AN EVALUATION OF WHETHER THE AUSTRALIAN REGIME OF INCOME TAX ON CAPITAL GAINS SATISFIES THE MACRO-LEVEL POLICY OBJECTIVE OF HORIZONTAL EQUITY

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The Australian income tax regime on capital gains ('the CGT regime') was enacted in 1986. The government which enacted the CGT regime so enacted it largely on the perception that the CGT regime will enable the macro-level policy objective of horizontal equity to be satisfied better. This paper reviews whether that perception is largely correct. Whether that perception is largely correct or not is germane for the following reason. In order to be able to enact the CGT regime, the government which enacted it had to necessarily ensure, or it is reasonable to infer that government may have had to necessarily ensure, that the CGT regime also satisfied a number of macro-level policy objectives other than horizontal equity. And those other macro-level policy objectives are not necessarily wholly co-extensive with horizontal equity.

This paper identifies six macro-level policy objectives (other than horizontal equity) that the CGT regime may have had to satisfy at the time of its enactment and may have had to continue to satisfy after its enactment, in order to remain enacted. This paper then analyses whether the satisfaction of those six macro-level policy objectives (other than horizontal equity): did compromise the capacity of the CGT *regime, as first enacted, to satisfy the macro-level policy objective of horizontal equity; and has compromised the capacity of the CGT regime, on incorporating amendments to that regime made subsequent to its first enactment, to satisfy the macro-level policy objective of horizontal equity.*

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Based on that analysis, this paper concludes that the perception (of the government which enacted the CGT regime) that the CGT regime will enable the macro-level policy objective of horizontal equity to be satisfied better is a perception that is largely correct.

I INTRODUCTION

The objective of this paper is to evaluate whether the Australian regime of income tax on capital gains ('the CGT regime') satisfies the macro-level policy objective of horizontal equity. Accordingly, two questions require to be addressed:

- Was it perceived that, through the enactment of the CGT regime, the macro-level policy objective of horizontal equity will be better satisfied?; and, if it was so perceived,
- Was that perception correct?

The perception relevant to the first of those two questions, as referred to throughout this paper, is the perception of the government which enacted the CGT regime.

In an earlier work,[1] I comprehensively addressed the first of those two questions, and concluded that first question should be answered in the affirmative.[2] That is, there, I concluded that the enactment, in 1986, of the CGT regime was actuated by a perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity.[3] I also concluded there that the continuance of CGT regime, after its enactment, has also been based on the same perception.

This paper addresses the second of those two questions – of whether the perception the CGT regime will satisfy horizontal equity is largely correct – and answers that question in the affirmative.

This paper contains a comprehensive discussion of six of the macro-level policy objectives a tax system (such as the CGT regime) should satisfy. That discussion demonstrates that each of those macro-level policy objectives may not be

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1 M Sridaran, 'Taxation of Capital Gains: A Review of the Australian Perception' (2005) 20(1) *Australian Tax Forum* 41. The tax commonly referred to in Australia as 'the capital gains tax' is in fact comprehended by the income tax (and is not a separate tax, as in the UK), but the legislative provisions imposing that tax (at the time that tax was first enacted) were largely modelled on comparable legislative provisions that then obtained in the UK.

2 Ibid 69, 71-72, 81: The *Draft White Paper* (whose citation is given in note 46, and which provided the immediate basis for the enactment of the CGT regime) and the *Final Report of the Asprey Committee* (whose citation is given in note 109, and which served as a most influential source of reference in the preparation of the *Draft White Paper*) both strongly recommended that (in Australia) there should be comprehensive taxation of capital gains, primarily on the ground that such taxation will enable horizontal equity to be satisfied better.

3 Sridaran, above n 1, 57: 'Horizontal equity' requires those in an equal economic situation to pay an equal amount of taxes, and, by extension, those not in an equal economic situation not to pay an equal amount of taxes. There, there is an extensive discussion of concepts of equity as applicable to taxation.

necessarily wholly co-extensive with horizontal equity. And, therefore, that the satisfaction of horizontal equity (as a macro-level policy objective) by the CGT regime can potentially be compromised due to that regime also having to satisfy those other macro-level policy objectives.

In this paper, at the end of the discussion of each of those macro-level policy objectives (other than horizontal equity), one of the following two conclusions is drawn:

- The satisfaction of that macro-level policy objective by the CGT regime did not perhaps affect the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity being largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime have perhaps not affected that perception being largely correct.
- The satisfaction of that macro-level policy objective by the CGT regime did compromise the capacity of the CGT regime to also satisfy the macro-level policy objective of horizontal equity. But that compromise was perhaps not of such significance as to displace the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity from being a perception that is largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime have not perhaps affected that position.

II Macro-Level Policy Objectives: A Tax System (such as the CGT Regime) should Satisfy

A *Introduction*

The bulk of the literature limits the enumeration of macro-level policy objectives that a tax system (such as the CGT regime) should satisfy to a small number of such macro-level policy objectives; that small number of macro-level policy objectives being those in terms of which analyses of tax policy analysts are generally carried out.[4] In this paper, an attempt has been made to formulate such an enumeration

4 For instance, see M McKerchar, *The Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers* (2003): C Evans, *Taxing Personal Capital Gains: Operating Cost Implications* (2003). McKerchar canvassed three sets of macro-level policy objectives that a tax system should satisfy. Those three sets were not mutually exclusive; rather each of those sets was seemingly purported to cover the same ambit as the other two, though each was articulated differently to the other two. First, McKerchar, based on the work of Adam Smith (written as far back as 1776, when circumstances impinging on public finance were, at the least in some respects, markedly different to those as of now), canvassed four macro-level policy objectives that a tax system should satisfy, which were equality, certainty, convenience of payment, and economy in collection (24). Second, McKerchar, based on the work of the *Asprey Committee* (see n 109 for citation), canvassed three macro-level policy objectives that a tax system should satisfy, which were efficiency, equity, and simplicity (24). And, third, based on the work of Cedric Sanford, McKerchar canvassed four macro-level policy objectives that a tax system should satisfy, which were equity, ability to pay, efficiency, and simplicity (27).

comprehensively, so as to ensure that the analysis developed in this paper is comprehensive. The following is an enumeration, which is not in any order of importance, of macro-level policy objectives a tax system (such as the CGT regime) should satisfy that has been thus formulated:

- A tax system should satisfy horizontal equity.[5]
- A tax system should satisfy vertical equity.[6]
- A tax system should cause the least of interference with economic efficiency.[7]
- A tax system should be compatible with tax systems of other countries, as well as be in conformity with Australia's international treaty and other like obligations.[8]
- A tax system should be sufficiently simple, so that the costs of administering it (by government) and the costs of complying with it (by taxpayers) are tolerably low.[9]
- A tax system should be stable, so as to enable those potentially affected by it to anticipate its incidence with certainty.[10]
- A tax system should yield to the government the net revenue that that tax system is expected to yield.[11]

A discussion, in turn, of each of those macro-level policy objectives follows.

B *Horizontal Equity*

A comprehensive discussion of the macro-level policy objective of horizontal equity was set out in my earlier work.[12] That discussion, therefore, is not repeated in this paper.

Evans, similar to McKerchar, canvassed macro-level policy objectives that a tax system should satisfy based on the work of Adam Smith (36-37), and concluded that all those macro-level policy objectives were effectively comprehended by the following three macro-level policy objectives that a tax system should satisfy: equity, efficiency, and simplicity (37).

5 J E Meade and Others, *The Structure and Reform of Direct Taxation (Meade Committee Report)* (Chairman: J E Meade) (1978) 12.

6 Ibid 12.

7 Ibid 7.

8 Ibid 16.

9 Ibid 18.

10 Ibid 21.

11 R Woellner and Others, *Australian Taxation Law 2001* (2001) 41.

12 Sridaran, above n 1, 57-60.

C *Vertical Equity*

'Vertical equity' has been defined as the requirement that those in a more advantageous economic situation pay a greater amount of taxes, relative to those in a less advantageous economic situation.[13]

At the time the CGT regime was enacted, as well as well before, Australia imposed income tax on individuals at progressive rates. That, therefore, was a manifestation that Australia, at the time the CGT regime was enacted, did regard vertical equity as a macro-level policy objective a tax system (such as the CGT regime) should satisfy.

The appropriateness of 'vertical equity' as a macro-level policy objective a tax system should satisfy is, at best, open to conflicting views. That position has been summarised well thus:

> The case for progression, after a long critical look, thus turns out to be stubborn but uneasy. … It is hard to gain much comfort from the special arguments, however intricate their formulations, constructed on notions of benefit, sacrifice, ability to pay, or economic stability. The case has stronger appeal when progressive taxation is viewed as a means of reducing economic inequalities. But the case for more economic equality is itself perplexing. And the perplexity is greatly magnified for those in the quest for greater equality are unwilling to argue for radical changes in the fundamental institutions of the society.[14]

The conflicting views that pertain in Australia over whether vertical equity is an appropriate macro-level policy objective that a tax system should satisfy are evidenced by a work, published in 2004, by Lauchlan Chipman[15] and a work, published in 2004, by me[16] as a response to that work of Chipman.

Chipman, in his work, concluded that, in Australia, income tax on individuals should be imposed at a flat rate, and not at progressive rates, as currently happens.[17] Chipman formed that conclusion based on eight arguments:

- A flat tax is simpler.[18]
- A flat tax will preclude scope for tax avoidance by diversion of income from a high taxpaying individual to a low taxpaying individual.[19]

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13 R A Musgrave and P B Musgrave, *Public Finance Theory & Practice* (1984) 232.

14 W J Blum and H Kalven, 'The Uneasy Case for Progressive Taxation' (1952) 19(3) *The Chicago Law Review* 519.

15 L Chipman, 'The Very Idea of a Flat Tax', *CIS Policy Monograph*. 2004, 66 accessible < http://www.cis.org.au > (8 December 2004).

16 M Sridaran, 'Some Arguments for not Having a Flat Personal Income Tax' (2004) (48) *CCH Tax Week* 793.

17 Chipman, above n 15, 18.

18 Chipman, above n 15, 4.

19 Chipman, above n 15, 4.

- A flat tax is consistent with vertical equity, primarily as, even with a flat tax, a tax-free threshold applicable to income tax imposed on individuals should exist.[20]

- The additional income of the rich does not have less value to them than the value that same income has to those less rich.[21]

- Disparities in income between individuals do not necessarily mean that the lowest of incomes is not able to support a life of reasonable sufficiency.[22]

- If a policy of progressive income tax rates imposed on individuals is designed to ameliorate feelings of envy caused by inequality of income between individuals, respecting and reinforcing such feelings is an unacceptable basis for such a policy.[23]

- If a policy of progressive income tax rates imposed on individuals is designed to ameliorate feelings of resentment caused by inequality of income between individuals, respecting and reinforcing such feelings is an unacceptable basis for such a policy.[24]

- One's moral obligation to assist the poor is an obligation that is assumed by one, and therefore has nothing to do with distributive justice (distributive justice deals with the manner in which wealth is distributed amongst those in a country).[25]

Those eight arguments did not include an argument to the effect that a flat tax is, relative to a policy of progressive income tax rates imposed on individuals, conducive to the attainment of economic efficiency. Chipman, in his work, extensively canvassed the appropriateness of such an argument, but was not able to conclude that such an argument was tenable.[26]

I, in the work that I published as a response to the work of Chipman, contended that those eight arguments do not represent an exhaustive enumeration of arguments that should be addressed in concluding whether a flat tax is to be preferred over a policy of progressive income tax rates imposed on individuals.[27] I advanced nine arguments, as articulated by others before, as to why a flat tax cannot be regarded as

20 Chipman, above n 15, 7.
21 Chipman, above n 15, 8.
22 Chipman, above n 15, 10.
23 Chipman, above n 15, 12.
24 Chipman, above n 15, 14.
25 Chipman, above n 15, 15.
26 Chipman, above n 15, 4-6.
27 Sridaran, above n 16, 794.

being superior to a policy of progressive income tax rates imposed on individuals that had not been addressed in Chipman's work.[28] Those arguments are:

- A flat tax cannot be justified on the basis that a policy of progressive rates of income tax imposed on individuals is effectively an oppression of the minority, whose levels of income are high to warrant exposure to income tax at the higher rates, by the majority, whose levels of income are low to warrant exposure to income tax at the lower rates. That is so as, even with a flat tax, a government can effectively redistribute wealth through the use of its powers to undertake expenditure programmes.[29]

- The case for simplicity of a flat tax, relative to progressive rates of income tax imposed on individuals, is overstated, if not essentially non-existent due to the fact that the calculation of personal income tax is now done largely through automated computing devices.[30]

- The case for a flat tax as a means for precluding scope for tax avoidance by diversion of income from a high taxpaying individual to a low taxpaying individual is not as strong as it is made out to be for two reasons: First, the scope for such diversion will continue to remain even with a flat tax so long as a tax-free threshold applicable to income tax imposed on individuals exists, which Chipman, in his work, on balance, concedes should exist, even with a flat tax.[31] Second, such diversion, in the broadest sense, can never be avoided altogether so long as different types of entity, including individuals, are not taxed at the same income tax rate, as is currently so in Australia.[32]

- For a proper evaluation of the fairness, or otherwise, of the rates of personal income tax, one has to consider not just income tax but also all other taxes imposed by government as well as the benefits conferred on individuals by all government expenditure programmes. On that basis, progressive rates of income tax imposed on individuals may be viewed as necessary to counter regressive effects ensuing from other taxes as well as government expenditure programmes.[33]

- If the tax-free threshold applicable to income tax imposed on individuals is fixed below the level of income required for minimum subsistence, as is so in Australia currently, progressive income tax rates imposed on individuals are necessarily required to mollify the effect of income tax on the genuinely poor. If, on the other hand, the tax-free threshold applicable to income tax

28 Sridaran, above n 16, 794.
29 Sridaran, above n 16, 794; C O Galvin and B I Bittker, *The Income Tax: How Progressive Should It Be* (1974) 33.
30 Ibid.
31 Sridaran, above n 16, 794; Galvin and Bittker, above n 29, 42.
32 Sridaran, above n 16, 794.
33 Sridaran, above n 16, 794; Galvin and Bittker, above n 29, 34, 39.

imposed on individuals is fixed above the level of income required for minimum subsistence, for pragmatic fiscal and political reasons, progressive income tax rates imposed on individuals are necessarily required to ensure a sufficient number of individuals is captured as taxpayers by the income tax system.[34]

- In a developed country like Australia, 'minimum subsistence' is a concept which is cultural, rather than physiological. In that light, it is not difficult to conceive a different income requirement on the part of different individuals to sustain a living standard at different intermediate levels in Australian society (that is, levels of living standard of, say, 'modest' and 'comfortable' progressively above the level of 'minimum subsistence'). And to recognise each of those levels of living standard through a policy of progression in income tax rates imposed on individuals. Admittedly, such recognition does call for the application of discretion, but that is inevitable in as much as fixing a flat tax rate calls for the application of discretion.[35]

- The greater an individual's income is, generally, the larger portion of that income is not potentially impaired by illness or destroyed by death. That is especially so of income derived from capital. It is also so of income derived from labour, as the larger the income from labour an individual has, the more likely it is that that individual, relative to an individual with a smaller income from labour, enjoys greater security of tenure and is able to add to her or his capital a greater share of that income from labour. In the absence, as currently in Australia, of an income tax system for taxing an individual differentially based on that individual's sources of income, a policy of progressive rates of income tax imposed on individuals represents a proxy for accomplishing the effects of such a system.[36]

- Based on anecdotal evidence, one may plausibly conclude that greater an individual's wealth proportionally greater is the governmental services (say, in areas of international affairs, national security etc.) that individual will benefit from. That conclusion supports a policy of progressive rates of income tax imposed on individuals, instead of a flat tax. [37]

- Pragmatically, it is difficult to sustain the argument that the additional income of the rich does not have less value to them than the value that same income has to those less rich. An average Australian is likely to respond that the value of additional income of $1,000 to someone who already earns an annual income of $1 million is less than it is for someone who already earns an annual income of $40,000. The state of affairs that pertains in Australia, and all other developed countries which are liberal democracies, is a not a

34 Sridaran, above n 16, 794; Galvin and Bittker, above n 29, 43.
35 Sridaran, above n 16, 795; Galvin and Bittker, above n 29, 43-45.
36 Sridaran, above n 16, 795; Galvin and Bittker, above n 29, 45-46.
37 Sridaran, above n 16, 795; Galvin and Bittker, above n 29, 48-49.

free-market economy, but a partially free-market economy and a collection of half-measures to reduce income equality (that necessarily results from a free-market economy) amongst its residents. And Australians are seemingly disposed to live in state of compromise between those two poles, rather than abandon one altogether in order to wholly migrate to the other. A policy of progressive rates of income tax imposed on individuals is consistent with such a state of affairs.[38]

I, from those nine arguments, summed up:

- The case for a flat tax in preference to a policy of progressive rates of income tax imposed on individuals is by no means clear-cut.[39]
- The preference for a policy of progressive rates of income tax imposed on individuals over a flat tax is guided very much viscerally, by instinct, than by philosophical reason.[40]

- A policy of progressive rates of income tax imposed on individuals, which has stood the test of time (not just in Australia, but in all other countries comparable to Australia) should, therefore, not be abandoned lightly, even if the political will to do so can be found, which is doubtful.[41]

Those conclusions, resulting from the work of respectively Chipman and myself, evidence the conflicting views that pertain in Australia over whether vertical equity is an appropriate macro-level policy objective that a tax system should satisfy. Each of those two sets of conflicting views is, considered in isolation, plausibly articulated, such that it is difficult to conclusively determine that one of them is superior to the other.[42]

The inability to conclusively determine so, however, does not affect the following conclusion that, in the context of vertical equity and comprehensively taxing capital

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38 Sridaran, above n 16, 795; Galvin and Bittker, above n 29, 57.

39 Sridaran, above n 16, 795.

40 Sridaran, above n 16, 795.

41 Sridaran, above, n 16, 795.

42 Similar conflicting views have been expressed in other countries with respect to income taxation that obtains in those countries. For instance, in the context of income tax imposed in the USA and in Canada, see: Hamond M J, 'The failings of the flat tax', accessible at < http://www.ndol.org/print.cfm?contentid=2471 > (10 December 2004); Hoover Institution, 'The flat tax', accessible at < http://www-hoover.stanford.edu?PRESSWEBSITE?FlatTax/chpt2.html> (10 December 2004); and E W Younkins, 'Taxation and Justice' accessible < http://www.quebecoislibre.org/000930-11.htm > (10 December 2004). The work of Blum and Kalven, above n 14, represents a most comprehensive (if somewhat dated) analysis of the pros and cons of a policy of progressive rates of income tax imposed on individuals as relevant to the USA. There (520) it is appositely concluded: '… in the end it is the implications about economic inequality which impart significance and permanence to the issue and institution of progression. Ultimately a serious interest in progression stems from the fact that a progressive tax is perhaps the cardinal instance of the democratic community struggling with its hardest problem.'

gains in Australia, was highly material. That conclusion is that the failure to comprehensively tax capital gains in Australia will have nearly exclusively benefited the wealthy, as the bulk of capital gains in Australia is realised by the wealthy.[43] The failure to comprehensively tax capital gains in Australia will thus have caused a significant violation of vertical equity.[44] That is so as, even on conceding that conflicting views, each articulated equally plausibly, do pertain in Australia over whether vertical equity is an appropriate macro-level policy objective that a tax system should satisfy, there is no justification that the rich should pay a lesser proportion of their income as tax than the poor.[45]

An acknowledgment of that conclusion–which is that the failure to comprehensively tax capital gains in Australia will have nearly exclusively benefited the wealthy can be found in the *Draft White Paper*, which provided the immediate basis for the enactment of the CGT regime:

> … The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of objectives of equity …[46]

That conclusion – which is that the failure to comprehensively tax capital gains in Australia will have nearly exclusively benefited the wealthy – underlay the enactment of the CGT regime so as to satisfy the macro-level policy objective of vertical equity. That same conclusion also underlay the enactment of the CGT regime so as to satisfy the macro-level policy objective of horizontal equity, as, if income that is made liable to income tax is legislated or judicially interpreted to exclude capital gains, a serious violation of horizontal equity does result.

That position is consistent with the analysis that there is generally no conflict between vertical equity and horizontal equity, an analysis which has been summarised well thus:

> Whereas the label 'vertical equity' refers to a normative question, the label 'horizontal equity' states a normative conclusion: People with the same incomes (or other relevant economic measure) should pay the same amount of tax. However, these two dimensions of tax equity are not really distinct. Horizontal equity is just a logical implication of any traditional answer to the question of vertical equity. If tax justice is fully captured by a criterion that directs government to tax each level of income at a certain rate, it simply follows that people with the same pre-tax incomes should be taxed at the same rate.[47]

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43 R Krever and N Brooks, *A Capital Gains Tax for New Zealand* (1990) 44.
44 Ibid 57-58.
45 Ibid 45.
46 Australia, *Reform of the Australian Tax System: Draft White Paper (Draft White Paper*) (1985) 77.
47 L Murphy and T Nagel, *The Myth of Ownership: Taxes and Justice* (2002) 37.

Following the Ralph Review, some significant changes were made to the CGT regime. All of those changes, bar one, violated horizontal equity.

The abolition of averaging was rationalised by the Ralph Review due to averaging contributing little to 'encouraging investment or removing inflexibilities in the capital markets'.[48] And being susceptible to use 'by a section of asset-holding community to reduce capital gains taxation to zero, or near to zero', thus causing 'considerable [horizontal] inequity'.[49]

Whether that rationalisation is wholly tenable is moot, in view of averaging having been enacted to seemingly restore a loss of horizontal equity inherent in the CGT regime taxing capital gains on a realisation, and not accruals, basis.[50] However, any violation of horizontal equity resulting from the abolition of averaging may somewhat be extenuated by the enactment of the CGT discount applicable to the disposal by a taxpayer (except a company) of assets owned by that taxpayer for at least 12 months.

The abolition of indexation after 30 September 1999 may, overall, promote the satisfaction of horizontal equity, as, with that abolition, generally all regimes, including the CGT regime, imposing income tax do not incorporate adjustments for the effects of inflation. That is so despite any violation of horizontal equity that may be caused by the CGT discount, as referred to in the paragraph just below.

The enactment of the CGT discount somewhat extenuated the violation of horizontal equity resulting from the abolition of averaging. However, the CGT discount also causes most capital gains to effectively be taxed at a rate of income tax much lower than the rate at which other forms of taxable income are taxed, and thus violates horizontal equity.

The Ralph Review rationalised the concessions comprising 'small business CGT relief' as necessary 'to provide small business people with access to funds for retirement and expansion'.[51] Those concessions are discriminatory, as capital gains realised from the sale of assets of small businesses are, pursuant to those concessions, effectively taxed at a rate of income tax much lower than that at which other forms of capital gain (or any other taxable income) are taxed. Those concessions thus violate horizontal equity.

However, the violation of horizontal equity caused by those concessions is likely to be limited in extent. That is so as two of those concessions are unlikely to be

48 Australia, *Review of Business Taxation: A Tax System Redesigned (Ralph Review Report)* (Chairman: Ralph J) (1999) 599.

49 Ibid 599.

50 The concession of averaging was afforded by government in recognition of the seeming horizontal inequity that may arise due to a capital gain that has accrued over a number of years being taxed at progressive rates of income tax in one income year (in which that capital gain is realized): CCH Australia Limited, *1987 Australian Master Tax Guide* (1987) 445.

51 *Review of Business Taxation*, above n 48, 587.

availed of by any one taxpayer frequently. The first of those two concessions – the exemption of any capital gain made on the sale of business assets where the owners of those assets retire after such sale – can be availed of by any one taxpayer only on that taxpayer's retirement. The second of those two concessions – the exemption of any capital gain made on the sale of business assets where those assets had been owned by the taxpayer selling those assets for at least 15 years – can be availed of by any one taxpayer only in relation to a business asset owned by that taxpayer for as long as 15 years.

Accordingly, though all of the significant changes that were made to the CGT regime following the Ralph Review, except the change limiting indexation only up to 30 September 1999, violated horizontal equity, that violation of horizontal equity, however, did not occur due to those changes satisfying the macro-level policy objective of vertical equity. Rather, those changes that did violate horizontal equity – the CGT discount (to the extent that it does not negate the effects of the abolition of averaging), and the concessions comprising 'small business CGT relief' – also violated vertical equity, as those changes are likely to benefit a segment of taxpayers who are relatively more wealthy.

The requirement that the CGT regime does satisfy the macro-level policy objective of vertical equity did not, accordingly, affect the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity being largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime have not affected that perception being largely correct.

D *Economic Efficiency*

As noted in my earlier work:[52]

- The attainment of economic efficiency is defined as a state that pertains where scarce resource use occurs such that there is no possibility of making a change of scarce resource use which helps one person without hurting anyone else.[53]

- And, in practical terms, in a country which is a liberal democracy, the attainment of economic efficiency in the use of scarce resources by that country is generally ensured through permitting the unfettered operation of market forces.[54]

In comparison with any economic system in the entire history of humankind, a free-market economy must be regarded as one with a high, if not the one with the highest, performance rating, if that performance were to be judged in terms of the

52 Sridaran, above n 1, 27.
53 Musgrave and Musgrave, above n 13, 82.
54 Meade, above n 5, 10.

level of wealth produced due to the economic system.[55] Accordingly, the choice of a free-market economic system as the optimal means for accomplishment economic efficiency is a choice hard to impugn.

An income tax can affect the operation of a free-market economy in two ways: First, an income tax can cause an 'income effect'.[56] Or, second, it can cause a 'substitution effect'.[57]

An income effect is caused where a tax on income, as that tax reduces the spendable income of the taxpayer on whom that tax is imposed, induces that taxpayer to either work harder, save more, or employ her or his capital better, so as to restore that taxpayer's post-tax income to negate that reduction.[58]

And a substitution effect is caused where a tax on income, as that tax reduces, with respect to a taxpayer on whom that tax is imposed, the spendable income that that taxpayer can earn from either working an additional unit of time or employing her or his capital better, induces that taxpayer to prefer leisure to work,[59] to save less, or be indifferent as to how that taxpayer's capital is employed.[60] Accordingly, a substitution effect, caused by an income tax, is compounded where one type of income is taxed differently, or not taxed at all, relative to other types of income. That is so as then a taxpayer will be induced to convert income that is highly taxed to income that is taxed less; in other words, substitute income that is highly taxed with income that is taxed less.[61] A substitution effect may thus result if capital gains are not taxed, whilst other forms of income are taxed.[62]

An income effect does not impair, but rather promotes, economic efficiency.[63] Conversely, a substitution effect does impair economic efficiency, unless that substitution effect is offset by the impact of income effects.[64]

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55 A M Okun, *Equity and Efficiency: The Big Trade-Off* (1975) 51.

56 Meade, above n 5, 8.

57 Meade, above n 5, 8.

58 Meade, above n 5, 8.

59 For an empirical finding that high marginal rates of income tax may not necessarily cause those deriving labour income to work less, see Break G F, 'Income Taxes and Incentives to Work: An Empirical Study' (1957) 47(5) *The American Economic Review* (September 1957) 529-549.

60 Meade, above n 5, 8; Conversely, for empirical findings essentially to the effect that marginal rates of income tax may not have a significant influence on how taxpayers employ their capital, see J E Stiglitz 'The Corporation Tax' (1976) 5 *Journal Of Public Economics* 303-311; D F Bradford, 'The Incidence and Allocation Effects of a Tax on Corporate Distributions' (1981) 15 *Journal Of Public Economics* 1-22.

61 Okun, above n 55, 61.

62 Okun, above n 55, 61.

63 Meade, above n 5, 8.

64 Meade, above n 5, 8.

Accordingly, the avoidance (or, at least, the minimisation) of substitution effects that an income tax causes is conducive to the unfettered operation of a free-market economic system.

The unfettered operation of a free-market economic system essentially means that those of the public of a country that operates such a system who are most "efficient" (or "productive") are allocated the largest share of that country's scarce resources. There will, thus, be caused inequalities in income and wealth amongst those in that country, as well as collateral inequalities amongst them in social status and power that accompany income and wealth.[65] Two of potentially many significant manifestations of such inequalities in social status and power are:

- The less-wealthy, relative to the wealthy, will in reality not enjoy equality before the law. That is so as the less-wealthy will be less educated, and therefore be less informed as to how they can take full advantage of the legal system, as well as lack the financial means to secure optimal legal representation to assert their position at law.[66]
- The less-wealthy, relative to the wealthy, will have limited, if any, means to influence political outcomes, other than through voting at elections, as, unlike the wealthy, they will not be able to make significant financial contributions to political parties or engage political lobbyists.[67]

Accordingly, the effects of an unfettered operation of a free-market economic system, and therefore economic efficiency, will generally not be wholly co-extensive with horizontal equity.

Despite that, there are those (some of considerable authority) who assert that the maintenance of an unfettered free-market economic system by any country is sacrosanct.[68] That assertion is generally principally based on four grounds:

- A free-market economic system is consistent with the conferment on individuals the broadest possible scope of private property and rights, thereby facilitating amongst individuals the broadest range of choice, and thus personal freedom.[69]

- A free-market economic system helps to safeguard individuals' political rights against encroachment by government.[70]

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65 Okun, above n 55, 51.
66 Okun, above n 55,23.
67 Okun, above n 55, 24-26.
68 M Friedman, *Capitalism and Freedom* (1962) 158.
69 Okun, above n 55, 36.
70 Okun, above n 55, 38.

- A free-market economic system represents the only ethical method of rewarding one for her or his contribution, as what one receives as a reward for one's contribution is what someone else is freely prepared to pay.[71]

- A free-market economic system is the economic system that best promotes economic efficiency (or economic growth).[72]

All of those grounds, except the last one, are, on close review, not wholly tenable, for the following reasons.[73]

In practice, in all countries that are liberal democracies that essentially adopt a free-market economic system, private property and rights of individuals of those countries are necessarily, in some respects, circumscribed by government action. For instance, an individual is not allowed the freedom to engage in any occupation that she or he likes; in Australia, for instance, an individual must possess certain qualifications prescribed by government if she or he is to engage in the occupation of a medical practitioner.[74] And a large part of private property, such as company shares, is created by government action. Ownership of such property, and resulting rights, therefore, cannot be asserted by any individual generally without recourse to government initiated legislation.[75]

The ground that a free-market economic system helps to safeguard individuals' political rights against encroachment by government has more substance, but that ground too is not wholly tenable. For instance, Scandinavian governments have generally exercised significant control over the economies of their respective countries, but they have done so without compromising the democratic institutions of those countries.[76] In contrast, previous fascist governments in Italy and Germany have, in those countries, suppressed democratic institutions, whilst largely maintaining a free-market economic system.[77]

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71 Okun, above n 55, 40.

72 Above, note 55, p 51.

73 See J Gray, *False Dawn: The Delusions of Global Capitalism* (1998) 1-21 for a perceptive, thorough and persuasive analysis as to why a 'free-market economic system' is not as 'free' as many claim it is. The following passage from there sums up that analysis: 'Free market governments model their policies on the era of *laissez-faire*–the mid-nineteenth century period [in the UK] in which government claimed that it did not intervene in economic life. In reality a *laissez-faire* economy – that is to say, an economy in which markets are deregulated and put beyond the possibility of political and social control–cannot be reinvented. Even in its heyday it was a misnomer. It was created by state coercion, and depended on every point in its workings on the power of government. By the First World War the free market had ceased to exist in its most extreme form because it did not meet human needs – including the need for personal freedom' (5).

74 Okun, above n 55, 36.

75 Okun, above n 55, 36.

76 Okun, above n 55, 40.

77 Okun, above n 55, 40.

The reward one receives, in a free-market economic system, for one's contribution may not necessarily be ethical for a number of reasons, such as the following. One's contribution can be influenced by factors such as one's family background, privilege or status, factors which do not evenly apply to everyone in a country.[78] One's contribution may also be influenced by physical or mental deformities.[79] And one's contribution may be influenced, even significantly, by the contribution of others.[80] For instance, Bill Gates can never contribute the effort he does contribute to Microsoft, an effort which is highly valued by Microsoft as it rewards that effort to the tune of several million dollars, if not for the efforts of the entire workforce of Microsoft, most of whom are rewarded by Microsoft modestly relative to the reward Microsoft offers Bill Gates.

The ground that a free-market economic system is the economic system that best promotes economic efficiency (or economic growth) is, as noted above, a ground that is hard to impugn.[81] Accordingly, it is that ground which furnishes the most cogent basis for regarding economic efficiency (or, in other words, the causation of minimal disruption to the unfettered operation of the free-market economic system) as a macro-level policy objective that a tax system (such as the CGT regime) should satisfy. That is so despite economic efficiency, as explained above, generally not being wholly co-extensive with horizontal equity.[82]

The satisfaction of the macro-level policy objective of economic efficiency, accordingly, as explained above, essentially means that substitution effects that an income tax causes should be avoided (or, at least, minimised), for which, as explained above, all forms of income, including capital gains, should be made liable to income tax similarly. A failure to capture capital gains as being liable to income tax, accordingly, may, as explained above, compound the substitution effects that an income tax causes.

There is a view that the capture of capital gains as being liable to income tax (as the CGT regime does), rather than contributing to the avoidance (or minimisation) of substitution effects that an income tax causes, compounds such substitution effects, as such capture may disincline owners of assets to dispose of those assets, thereby inhibiting the free movement of capital from a less productive use to a more

78 Okun, above n 55, 43.

79 Okun, above n 55, 44.

80 Okun, above n 55, 46.

81 In note 56 in my earlier work (cited in note 1 above), a number of works (by respectively R Ball, J Q Wilson, L Chipman, and E H Nell) is cited that canvass the pros and cons of a free-market economic system as a means for accomplishing economic efficiency.

82 In note 61 in my earlier work (cited in note 1 above), a work (by Stilwell F) is cited that articulates an analysis as to why an 'equal' distribution of a country's scarce resources may never cause a too severe impairment of economic efficiency. In note 62 in my earlier work (cited in note 1 above), a work (by Stein H) is cited that discusses why (in terms articulated by Henry Simons) a country's government should intervene to reallocate that country's scarce resources (otherwise allocated through unfettered operation of market forces) amongst that country's public.

productive one.[83] That seeming disinclination of owners of assets to dispose of those assets is generally referred to as 'the lock-in effect'.[84]

That view has seemingly never been confirmed or contradicted by conclusive empirical research.[85] That view has been countered by the following arguments, none of which has been confirmed or contradicted by conclusive empirical research:

- The seeming 'lock-in effect', if it in fact does obtain, does not affect the aggregate level of investment in a country, as, whilst the capital of the owner of 'locked-in' assets remains immobile, the capital of an investor who may have, if not for the 'lock-in effect', purchased those 'locked-in' assets remains mobile, free to be invested in other assets.[86]

- The seeming 'lock-in effect', if it in fact does obtain, in the case of company shares quoted on a stock exchange, does not cause steep fluctuations in the prices of such shares, as, often, those who sell such shares, which are 'locked-in', use the proceeds realised from those sales to buy other such shares, rather than withdrawing those proceeds altogether from investment in such shares.[87]

- The seeming 'lock-in effect', if it in fact does obtain, may render some stability to the periods for which owners of assets invest in those assets by discouraging those owners from frequently disposing of those assets for speculative purposes.[88]

- The seeming 'lock-in effect', if it in fact does obtain, will cause owners of assets to retain those assets, rather than to dispose of those assets and expend the proceeds realised from such disposal on consumption.[89] Such an inducement on owners of assets to retain those assets will negate the inherent bias of an income tax, relative to a consumption tax, against saving.[90]

- The seeming 'lock-in effect', if it in fact does obtain, will cause greater mobility of capital during an economic downturn, as owners of assets may dispose of their assets, during an economic downturn, so as to realise capital losses, as those capital losses will be deductible on the capture of capital gains as being liable to income tax, but not otherwise.[91]

83 Krever and Brooks, above n 43, 63.
84 Krever and Brooks, above n 43, 63.
85 Krever and Brooks, above n 43, 72.
86 Krever and Brooks, above n 43, 73.
87 Krever and Brooks, above n 43, 73.
88 Krever and Brooks, above n 43, 73.
89 Krever and Brooks, above n 43, 74.
90 Krever and Brooks, above n 43, 74.
91 Krever and Brooks, above n 43, 74.

The *Draft White Paper* stated:

> … The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of objectives of equity, efficiency and combating tax avoidance …[92]

The meaning of that statement in the *Draft White Paper* is best decomposed thus:

- The CGT regime, upon enactment, will promote the satisfaction of horizontal equity.

- Whilst income tax in general does cause substitution effects that impair economic efficiency, those substitution effects will be reduced upon the enactment of the CGT regime, as, upon the enactment of the CGT regime, the scope, as was then obtaining, for a taxpayer to substitute highly taxed income with untaxed capital gains is foreclosed.

Accordingly, in the enactment of the CGT regime, the requirement for satisfying the macro-level policy objective of economic efficiency was perceived to be significant, as was the requirement for satisfying the macro-level policy objective of horizontal equity. And that first requirement did not cause that second requirement to be compromised.

Of those changes made to the CGT regime following the Ralph Review, one change is of significance in relation to economic efficiency and horizontal equity. That change is the CGT discount that was made applicable with respect to capital gains realised by taxpayers, except companies, after 21 September 1999.

That CGT discount was rationalised by the Ralph Review as necessary in order to negate the 'lock-in effect', without offering any empirical analysis to support that rationale. Accordingly, in the view of the Ralph Review, that CGT discount was necessary in order that the CGT regime satisfies the macro-level policy objective of economic efficiency.

That CGT discount violates horizontal equity as those capital gains that are eligible to that CGT discount (and most capital gains would) become taxed effectively at a rate of income tax much lower than the rate at which other forms of taxable income are taxed. The effect of that violation of horizontal equity, however, is somewhat extenuated, as that violation negates the violation of horizontal equity resulting from the abolition (following the final report of the Ralph Review) of averaging. Accordingly, on balance, the net violation of horizontal equity which that CGT discount does cause may not be significant.

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92 *Reform of the Australian Tax System*, above n 46, 77.

The requirement that the CGT regime does satisfy the macro-level policy objective of economic efficiency did not, accordingly, affect the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity being largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime may have not affected that perception being largely correct.

E *Compatibility with Tax Systems of other Countries, and Conformity with Australia's Treaty and other like Obligations*

As noted earlier,[93] at the time CGT was enacted in Australia, of those developed countries which have tax systems generally comparable to those of Australia, the USA, the UK, and Canada had already enacted regimes for the comprehensive taxation of capital gains.[94] As of 1990 (that is, just about four years after the CGT regime was enacted in Australia), all of Australia's major trading partners (bar New Zealand) were taxing capital gains.[95]

That fact – which is that all Australia's major trading partners (bar New Zealand) were taxing capital gains–cannot by itself be taken as necessarily having required that Australia enacts a regime for the comprehensive taxation of capital gains. However, that fact did mean that, if Australia did choose to enact a regime for the comprehensive taxation of capital gains (as Australia did, by way of the CGT regime), that choice would not have been incompatible with the tax systems of Australia's major trading partners. Any lack of compatibility of the tax systems of Australia applicable to taxation of capital income, which includes capital gains, with corresponding tax systems of Australia's major trading partners does possibly affect the level of Australia's inbound and outbound capital flows.[96]

The *Draft White Paper* stated:

> … The lack of general capital gains tax represents a structural defect in the income tax system which lies at the core of many avoidance arrangements: if income can be converted into or dressed up as capital gains, income tax can be avoided completely. The imposition of a capital gains tax would, therefore, strike at one of the foundations of tax avoidance in Australia. …[97]

Accordingly, the CGT regime was rightly perceived as being necessary to complement the income tax regime that was then obtaining, that is, obtaining before

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93 Sridaran, above, n 1, 76.

94 Krever and Brooks, above n 43, 8.

95 Krever and Brooks, above n 43, 40.

96 See generally H Grubert, 'Source Rules, Trade and Income Taxes, and Electronic Commerce: Designing Rules for the Taxation of Cross-Border Income' (2003) 33(2) *Economic Analysis & Policy* 237; P Burn, 'How Highly Taxed Are We?: The Level and Composition of Taxation in Australia and the OECD' *CIS Policy Monograph*, 2004, 67 accessible < http://www.cis.org.au > (28 December 2004).

97 *Reform of the Australian Tax* System, above n 46, 78.

the enactment of the CGT regime.[98] For, with the enactment of the CGT regime, revenue lost by the Australian government through the avoidance of income tax by taxpayers converting income gains liable to income tax to untaxed capital gains will cease to be lost, as taxpayers will then cease to have an incentive to so convert income gains to capital gains.[99]

Absent the CGT regime, therefore, unlike its major trading partners (bar New Zealand), Australia lacked a basis, and therefore an entitlement, to exact income tax on a gain that is characterised as a capital gain, but which, if not for the absence the CGT regime, will have been characterised in its true form as an income gain. Australia was thus, in a fiscal sense, at a competitive structural disadvantage vis-à-vis its major trading partners before the CGT regime was enacted, as those countries (bar new Zealand) will have exacted tax from that gain irrespective of its form (that is, irrespective of whether it is a capital gain or an income gain) where either that gain is sourced in those countries or the entity deriving that gain is a tax-resident of those countries.

If the CGT regime was not enacted, with respect to Australian sourced capital gains derived by entities that were not tax-residents of Australia, therefore, Australia will have not had a basis, and therefore an entitlement, to exact any taxes. The country of residence of those entities, however, will have exacted taxes on those capital gains, as, as noted earlier, all of Australia's major trading partners (bar New Zealand) were taxing capital gains. Australia was thus, in a fiscal sense, at a competitive structural disadvantage vis-à-vis its major trading partners before the CGT regime was enacted.

At the time the CGT regime was enacted, Australia had concluded a number of double tax avoidance treaties with other countries, but had not entered into any other like obligations, bi-laterally or multi-laterally, that potentially impinged on the CGT regime.[100]

With respect to those double tax avoidance treaties, Australia's official position, as promulgated by the Commissioner – a position that has yet not been contested in court, but which has been the subject of some criticism[101] – was:

98 *Reform of the Australian Tax System*, above n 43, 70.

99 *Reform of the Australian Tax System*, above n 43, 70.

100 *Taxation Ruling*, TR 2001/12 (2001) para 5.

101 The position promulgated by the Commissioner has, however, been the subject of authoritative criticism. For instance, see I Gzell, 'International Tax: Current Issues' (2001) 4(3) *The Tax Specialist*, 114. There, essentially, it is argued that the Commissioner's position that the types of taxes to which double tax avoidance treaties concluded by Australia before the enactment of the CGT regime were explicitly made applicable did not encompass a tax (even if it is nominally described as an income tax, as the CGT is) on capital gains is not tenable. That is so, it is argued there, as the CGT is, through its introduction to the 1936 Act and subsequently the 1997 Act, indisputably comprehended by income tax. Arguments consistent with those of Gzell (described just above) are found in R I Hamilton, R L Deutsche and J C Raneri, *Guidebook to Australian International Taxation* (2001) 6-33-6-36.

- None of those double tax avoidance treaties (except the double tax avoidance treaty Australia had concluded with Austria) applied to the taxation of capital gains pursuant to the CGT regime, as the types of taxes to which those treaties were explicitly made applicable did not encompass a tax on capital gains, even if it is nominally described as an income tax, as the CGT is.[102]

- And, in any event, none of those double tax avoidance treaties contained provisions that in any way limited Australia's right to tax pursuant to the CGT regime Australian sourced capital gains derived by entities who are not tax- residents of Australia and capital gains wherever sourced derived by entities who are tax-residents Australia.[103]

Accordingly, the enactment of the CGT regime did not cause a breach of conformity, on Australia's part, of Australia's treaty and other like obligations.

Of those changes made to the CGT regime following the Ralph Review, one change is of significance in relation to (on the one hand) satisfying the macro-level policy objective of Australia's tax systems being compatible with tax systems of other countries and Australia maintaining conformity with its treaty and other like obligations, and (on the other) horizontal equity. That change is the CGT discount.

That CGT discount was rationalised by the Ralph Review as necessary in order to ensure that the concession offered in Australia to negate the 'lock-in effect' be akin to corresponding concessions available abroad. Accordingly, in the view of the Ralph Review, that CGT discount was necessary in order that the CGT regime satisfies the macro-level policy objective of Australia's tax systems being compatible with tax systems of other countries.

That CGT discount violates horizontal equity as those capital gains that are eligible to that CGT discount (and most capital gains would) become taxed effectively at a rate of income tax much lower than the rate at which other forms of taxable income are taxed. The effect of that violation of horizontal equity, however, is somewhat extenuated, as that violation negates the violation of horizontal equity resulting from the abolition of averaging; the abolition of averaging was a change made to the CGT regime following the final report of the Ralph Review. Accordingly, on balance, the net violation of horizontal equity which that CGT discount does cause may not be significant.

Thus, in summary, with the enactment of the CGT regime, tax systems of Australia will have become more compatible than they would have been otherwise with tax systems of its major trading partners (bar New Zealand), and Australia will have not breached its conformity with its treaty and other like obligations. Accordingly, the requirement for satisfying the macro-level policy objective of Australia's tax

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102 *Taxation Ruling,* above n 100, para 5.
103 *Taxation Ruling*, above n 100, para 5.

systems being compatible with tax systems of other countries and Australia maintaining conformity with its treaty and other like obligations did not affect the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity being largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime may have not affected that perception being largely correct.

F *Simplicity*

The simplicity of a tax system causes three possible effects:[104]

1 *Substantive Simplicity*

If the legislative provisions pertaining to that tax system are drafted in a manner that is comprehensible with ease and certainty, administration of that tax system and compliance with that tax system are made easier.[105]

2 *Transactional Simplicity*

If the legislative provisions pertaining to that tax system are drafted in a manner that the scope of those legislative provisions is cohesive, the potential for manufacturing transactions of such form that those transactions are not captured by those legislative provisions is minimised.[106] Therefore, administration of that tax system and compliance with that tax system are made easier where legislative provisions pertaining to that tax system are drafted in a manner that the scope of those legislative provisions is cohesive.[107]

3 *Administrative and Compliance Simplicity*

If a tax system is so designed that the record keeping and information processing required for the administration of that tax system and the compliance with that tax system are not elaborate, administration of that tax system and compliance with that tax system are made easier.[108]

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104 In 2004, Chris Evans published a work (C Evans, *Taxing Personal Capital Gains: Operating Cost Implications* (Research Study No 40, Australian Tax Research Foundation, Sydney, 2003) (cited in note 4), which addressed the question of whether the manner in which capital gains are taxed influence the operating costs of the CGT regime. That work was reviewed as part of the research undertaken for this paper. But that work is not considered to be of relevance to the issue of whether, in the enactment of the CGT regime, the satisfaction of the macro-level policy objective of simplicity warranted a significant compromise of the perception (of the government of the day) that the CGT regime (upon enactment) will satisfy the macro-level policy objective of horizontal equity. That is so as that work is not an empirical study that canvasses the motivations that underlay the enactment of the CGT regime.

105 Krever and Brooks, above n 43, 138.

106 Krever and Brooks, above n 43, 138.

107 Krever and Brooks, above n 43, 138.

108 Krever and Brooks, above n 43, 138.

In its *Final Report*, the Asprey Committee stated:

> … It is on the ground of equity that, in the Committee's view, the arguments for capital gains tax may reasonably be held to be so strong to overwhelm the admittedly strong case against it on grounds of simplicity.[109]

The recommendations in the Final Report of the Asprey Committee proved influential in the eventual enactment of the CGT regime, as that report was reviewed by the Economic Planning and Advisory Committee (appointed by the government which enacted the CGT regime) in the preparation of the *Draft White Paper*.

Accordingly, in the enactment of the CGT regime, the government of the day did concede that the satisfaction of the macro-level policy objective of simplicity will have to be compromised so as to satisfy the macro-level policy objective of horizontal equity. That concession, however, was made subject to a single significant exception.

In the interest of satisfying the macro-level policy objective of simplicity, the CGT regime (as enacted) taxed capital gains only when those capital gains are realised, rather than when they accrued. There is considerable authority for the view that the CGT regime, for it to optimally satisfy horizontal equity, should tax capital gains as they accrue.[110] Those authorities essentially reason that a taxpayer who has realised a capital gain and a taxpayer who has an accrued but unrealised capital gain of equal value are in a similar economic situation, and therefore taxing the former taxpayer (merely because that taxpayer has chosen to realise that capital gain) but not the latter taxpayer violates horizontal equity.

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109 Aust, *Taxation Reform Committee Full Report (Asprey Committee Report)* (Chairman: Asprey K W) (1975) 414.

110 W D Andrews, 'The Achilles Heel of the Comprehensive Income Tax' in C E Walker and M A Bloomfield eds, *New Directions in Federal Tax Policy for the 1980s* (1983); A J Auerbach, 'Retrospective Capital Gains Taxation' (Working Paper 2792, National Bureau Of Economic Research, Cambridge, Massachusetts 1988) accessible < http://papers.nber.org/papers/w2792.pdf > (27 December 2004); A J Auerbach, 'Capital Gains Taxation and Tax Reform' (1989) 42(3) *National Tax Journal* 391; R Brinner, 'Inflation, Deferral and the Neutral Taxation of Capital Gains' (1973) 26(4) *National Tax Journal* 565; M W Bucovetsky, 'Inflation and the Personal Tax Base: The Capital Gains Issue' (1977) 25 *Canadian Tax Journal* 79; and D J Shakow, 'Taxation without Realization: A Proposal for Accrual Taxation' (1986) 134 *University of Pennsylvania Law Review* 1111. A comprehensive analysis as to why taxing capital gains as they accrue ('accruals basis') is to be preferred over taxing capital gains as they realize is given in the source cited in note 43 (131-150). There, it is argued as follows: The accruals basis better satisfies horizontal equity (as, under the accruals basis, a taxpayer who has realised a capital gain and a taxpayer who has an accrued but unrealised capital gain of equal value, are both taxed similarly) (137). The accruals basis better satisfies economic efficiency (as, under the accruals basis, there is no possibility that a 'lock-in' effect will arise) (138). The accruals basis better satisfies simplicity (as, under the accruals basis, the scope for postponement of tax payments through a contrived deferral of the realization of a capital gain is absent) (139). The argument that, under the accruals basis, a taxpayer's liquidity is burdened as the tax on capital gains has to be paid before those gains are realized in liquid form is overstated (141).

However, not any one country, as at the time CGT regime was enacted (or as of now), taxes all capital gains as they accrue.[111] That is so for two main reasons:

- Taxing capital gains as they accrue will require annual valuations by a taxpayer of that taxpayer's capital assets, a requirement that will necessarily result in considerable complexity to the legislative provisions imposing a tax on capital gains.[112]

- Taxing capital gains as they accrue will impose a burden on the liquidity of taxpayers who own capital assets, as those taxpayers will have to pay the tax on capital gains annually, based on accrued values, despite not having realised those capital gains in liquid form.[113]

Those reasons have strong pragmatic relevance. The enactment of the CGT regime, in deference to those reasons, such as to tax capital gains only when those capital gains are realised, rather than when they accrue, however, did not amount to a significant compromise of the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity. That is so as, even if capital gains are not taxed when those capital gains accrue, taxing capital gains when those capital gains are realised, as the CGT regime does, is an option that better satisfies horizontal equity than not taxing capital gains at all.

Accordingly, the requirement that the CGT regime satisfies the macro-level policy objective of simplicity did compromise the capacity of the CGT regime to also satisfy the macro-level policy objective of horizontal equity. That compromise, though, was not of such significance as to displace the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity from being a perception that is largely correct. And no changes to the CGT regime have occurred since the enactment of that regime to affect that position.

G *Stability*

A tax system should satisfy the macro-level policy objective of stability, so as to enable those potentially affected by that tax system to anticipate the incidence of that tax system with certainty.[114] Stability of a tax system, accordingly, comprises two features:

- The tax which that tax system imposes must be imposed in such manner as to be capable of being ascertained with certainty by a taxpayer who may potentially be liable to that tax.[115]

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111 Krever and Brooks, above n 43, 132.
112 Krever and Brooks, above n 43, 105.
113 Krever and Brooks, above n 43, 105.
114 Krever and Brooks, above n 5, 21.
115 Krever and Brooks, above n 5, 39.

- And that tax system, once enacted, remains enacted, with minimal change.[116]

The first of those two features is comprehended by 'substantive simplicity', addressed above under the heading 'Simplicity'. Only the second of those features, therefore, will be addressed under this heading.

The second of those two features of stability of a tax system, such as the CGT regime, is a macro-level policy objective whose satisfaction can be assessed as such only in hindsight (that is, after that tax system has been enacted).

Having been enacted, the CGT regime has, though it has been subject to some amendment, largely remained intact. And currently it is not the official policy of any prominent political party in Australia that the CGT regime should either completely or substantially be abolished.

What is pertinent, however, is the question of whether, in the enactment of the CGT regime, in order to ensure that that regime will remain enacted with minimal change, features that were incorporated in that regime amount to a significant compromise of the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity.

The CGT regime did contain a number of concessions, concessions which in large part were conceded by the government which enacted the CGT regime for reasons of political expedience. That is, if those concessions were not conceded by the government which enacted the CGT regime, it is unlikely that the CGT regime will have been enacted, or, even if it did get enacted, it is unlikely that it will have remained enacted without change.

Three of those concessions were of such nature that they violated horizontal equity. Those three concessions were:

- Capital gains realised from the disposal of assets acquired by a taxpayer before 20 September 1985 were not subject to the CGT regime, that is, those capital gains were effectively not liable to any tax.

- In calculating a capital gain assessable to CGT, where that capital gain is realised from the disposal of an asset that a taxpayer had owned for more than 12 months, that capital gain was adjusted for inflation through indexation by reference to the Consumer Price Index.

- Capital gains realised from the disposal of a taxpayer's principal residence was made exempt from CGT.

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[116] Meade, above n 5, 39.

The first of those concessions violated horizontal equity as taxpayers who realise capital gains from the disposal of their assets acquired before 20 September 1985 were being favoured relative to other taxpayers who realise capital gains otherwise of equal value.

The second of those concessions violated horizontal equity as adjustments for the effects of inflation, through indexation, were offered only under the CGT regime, but generally not under any other regime imposing income tax. Capital gains, which were eligible for such adjustments for the effects of inflation, were, accordingly, effectively taxed less than other forms of capital gain or income gain of equal value, thus violating horizontal equity.

The third of those concessions violated horizontal equity as that concession favours owner-occupiers of homes over those that are not. And, moreover, as that concession compounds the violation of horizontal equity arising from the failure in Australia to subject to income tax owner-occupiers of homes on imputed (economic) rent in respect of their homes.

There has not been any empirical research to establish how significant the violation of horizontal equity caused by each of those three concessions is. Accordingly, the conclusions noted below as to the significance of the violation of horizontal equity caused by each of those three concessions are based on anecdotal observation.

The first of those concessions, in effect, is narrower in scope when one considers the applicability of CGT event K6[117] and Subdivision 149-B, two provisions which (in certain circumstances) operate to deem assets acquired by a taxpayer before 20 September 1985 to be assets acquired by that taxpayer on or after 20 September 1985.

CGT event K6 effectively treats shares in a company or interests in a trust, which a taxpayer acquired before 20 September 1985, as having been acquired by that taxpayer on or after 20 September 1985, where the total assets of that company or trust comprise assets acquired by that company or trust on or after 20 September 1985 to the extent of at least 75% of the value of net assets of that company or trust.[118] CGT event K6 does not generally apply to companies whose shares, or trusts whose interests, are listed for quotation in the official list of an approved stock exchange.[119]

Subdivision 149-B effectively treats assets of a company or trust, which were acquired by that company or trust before 20 September 1985, as having been acquired by that company or trust on or after 20 September 1985, where the ultimate ownership of that company or trust has, to the extent of more than 50%,

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117 Income Tax Assessment Act 1997 (Cth) s 104-230.
118 Income Tax Assessment Act 1997 (Cth) s 104-230(2).
119 Income Tax Assessment Act 1997 (Cth) s 104-230(7).

changed since 20 September 1985.[120] Subdivision 149-B does not generally apply to companies whose shares, or trusts whose interests, are listed for quotation in the official list of an approved stock exchange.[121]

The first of those concessions may not have caused a significant violation of horizontal equity for two reasons. First, that concession, in effect, is narrower in scope when one considers the applicability of CGT event K6[122] and Subdivision 149-B. Second, any violation of horizontal equity caused by that concession abates as time passes as, with the passage of time, the stock of assets acquired by a taxpayer before 20 September 1985 reduces, due to a change of ownership of those assets, on or after 20 September 1985, having to often necessarily occur.

The second of those concessions may not have caused a significant violation of horizontal equity as, over the past decade or so, the rates of inflation in Australia have considerably reduced, and have remained at low levels.[123] Thus, the adjustments for inflation, through indexation by reference to the Consumer Price Index, in calculating a capital gain assessable to CGT realised from the disposal of assets that taxpayers had owned for more than 12 months are likely to have been correspondingly low in value.

The violation of horizontal equity caused by the third of those concessions is hard to refute. However, strong pragmatic reasons did perhaps exist for the enactment of that concession. Three of those significant reasons are:

- As at the time the CGT regime was enacted, there was apparently only one member of the OECD–Switzerland–that did tax the entire capital gain realised from the disposal of a taxpayer's principal residence.[124] Apart from Switzerland, at the time, all members of the OECD exempted from tax the entire capital gain realised from the disposal of a taxpayer's principal residence, with the exception of Spain, Sweden and the USA.[125] In those latter three countries, such an exemption was conferred only if the taxpayer realising such a capital gain acquired another principal residence within a prescribed period from the time of such disposal.[126]

- That exemption was warranted as home ownership possibly generated positive social 'externalities'.[127] Such positive 'externalities' are social stability, reduced physical illness, greater economic security for families, and, as owner-occupied homes tend to be maintained better than those that

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120 Income Tax Assessment Act 1997 (Cth) s 149-30.
121 Income Tax Assessment Act 1997 (Cth) s 149-50.
122 Income Tax Assessment Act 1997 (Cth) s 104-230.
123 C Evans, *'CGT after Ralph – The New Regime'* (paper presented at the Taxation Institute of Australia Conference, Western Australia, January 2000) 6.
124 Musgrave and Musgrave, above n 13, 93.
125 Musgrave and Musgrave, above n 13, 93.
126 Krever and Brooks, above n 43, 93.
127 Krever and Brooks, above n 43, 98.

are not, increase in values of properties in the neighbourhood of owner-occupied homes.[128]

- There has always been a general perception amongst Australian politicians that '[h]ome was a castle in which a citizen was barricaded against the avaricious tax commissioner and his assessors'.[129]

The third of those concessions, though it does violate horizontal equity, is unlikely to cause such violation to an extent of such significance as to compromise the capacity of the CGT regime overall to satisfy the macro-level policy objective of horizontal equity. That is especially so as, in Australia, as it is a developed country, home-ownership is relatively widespread such that the proportion of taxpayers in Australia who are not owner-occupiers of homes is relatively low.

Accordingly, the effects of those three concessions are unlikely to constitute a significant compromise of the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity.

The requirement that the CGT regime satisfies the macro-level policy objective of stability, accordingly, did compromise the capacity of the CGT regime to also satisfy the macro-level policy objective of horizontal equity. That compromise, though, was perhaps not of such significance as to displace the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity from being a perception that is largely correct. The fact that the CGT regime has largely remained intact and that currently it is not the official policy of any prominent political party in Australia that the CGT regime should either completely or substantially be abolished means that nothing has occurred since the enactment of the CGT regime to affect that position.

H *Yielding Expected Net Revenue to the Government*

A tax system should satisfy the macro-level policy objective of yielding to the government the net revenue that that tax system is expected to yield.[130]

The net revenue that a tax system yields to a government is the gross tax revenue that tax system yields minus the administrative costs borne by that government in relation to that tax system.[131] In relation to the CGT regime, there are no statistics as to what administrative costs are borne by the government in relation to that

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128 Meade, above n 5, 98.

129 R Stokes, 'Taxing Family Homes: An Autopsy of the Premium Property Tax in New South Wales' (paper presented at the Australasian Tax Teachers' Association 17th Annual Conference in Wellington, 26-28 January 2005) 8.

130 Woellner, above n 11, 41.

131 C Evans, 'The Australian Capital Gains Tax: Rationale, Review and Reform' (1998) 14(3) *Australian Tax Forum* 306.

regime.[132] Therefore, the analysis under this heading is limited to a review of the gross tax revenue that the CGT regime yields to the government.

The *Draft White Paper* estimated that a comprehensive tax on capital gains 'could generate tax liabilities around $450 million in the fifth year of operation'.[133] That estimate was seemingly based on what a comprehensive tax on capital gains yielded the Canadian government, when such a tax was first enacted in Canada.[134] Following the government's announcement that the regime of comprehensive tax on capital gains that is to be enacted will depart in some respects from that recommended in the *Draft White Paper* the then Treasurer announced that that amount of $450 million estimated in the *Draft White Paper* is revised to be $25 million.[135] In the event, the actual gross tax revenue yielded by the CGT regime has considerably exceeded that revised estimate announced by the then Treasurer,[136] and also has, relative to the Commonwealth government's total gross tax revenue, been rising.[137]

Further, with the enactment of the CGT regime, tax revenue lost by the government through avoidance of income tax, by taxpayers converting income gains liable to income tax to untaxed capital gains, generally ceased to be lost, as taxpayers then ceased to have an incentive to so convert income gains to capital gains. The resulting increase in income tax, an increase which is correctly attributable to the enactment of the CGT regime, is not included in the gross tax revenue actually yielded by the CGT regime referred to in the paragraph just above, as there is currently no measure of that resulting increase in income tax.[138]

Accordingly, the CGT regime does satisfy the macro-level policy objective of yielding to the government the net revenue that that regime is expected to yield. Whether that satisfaction did compromise the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity becomes moot only in the following situation.

That situation is where the government which enacted the CGT regime was forced to incorporate in the CGT regime features that fail to satisfy horizontal equity, so as to ensure that that regime satisfies the macro-level policy objective of yielding to the government the net revenue that that regime is expected to yield. In the event, no such features were incorporated in the CGT regime; rather, what came to pass was the opposite. That is, the form in which the government which enacted the CGT regime was forced to enact the CGT regime was such that, as that regime in that form represented a departure in some respects from the regime for

[132] Ibid 306.
[133] *Reform of the Australian Tax System*, above n 46, 85.
[134] Evans, above n 131, 306.
[135] Evans, above n 131, 306.
[136] Evans, above n 131, 306.
[137] Evans, above n 131, 306.
[138] Evans, above n 131, 307.

comprehensive taxation of capital gains which was recommended in the *Draft White Paper*, that regime caused not a gain but a loss of gross tax revenue yielded by that regime to the government.

The changes made to the CGT regime following the Ralph Review, except one, violated horizontal equity. That violation of horizontal equity, however, did not occur due to the government being forced to incorporate in the CGT regime those changes, so as to ensure that the CGT regime satisfies the macro-level policy objective of yielding to the government the net revenue that that regime is expected to yield. That is so as the remit of the Ralph Review was explicitly to the effect that its recommendations should be 'revenue neutral'.[139]

Accordingly, the requirement that the CGT regime does satisfy the macro-level policy objective of yielding to the government the net revenue that that regime is expected to yield did not affect the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity being largely correct. And no changes to the CGT regime have occurred since the enactment of that regime to affect that perception being largely correct.

III CONCLUSION

My earlier work addressed the question of whether the enactment of the CGT regime, and the continuance of the CGT regime after its enactment, was actuated by a perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity.[140] And that question, in that work, was answered in the affirmative. This paper addressed the question of whether that perception is largely correct. A question which, based on the analysis recorded in this paper, is answered in the affirmative.

This paper contained a comprehensive discussion of six of the macro-level policy objectives a tax system, such as the CGT regime, should satisfy. That discussion was warranted, as each of those macro-level policy objectives is not necessarily wholly co-extensive with horizontal equity, in order to conclude whether the satisfaction of each of those macro-level policy objectives:

- did compromise the capacity of the CGT regime, as first enacted, to satisfy the macro-level policy objective of horizontal equity; and

- has compromised the capacity of the CGT regime, on incorporating amendments to that regime made subsequent to its first enactment, to satisfy the macro-level policy objective of horizontal equity.

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139 *Review of Business Taxation*, above n 48, vii.
140 Sridaran, above n 1, 41.

That discussion resulted, with respect to each of those macro-level policy objectives (other than horizontal equity), in one of the two following conclusions essentially being drawn:

- The requirement to satisfy that macro-level policy objective by the CGT regime did not perhaps affect the perception the CGT regime will satisfy the macro-level policy objective of horizontal equity being largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime have perhaps not affected that perception being largely correct.

- The requirement to satisfy that macro-level policy objective by the CGT regime did compromise the capacity of the CGT regime to also satisfy the macro-level policy objective of horizontal equity. But that compromise was perhaps not of such significance as to displace the perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity from being a perception that is largely correct. And those changes to the CGT regime that have occurred since the enactment of that regime have not perhaps affected that position.

The first of those two conclusions was drawn with respect to the following macro-level policy objectives:

- Vertical equity

- Economic efficiency

- Compatibility with tax systems of other countries, and conformity with Australia's treaty and other like obligations

- Yielding expected net revenue to the government

The second of those two conclusions was drawn with respect to the following macro-level policy objectives:

- Simplicity

- Stability

Despite that perception that the CGT regime will satisfy the macro-level policy objective of horizontal equity, the question as to what reasons could, in theory, cause the CGT regime to produce micro-level outcomes that fail to satisfy horizontal equity (that is, outcomes that violate horizontal equity) is a question that is addressed in my subsequent research that is hoped to be published soon.[141]

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141 Chapter 5 of my draft doctoral thesis, a thesis which is entitled 'A Study on Whether the Australian Regime of Income Tax on Capital Gains causes Widespread Violation of Horizontal Equity'.