an income tax, an annual net wealth tax can lead to increased use of funds in the present and less savings for the future by the individual. Or, people may decide to save harder in order to maintain the annual rate of increase in their wealth which they wish to achieve.

In the specific case of an annual net wealth tax, such a tax creates an excess burden, or efficiency cost, in the same way that an income tax does by reducing the ratio at which future consumption can be substituted for present consumption (Shoup1970, p.364). The reason for this is that interest income earned on savings, as an increment to wealth, is included in the base of the annual net wealth tax, and therefore the same distortion arises between present and future consumption as that which occurs for the income tax. However to the extent that an annual net wealth tax also taxes the intangible utility derived from the ownership of wealth, it is not likely to cause a substitution effect between present and future consumption. i.e. in such cases an increase in the equity of the tax system is gained without any cost in efficiency.

The effects of an annual net wealth tax and an income tax may differ in relation to risk taking behaviour. In the case of income tax, under conditions of 'loss offset', investors will pay tax if profit is earned on a project, but will decrease their tax liability on other income if a loss is made. Therefore the effects of an income tax on risk taking are ambiguous. By contrast, tax is liable in both instances under an annual net wealth tax. But a limited form of 'loss offset' does occur since a loss will diminish the net assets of the investor, hence reducing the liability for annual net wealth tax.

Efficiency costs may occur in the case where capital income in various industries is taxed at different rates. Musgrave observed

> .....those who invest in the taxed sector after the tax has been imposed are not discriminated against. At the same time, the efficiency cost of the partial taxation remains in place as the capital stock in the taxed sector is less, relative to that in tax free sectors, than would be under a general tax. Thus output is distorted from its efficient mix (1984, p.300).

It is arguable that at the same time an annual net wealth tax will encourage investors to invest in cash income-earning assets, or to invest in higher yielding assets, as a wealth tax is based on the value of the asset regardless of the stream of income it earns. These tax effects are based on a long term view after balanced growth has taken place. However in policy-making processes governments may find a shorter time frame more relevant, in which case the comparative statics approach to assessing the effects of taxes may be more applicable. In this case the elasticity of supply of labour and capital is seen to be of more importance than the slower process of changes in capital accumulation due to different rates of saving. In contemplating the possible effects of an annual net wealth tax on savings, investment and work effort in an economy, it is necessary to bear in mind that an income tax may give rise to similar effects, and this is an especially relevant consideration in view of the likelihood that an annual net wealth tax is considered as a possible partial replacement for income tax revenue.

In conclusion, it is extremely difficult to know what the effects of an annual net wealth tax will be on efficiency of resource use. However, the introduction of a wealth tax is likely to have a similar effect on work effort, saving and investment as a change in personal and company income taxation. The merits of a new wealth tax have to be seen in the light of the system of taxation which would be in operation if the wealth tax were not implemented. Opposition to the inclusion of a wealth tax in a tax system on the grounds of perceived efficiency costs and adverse effects on investment have to be judged in terms of the efficiency costs of the tax system which presently exists, or which would exist in the alternative 'tax world'. In all, one

answer to the question about the impacts of a wealth tax on the economy is 'It depends': and it depends particularly on the length and breadth of the perspective which is of concern to the questioner. Another answer is 'It is virtually impossible to know, once all the effects have worked their way through the economy'. The further response, of course, is to 'answer' with the question 'compared with what?'.

ADMINISTRATIVE ASPECTS

It is necessary to establish whether or not wealth taxes such as annual net wealth taxes can be successfully implemented in practice. To this end it is useful to examine the overseas experience of wealth taxation. Since each country represents a unique set of circumstances, the study of the overseas experience of annual net wealth taxation is of limited relevance to the question of the possible viability of the tax in Australia. However there are some important and useful lessons to be learned from the experience of wealth taxation in other countries, and not just from the majority of countries where the tax has been a success. There are also some salutary lessons to be gleaned from the experience of the few countries where annual net wealth taxes have been spectacular failures.

The argument is usually put forward that annual wealth taxes are inefficient to administer and collect because of problems with identifying and valuing assets held by taxpayers, and so such taxes rapidly become taxes on land assets only. The experience of the OECD countries which have annual net wealth taxes refutes claims that wealth taxes are administratively more difficult to implement than any other form of tax (Sandford 1988a). There are also likely to be complementary benefits from having a wealth tax in administering and collecting other types of tax. Computer technology ought to contribute something to increasing the ease of administering and collecting an annual net wealth tax, as it has done for collecting income and consumption taxes.

Revenue

The revenue coming from annual net wealth taxes in countries which have them is always only a small proportion of total tax revenue.
Annual net wealth taxes are levied at very low rates on the accumulated wealth of individuals less any liabilities owed. In those countries which have annual net wealth taxes the rate of tax is usually less than one percent of total net worth. Asset valuations are usually concessionary so as to get around some of the difficulties of valuing assets, and of the values of assets which fluctuate from year to year. A tax exempt threshold level of assets is generally applied. As

well, some assets such as household and personal effects, pension rights and life assurance policies, are usually exempt from the tax.

The answer to the question about the potential revenue of an annual net wealth tax in an Australian context would depend on what structure was adopted for the tax. That is, whether the tax was progressive or flat, the rates adopted, and also other considerations such as thresholds, concessions and exemptions all influence the revenue raising capacity of an annual net wealth tax. In the Draft White Paper (1985), estimates were made of the potential revenue that estate duty and gift duty may have yielded in 1985, and these were as follows:

> If an estate duty were to exempt, say, the first $200 000 and impose a flat rate of, say, 40 percent thereafter, and exempt all assets passing to the surviving spouse, the revenue yield might be in the order of $125 million per annum. If a gift duty exempted the first $1000 a year and imposed a tax rate of 40 percent thereafter, the revenue yield from the gift duty could be around $150 million per annum. A new estate duty would require a lower threshold, a higher rate or a less generous treatment of assets passing to a surviving spouse - or a combination of these - if the yield were to be as high as $700 million, which would be today's equivalent to the amount of revenue collected by the Commonwealth and the States under estate and gift duty in 1975-76, the last full year in which all Commonwealth and State estate and gift duties operated (1985, p.181).

The added qualification was also made however, that better methods to prevent avoidance of the tax than those which existed in 1975-76 would mean that the required rates would be less severe. In the case of an annual net wealth tax, and bearing in mind assumptions about the above mentioned provisions, in the Draft White Paper it was estimated:

> ... if a flat rate of 1 percent were to apply to net wealth holdings of Australian households, with a threshold exemption of $100 000 per household, the annual revenue yield could be in the order of $300 million. A flat rate of 1 percent on all foreign holdings of Australian assets, without the benefit of any threshold, could in principle yield of the order of $500 million annually (1985, p.187).

The relative size of this potential amount of revenue from an annual net wealth tax, when compared with the tax revenue gained from other sources such as the Income Tax, was also gauged in the Draft White Paper (1985). The authors of this report commented that 'an Annual Net Wealth tax could not be expected to raise large amounts of revenue' (1985, p.187). However in contrast to death and gift duties, mention was made of the relative speed with which revenue could be generated by an annual net wealth tax.

Another estimate of the potential revenue yield of an annual net wealth tax was made by Groenewegen, cited in Ablett (1983, p.21). He calculated that for the year 1967-68, after a 10 percent allowance for administration costs, the tax yield would be of the order of $400 million. A progressive rate structure was assumed for this estimate, being 0.5 percent on $50 000 to $80 000 and rising to 3 percent on individual net worth over $200 000. It also was anticipated that for 1967-68 less than 200 000 taxpayers would have been affected. Ablett noted that in Australia 'it is difficult to envisage a politically acceptable annual net wealth tax which could raise more than 4 percent of Commonwealth tax revenue' (1983, p.22). In the context of the record of revenue yield in European countries, this was not an unrealistic observation.

In summary these two estimates of revenue yield for an annual net wealth tax in Australia, although divergent in terms of tax structure and also date of calculation, indicate that in early 1990s dollars it would not be unrealistic to expect a yield in the order of a minimum of half a billion, up to two billion dollars. Also, on the basis of the estimates put forward in the Draft White Paper, the yield of an annual net wealth tax and a death and gift tax would appear to be of similar magnitude.

In concluding this section it is interesting to note a prognostication of John Stone, who was head of the Australian Treasury during the years of the conservative Fraser government, and who is also a member of the Queensland National Party, which abolished death duties in that state and hence effectively in Australia. Cited in Groenewegen (1985, p.207), Stone confidently asserted in 1984:

> ....a reintroduced estate duty would have two great advantages to any government contemplating such enactments. First......there still exists a corpus of administrative knowledge and experience within the Australian Tax Office which could readily restore such taxes...... Secondly......a re-introduced estate duty could, within (say) three years, be yielding something in the order of one-half to three-quarters of a billion dollars in revenue (Address in Brisbane, November 12, 1984)

AN ANNUAL NET WEALTH TAX?: DISCUSSION

Proposed changes to taxing arrangements have to be judged in terms of equity, efficiency, administrative ease and revenue raising, and in the light of how well the remainder of the tax system performs in achieving these objectives at present. Any change to part of the tax system, such as the introduction of a tax on wealth can only be assessed along with consideration of any other related changes which might be implemented, such as an equivalent cut in the high rates of personal income tax on middle income earners. The likely performance of the whole tax system after a change to part of it has to be compared with the performance of the current system.

From the first principles of taxation, on equity grounds, a case can be made for the taxation of wealth within a balanced tax structure comprising taxes on income, consumption and wealth. An appropriate balance between different types of taxes makes it possible for a reasonable balance between the objectives of a tax system to be achieved. The uncertainty surrounding the real incidence of all types of taxes also dictates that this is a sensible approach in a practical sense. A tax system which places taxes on income or consumption alone, or one which does not tax wealth, would be less likely to fully achieve the objectives of the tax system, since the burden of any particular tax may be passed on by the intended bearer of the tax to someone else. That is, if two taxes are each less than perfectly equitable, then there is likely to be some combination of both that is more equitable than either on its own. Therefore the approach which is likely to go closest to achieving the objectives of a tax system is to tax to some degree all three of the potential bases of taxation, being income, consumption and wealth.

Why tax wealth?

The argument for taxing wealth rests mainly on the aim of improving the horizontal equity of a tax system. The achievement of objectives of vertical equity can also be enhanced.Some forms of wealth yield very little taxable income, and other forms of wealth yield much taxable income. Thus taxing only the income from wealth will not be a fair treatment of individuals with the same material circumstances, nor will it ensure that those with the most pay the most and those with the least pay the least. Thus the claim that there is no need to tax wealth because tax on income should capture all the benefits of wealth is only partly true at best. There are further reasons why a failure to tax wealth is a significant deficiency of a tax system. There is the only slightly esoteric notion that in a capitalist society wealth bestows intangible, but taxable, benefits. There is also the notion that income earned 'easily' is more taxable than income earned by with greater difficulty, because the benefit from the more easily earned income is greater than the net gain from hard-earned income. Another reason for taxing wealth is based on improving the lot of the worst-off in society by getting more of a contribution from the best-off. Reasons for doing this rest on basic concepts of acceptable and unacceptable disparities of living standards in society.

Annual net wealth, death or inheritance taxes?

In weighing-up the choice between alternative wealth taxes, the case for having an annual net wealth tax rests on the annual net wealth tax having less impact on liquidity than lump sum taxes on estates at death or on inheritances. Since an annual net wealth tax is imposed on an annual basis at very low rates, the burden of the tax can be spread more lightly over time compared with an inheritance or death tax, which is only imposed once a generation. Despite the widely held view amongst tax economists that an annual net wealth tax and an inheritance

tax are complements which contribute to different aspects of equity in a tax system, rather than substitutes, the debate in Australia about wealth taxation is often couched in terms of a choice between the two types of tax. Usually the inheritance tax is favoured on the grounds that it would not infringe on personal savings as much as an annual net wealth tax. Inheritance taxes and death taxes can be differentiated in their contriubtion to the operation of the tax system. Inheritance taxes can be seen as contributing to vertical equity and reducing wealth and income inequalities. Death taxes can be seen as helping apply the benefit principle, whereby some of the contribution of society to individual accumulation of wealth during a person's lifetime is retrieved at death.

Incidence and efficiency effects?

Wealth taxes, like nearly all taxes and especially those that are designed to achieve equity objectives, also have effects on the efficiency of operation of an economy. In assessing a system of taxation it is necessary, as far as is possible, to take account of the economic or real incidence of tax measures, rather than the statutory or nominal incidence. In this regard the annual net wealth tax, at least where it is imposed on business assets, may be passed on to some extent to consumers and co-factors of production such as labour in the long run. The efficiency effects of wealth taxes can be broken down into the effects on choices which individuals face between consumption and saving, and work and leisure. The net effects on efficiency of wealth taxes, which take the place of some income or consumption taxes, are very hard to know but to some extent at least will be similar, eventually, to the effects of similar amounts of tax collected from income taxes.

Taxing people or things?

Personal taxes are superior to *in rem* taxes from an equity point of view because they relate to the personal ability of the individual to pay the tax, whereas *in rem* taxes are imposed on objects such as land, irrespective of the ability of the owner to pay the tax. Therefore, if society is to desire a tax on wealth, a personal and comprehensive tax on the wealth of individuals, based on the ability to pay approach, is superior to an *in rem* tax on real property. The standing of a personal tax from an equity viewpoint is further improved if the debts of the individual are offset against his or her assets in the calculation of the tax, so that the tax is levied on the net wealth of the individual. In this way the base of the tax would reflect a more accurate measure of ability to pay. An annual net wealth tax is fundamentally different from a tax on real property, and it is superior to a tax on real property in terms of the tax principle of ability to pay.

However, the choice of an annual net wealth tax in a tax system may not necessarily preclude the employment of an *in rem* tax on real property. First, the two types of tax could be used to

complement each other by excluding land from the base of the annual net wealth tax, if concern was raised about the level of taxation of land under a system in which both types of tax were used. Second, due to the special nature of returns and benefits to land, a tax on land may be justified on grounds other than ability to pay, so that an *in rem* tax on real property may be seen to coexist with an annual net wealth tax without incurring double taxation.

Progressivity?

Despite the introduction of capital gains and fringe benefits tax legislation, the Australian income tax system, which contributes over half of the total tax revenue, has become less progressive in recent decades. That is, there is less vertical equity in the tax system. The reasons for this include the gradual reduction of top marginal rates; , the effects of the introduction of full dividend imputation of tax paid by company shareholders which has been a considerable bonus to the tiny proportion of the population who own a significant amount of shares, the majority of whom are at the top end of the income and wealth scales; the prevalence of avoidance and evasion, and the effects of inflation on unindexed tax scales. 'Bracket creep' has made the income tax burden fall increasingly heavily on middle income earners. The top rate of personal income tax is paid at an income which is only 1.8 times average income. Forty years ago, the top rate of tax was paid at 16 times the average taxable income. Wealth taxes can improve the vertical equity of a tax system.

Redistribution?

An argument for taxing wealth can be made on the grounds of redistributional objectives and progressivity of taxation if income and wealth in society is becoming more concentrated. Information about the distribution of wealth is scarce. It appears that Australia's distribution of income and wealth is no better than in any other modern industrialized country. Evidence suggests that there is considerable doubt as to whether the share of wealth held by the top decile in Australia has been significantly reduced this century, and further, it appears that there are good grounds for believing that wealth inequality has increased during the 1980s. The limited amount of evidence available indicates that the top decile of wealth owners possess more than half of the total personal wealth in Australia (See, for example, studies by Piggott 1984, 1988, 1989; Dilnot 1990; Nevile 1985, 1993). Furthermore, research into the causes of wealth inequality has revealed that the process of inheritance, rather than the influence of life cycle savings, is the most important determinant of personal wealth amongst the top decile of wealth owners (see Wedgewood 1928, Atkinson 1971, 1983, Harbury and Hitchens 1979, Piggott 1984 and Saunders 1983).

Although the distribution of income appears to be more equal than that of wealth, there is a strong correlation between wealth and income. Thus inequality in the distribution of wealth

also has implications for the distribution of income. The available evidence suggests that the trends in the distribution of income in Australia over the last eighty years have moved in different directions at different times. As was found to be the case for wealth, there is strong evidence to suggest that the overall trend in the distribution of income has become more unequal during the last decade (see Saunders et.al.1989, Nevile 1991).

Administration?

Administative costs include the public costs of collecting taxes and the private costs of compliance with tax laws. The experience of overseas countries that have imposed the annual net wealth tax shows that, despite widespread beliefs to the contrary, this tax is a feasible proposition from an administrative viewpoint. Evidence shows that if sensible valuation procedures are adopted, similar to those which have been used in many Western European countries for example, the tax is as easy to collect as income tax. These countries have successfully employed the annual net wealth tax since early this century. The recent experience in Australia of the successful administration of the capital gains tax in relation to valuation procedures adds weight to this argument. Under this tax assets are sometimes valued for the purposes of capital gains tax estimation without being sold, such as the valuation of assets at death.

Revenue?

Although the annual net wealth tax, like other forms of wealth tax, only contributes a very small amount to tax revenue in countries that have adopted it, it can make a contribution to the overall horizontal equity of tax systems. As discussed previously, such a tax in Australia, if set at a flat rate of 1 percent and based on some rough but generously concessionary values of assets, would raise at least 0.5 to 1 billion dollars per year and possibly a good deal more (In recent times, the annual total tax collected each year in Australia is around 100 billion.) A tax cannot be evaluated solely in terms of its contribution to tax revenue, as this will not accurately reflect all of the possible equity and efficiency effects of the tax. There are also other benefits of an annual net wealth tax, such as the provision of data on wealth distribution, which is extremely useful in the process of formulation of economic policy. Without this data it is also more difficult to make and 'sell' the case for wealth taxes on equity and distributional grounds. In addition to these benefits, an annual net wealth tax would also provide scope for cross-checking between income tax returns and wealth tax returns, and this facilitates improved detection of income tax evasion.

Preferential treatment of assets?

In the implementation of an annual net wealth tax, preferential treatment given to some classes of assets such as farmland would result in the tax being capitalised into the value of these

assets. The reason for this is that capital will move into sectors of preferred tax treatment in order to avoid the tax, thus pushing up the price of these assets. In so doing the after-tax returns to different forms of investment in an economy will tend to be equalised. As result under these conditions the net effect of the tax would be to grant all farmland owners a windfall capital gain at the time of introduction of the tax, whilst penalising all would-be farm land buyers. There would also be a distortion in the allocation of resources as additional capital is invested in farmland. This capital would be invested elsewhere in an economy without the preferential treatment given to farmland. Consequently tax concessions in the application of wealth taxes cannot be justified on equity or efficiency grounds.

Liquidity?

The possible introduction of taxes on accumulated wealth raises concern amongst some that such taxes would be inequitable on those with large amounts of assets but low income. However evidence about Australia suggests that income and wealth in this country are highly correlated, so that the number of 'asset-rich, income-poor' individuals or families would be relatively few. Therefore scepticism about the suggested plight of this group is justified on the grounds that the claim of large asset holdings but low income is, in general, a contradiction. Where this 'problem' exists, individuals concerned face choices of re-investing their capital in an alternative use which provides for more adequate returns, or consuming or borrowing against their accumulated wealth. In these ways an annual net wealth tax may contribute to the efficiency of resource allocation in an economy. As well there are ways in which wealth taxes can be designed to address concerns about possible liquidity problems. For example, cash flow problems brought about by the imposition of an annual net wealth tax on those with low incomes can be alleviated by the implementation of a ceiling on the combined burden of income tax and wealth tax. It must also be recognised that an annual net wealth tax is levied on the net wealth of individuals, so that any indebtedness of the taxpayer is fully accounted for.

Land taxes?

What of the claims that the existing network of capital gains taxes, land taxes and local government rates amount to an effective system of wealth taxation? First, capital gains taxes are taxes on income from an appreciation of the value of assets over time, and are thus an income tax, not a capital tax. Local rates, whilst based on a variety of unimproved capital value, site value, improved capital value, and assessed capital value associated with land and improvements, are essentially fees for services reflecting the benefit-principle of tax equity. They should not be confused with general taxes on accumulated wealth which are aimed at improving the horizontal and vertical equity of a tax system. Land taxes are a minor source of state revenue, based on urban land values, with a wide and numerous array of exemptions including, in Victoria, land owned by farmers, councils, unions, ex-servicemen's

organisations, sporting and cultural clubs, horse and pony racing clubs and so on. Despite the widespread exemptions, and minor amounts of revenue collected, land tax remains one isolated and miniscule form of wealth tax used in Australia.

Double taxation?

A common but fallacious argument against taxes on wealth is that they are a form of double taxation, since tax is already levied on the savings component and the capital gains components of an individual's wealth. Income is either consumed or saved. Therefore, whenever more than one type of tax exists, then the sources of taxable capacity (savings or consumption) are taxed more than once. For example, most tax systems have income and consumption taxes - this is double taxation, as gross income is taxed and expenditures from after-tax income iare taxed items are bought which have sales tax added onto the price.

Piggott (1989), in favouring an inheritance tax, asserted that only the inherited component of an individual's wealth should be subject to a special wealth tax, since tax is already levied on the saved income and capital gains components of the wealth of an individual. He asserted:

> Indeed, income taxes operate as a form of 'double' tax on saving: savings are accumulated out of net-of-tax income, and the return on those savings is also taxed. A strong argument could be made, on both efficiency and equity grounds, that the taxation of the wealth resulting from such accumulations is inappropriate (1989, p.333) .

There are two responses to this: first, there is nothing wrong with taxing something once, twice or any number of times, as must happen once more than one type of tax is used in a tax system. Second, it is true that taxes on income capture some of the benefits which derive from wealth, because wealth is the capitalised value of the income stream it produces. This fact is the basis for the misguided claims that taxing wealth as well as income is taxing a person twice for exactly the same thing However, this would only be true if all forms of wealth produced the same amount of taxable income. Then it would not make any difference if income or wealth was taxed. Taxing one or the other would be a fair treatment of the same amount of 'ability-to' pay'. But, wealth taxes are designed to capture a form of taxable capacity inherent in the ownership of wealth that is different and separate to that captured by the income tax. As a result wealth taxes act in a complementary manner to income taxes, regardless of whether they are 'taxes on capital' or 'capital taxes'.

As well, the taxation of a particular base may also occur at different levels of government at the same time, so that different taxes may coincide. For example state governments may see good reason to place a tax on income at a state level in addition to taxes that are levied on income at a

federal level. By the same token the same taxes on wealth may be justified at different levels of government. Each level of government may have their own reason for implementing the tax, and these reasons may or may not be identical. In this way local government may, for example, wish to impose a tax on real property irrespective of the imposition of a net wealth tax at a federal level.

Valuation?

The assessment of the value of illiquid assets such as land also introduces considerable complexity in the application of principles of horizontal equity. Owing partly to the uncertainty that often surrounds the valuation of such assets, and also partly to perceived problems of payment of the tax, concessionary valuation procedures usually apply. These were documented in the findings of the Taxation Review Committee (1975) as follows:

> Characteristically, some countries use values determined only periodically or by some special valuation procedures in dealing with real estate. In West Germany, for example, land values (apart from farmlands) were assessed, up to 1973, on values prevailing in 1935; they are now based on a method that produces a figure estimated to be only about 35 percent of current market value. In the Netherlands, the method of valuation produces a figure of about 40 percent of current market value.........Farmland in European countries imposing wealth tax tends to be valued well below its market price. Even in Norway, where the wealth tax hits farmland hardest, the land is valued by boards manned by both tax officials and locally elected members of the community to ensure that few farms are assessed at even two-thirds their market value. In Sweden agricultural land is assessed at three quarters of the market value based on the statistical average of free market prices in the two years before the assessment. In the Netherlands land is separately assessed in discussion between the taxation authorities and organisations representing the owners and farmers and always at a large discount on real values so that the tax can be paid out of the profits of the land; and there are exemptions for farms operating at a loss........In addition to farmland, associated assets tend to be brought to tax well below market price. In Denmark, for example, livestock is valued at approximately half its market price and farm machinery at its book value (1975, p.508).

Sandford also noted that 'both private businesses and agricultural land tend to get favourable valuation treatment in all countries' (1981, p.15). For example, in Norway values are estimated to be about 70 percent of the full market value of the land (Sandford 1988a, p.70). In other countries such as Germany the value of agricultural property is arrived at by the determination of the earning capacity of the land. That is, 'standard' farms are used to derive an estimated

capital yield and these are then multiplied by an arbitrary and highly questionable capitalisation rate of 18 to obtain an estimated land valuation (Sandford 1988a, p.70).

The arbitrary nature of this approach is obvious; however it must be recognised that the accurate valuation of land is a particularly difficult and contentious problem. As a consequence granting highly concessionary values for farm land should be an effective way of settling the issue and also of quelling dissent in general about the impost of a wealth tax.

The frequency of valuation of different types of assets may not always be the same, and in this instance horizontal equity may also be compromised to some extent. For example quoted shares are commonly assessed at their full market value, but the value attributed to land and buildings may have been fixed for several years and consequently may be well below or above current value.

In the context of a broad-ranging discussion of the administrative aspects of annual net wealth taxes, mention should also be made of a novel approach to ensure reasonabvle valuation of assets by taxpayers. Sandford reported:

> Another approach which has been suggested to try to ensure genuine rather than nominal values for personal possessions is to give the taxing authority the right to buy an article at, say, ten percent above the declared value........the authorities should further be under obligation to auction the property so acquired, within a specified time, informing the seller of the place and date, so that he can bid. If the valuation were genuine, the taxpayer could be expected to recover his goods and make a profit (1981, p.27).

Despite support from Sandford, this approach has not been attempted by any country! Therefore the feasibility of this idea remains purely a subject for wry conjecture. Nonetheless it is an inventive contribution to a difficult area in the administration of annual wealth taxes.

Political realities?

The political difficulties associated with the introduction of any new tax in Australia are all too clear, and could well be insurmountable. In the last decade the failed attempts on both sides of politics to introduce a general consumption tax serve to illustrate vividly the politically hazardous nature of tax reform in Australia. As well, the experience of the demise of death and gift duties in Australia at the hands of the states provides ample evidence of the type of resistance to be expected in introducing any taxes on accumulated wealth. In particular, the opposition of special interest groups such as farmers and small business people to proposals for wealth taxes in Australia is well documented

A Slight Digression: The Irish Experience with a Wealth Tax and Lessons for Australia.
The rise and prompt fall of the Irish wealth tax is well-documented in studies into the Irish wealth tax by Sandford (1981, 1988c). The essence of Sandford's findings are summarised below.

The Irish wealth tax was introduced by the Fine Gael/Labour party coalition which was elected in 1973. The wealth tax proposed was for a tax on annual net wealth (assets minus liabilities) of individuals, discretionary trusts and private non-trading companies. It was to apply to single taxpayers whose wealth exceeded 40 000 pounds and married taxpayers whose wealth exceeded 60 000 pounds. The tax was to commence at 30 000 and 50 000 pounds respectively. The proposed rate was 1.5 percent up to 100 000 pounds, 2 percent from 100 000 to 150 000 pounds, and 2.5 percent on the value above 150 000 pounds. There was to be no ceiling provision and a minimum of exemptions (Sandford 1988c, p.3).

The proposal for the wealth tax (Irish White Paper 1974) specified tax relief for farmers in the way their land was to be valued and there was exemption for 'heritage objects subject to public access' (Sandford 1988c, p.3). No other concessions were to be given.

As specified in the White Paper the main aim of the Wealth tax was the achievement of greater horizontal equity. That is, people with a similar economic state of affairs are supposed to be taxed similarly. Also, as in all proposals for wealth taxes it was hoped that it might reduce inequality in the distribution of wealth. The distribution of wealth in Ireland was very uneven, with 5 percent of the population owning 60-70 percent of the private wealth. It was also hoped that the tax would promote efficiency in resource use and create some administrative benefits from having more information, which might help reduce evasion or catch evaders. A further aim was to reduce periodic liquidity problems faced by some taxpayers by replacing the generational estate tax with an annual tax.

Though the proposed wealth threshold was double that of the next highest European wealth tax, though the Irish tax was unique in that the taxpayer's principal private residence was exempted; and though there were substantial concessions for agriculture and industry, the wealth tax was subject to ferocious opposition. Consequently the proposed wealth tax was watered down significantly. The thresholds for the tax were raised to 70 000 pounds for a single person, 100 000 pounds for a married couple and an additional threshold of 2500 pounds was added for each child. The proposed progressive rate structure was replaced by a single rate of 1 percent, and a ceiling of 80 percent of income for combined income and wealth tax was introduced. Other further concessions were made: an acre of land surrounding the principal residence was

exempted, as also were pension rights, household effects, and farmer's livestock and bloodstock. As well, concessionary valuations granted initially to farmers, were extended to fishermen, hoteliers and the shareholders of Irish trading corporations operating in Ireland (Sandford 1988c, p.3).

In Sandford's view (1988c), the wealth tax failed partly because taxpayers reacted adversely to high administrative and compliance costs and demanding inquiries from the tax collectors. The tax was based on a system of self-assessment under which taxpayers were expected to provide an inventory of their assets to the taxing authorities according to 'open market' valuations. Despite being the fairest form of valuation, Sandford asserted that 'insisting on open market values raises costs, slows proceedings and imposes uncertainty' (1988c, p.11). He had earlier reflected in 1981:

> The Irish tax and the United Kingdom proposals went for open market valuations at the cost of infringing, very badly, Adam Smith's canons of taxation - certainty, convenience of payment, and the requirement that 'every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the Public Treasury of the State'. On the other hand, the more some asset values diverge form open market values the less the horizontal equity attained (1981, p.29).

The approach adopted in Ireland to the valuation of assets was entirely different to that used in continental European countries, many of which have successfully employed the tax since early this century. In these countries the taxpayer is given an asset valuation, or a formula from which he or she can derive the value of the asset for tax purposes. These valuations are in turn used for other taxes, for example local property tax, as well as for the annual net wealth tax. Sandford remarked that with this type of system the administrative and compliance costs are contained (1988c, p.11). To reiterate, the importance of administrative aspects on the feasibility of an annual net wealth tax were summed up by Sandford (1981) as follows:

> In my view the method of administration chosen was an important reason why the Irish wealth tax was scrapped and the United Kingdom proposal shelved. The Anglo-Irish model produces a wealth tax which is neither cheap to run nor satisfying in terms of its objectives. The continental model, with its common valuations and guidelines has the advantage of certainty and convenience for the taxpayer. The other side of the coin is that some values are only an approximation to market values and for this reason some inequities and distortions result (1981, p.24).

Thus it would seem, from the administrative perspective alone, that the Irish attempt at annual wealth taxation was naive and doomed to failure. Despite its superiority in terms of fairness, the expectation that self-assessment procedure involving 'open market' valuations could be made to work smoothly at low cost would seem optimistic. The self assessment method of valuation may well be a feasible approach in the context of an income tax where the value of income is clear if the entire amount has been properly revealed. However in the case of an annual tax on wealth, even if all assets are revealed to the taxing authorities, the valuation of these assets may be open to much conjecture. Therefore in this instance it would be impossible to accuse a taxpayer of impropriety, if he or she assesses the value of assets held to be substantially lower than market value.

Sandford (1981) also identified other reasons for the demise of the annual wealth tax.

> Finally, the tax met a lot of opposition from farmers. Given the thresholds and the special agricultural reliefs, only the larger farmers would have come within the wealth tax net; but others may have feared that rising prices and an unindexed threshold would bring them into the scope of the tax in the course of time. Moreover, there seems to have been something psychological in the effect of the term 'wealth tax' on a traditionally land hungry people. The name appears to have stirred up feelings quite disproportionate to the burden of the tax, conjuring up pictures of expropriation - perhaps arising from a confusion between the tax base and the source of the source of payment. Whether the opposition would have been less, if it had been called something different, like a 'general property tax' is at least a point worth considering (1981, p.29).

The opposition groups claimed that the wealth tax acted to reduce the incentive to invest and the capacity to invest. This argument is difficult sustain because so few people were affected, and if they were, the cost to them was so small: at its peak the tax raised only 0.4 percent of tax revenue. Sandford (1981) remarked that 'There were statements, difficult to validate and repudiate, that some residents emigrated because of the tax, and that the tax also led to an outflow, and reduced the inflow, of investment funds (1981, p.29).

Turning to the issue of horizontal equity, Sandford saw the high thresholds as having the result that the wealth tax could have made little contribution in this regard. He argued that 'the logic of the horizontal equity argument is that the threshold should be set as low as practicable' (Sandford 1988c, p.4). The exemption of the principal residence and the contents effectively raised the high thresholds even higher. In no other OECD country was the principal residence totally exempt. Amazingly only 2 500 of the income tax paying population of 740 000 in 1975 were affected by the tax.

Thus Sandford asserted that the Irish Wealth Tax could have achieved virtually nothing in the way of improving horizontal equity in taxation, nor in reducing income inequality, neither did it encourage increased efficiency of resource use, and in fact the opposite was the case with incentive provided to move wealth into relatively unproductive but untaxable assets such as elaborate homes and contents. Not much was gained in terms of administration either as so few taxpayers were affected, though some cross-checking of asset values for wealth tax may have raised taxes collected under the capital gains tax. However the legislation failed to ensure that the same valuation applied to the same assets for assessment of the two different types of taxes (Sandford 1988c, p.6).

In conclusion Sandford said that the Irish wealth tax failed because it was innocuous, it was costly, it had high thresholds; it had many exemptions; it had used open market valuations which is costly to determine and to get free agreement on; it had too low a rate; and finally it was subject to sustained and concerted attack from self interested pressure groups. And, the government capitulated to them (1988c, pp.9-11).

No stretching of the imagination is needed to transfer the abortive Irish attempt at wealth taxation into the Australian setting. Indeed if any doubt as to this existed, study of the Australian experience with death and gift taxes and the circumstances surrounding the introduction of a capital gains tax in 1985, would be most instructive (Kelly 1992, Gruen and Gratton 1993). It is not difficult to envisage the response of Australia's propertied class and their lobbyists to any proposal to introduce a wealth tax. The reaction in the rural and small business sectors to any suggestion of wealth taxes would, without doubt be, be colourful, as has often been the case in Australia's history.

Finally

The main benefit of a tax system which includes wealth taxation is that different taxpayers are treated more fairly than is the case when wealth is not taxed. Wealth taxes enhance markedly the principles of treating different taxpayers with the same wherewithal equally and fairly, and treating taxpayers with different wherewithal unequally and thus also fairly. If the coverage of sources of taxes collected is broad it is more likely the total burden of a nation's tax bill will be shared more fairly than otherwise would be the case. In theory it can be established that wealth taxes contribute to achieving more horizontal and vertical equity of any tax system. Wealth taxes are also instruments which can serve the pursuit of less inequality in the distribution of wealth and income in society, and can also serve to discriminate against unearned wealth.

Whilst acknowledging that there are serious hurdles to be encountered in major taxation reform, the conclusion is that in a modern liberal democracy, wealth taxation ought to be an essential element of a tax system which is intended to be equitable and well-balanced; Australia does not have such a tax system. However, 'it's not the principle, it's the money' is likely to remain the popular call to arms in the tax debate.

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