AN ESTATE TAX FOR AUSTRALIA?

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The recommendations of the Henry's review of the Australian tax system warrant critical scrutiny by all citizens who are concerned to have a more equitable society. One particularly interesting possibility for reform is buried in just a few lines in the huge report. This is an estate tax – or what Henry rather quaintly calls a 'bequest tax' – a tax that would be levied on the accumulated wealth of people at the time of their death. The Henry review gives it a qualified thumbs-up, saying it would be economically efficient, but then drops it because of its 'controversial history'. The Federal government has made no mention of inheritance, bequest or estate taxes since it released the Henry report. Indeed, it seems that any tax on inheritance is now taboo for Australian governments.

It was not always so. Inheritance taxes used to exist in Australia until the late 1970's. They were levied by both State and Commonwealth governments. In 1978, Joh Bjelke-Petersen, the idiosyncratic National Party Premier of Queensland, resolved to abolish inheritance tax in that State. The governments of other States then felt they had to do likewise (although, given current governmental concerns about how to meet the costs of an ageing population, one might think they would have welcomed to prospect of waving their senior citizens goodbye to Queensland!).

Prime Minister Malcolm Fraser followed suit by eliminating the federal inheritance tax, probably thinking that this would boost his flagging electoral popularity. This decision was crucial because it is only at the federal government level that an estate tax could sensibly be created now. It would be well-nigh impossible to 'reverse' the historical process whereby the State governments abandoned their individual inheritance taxes. A new tax would need to be a federal initiative.

Inheritance taxes exist in many other countries, such as the United Kingdom, Germany, Italy, Belgium, the Republic of Ireland, France, the Czech Republic, Canada and some states in the USA. In the UK, for example, inheritance tax is imposed on assets with value in excess of £325,000, although there has been some recent political controversy over whether this threshold should be raised. The UK tax rate is currently 40% of the value of the estate above that threshold. There are some exemptions for business assets and family farms. Any gifts over £250 each and exceeding £3000 in total in any given year that are made within seven years of death are liable to the same rate of taxation. In other words, substantial gifts made late in life are counted as part of the estate for tax purposes.

Why Have an Estate Tax?

A strong case can be made for taxing wealth passed on through inheritance. It can be made on a range of economic, ethical and distributional grounds.

Inherited wealth is unearned income. It differs in this respect from wealth generated through thrift, enterprise or sheer hard work. So the ethical basis for an estate tax is quite distinctive. Looked at from the donor's perspective, of course, it may be regarded as an infringement on the freedom to pass on wealth that may have originally resulted from productive economic efforts. However, that 'infringement' already applies in respect of other taxes, such as income tax, so no new principle is involved there. As always, infringements on individual economic freedoms need to be balanced against broader issues of social justice.

The social equity argument for taxation on inherited wealth is particularly strong. Inheritance perpetuates economic inequalities inter-generationally and therefore obstructs egalitarian ambitions for a fair society. There is a strong connection between income and wealth: it works two ways because high incomes foster the accumulation of wealth, while accumulated assets are usually income producing. Income thereby begets wealth and wealth begets income. Decoupling the process by taxing inherited wealth would produce a less unequal distribution of income and wealth within the society.

What is rather less clear is whether inheritance of housing assets directly accentuates wealth inequalities. Housing is usually the largest single item in inherited wealth. Since about seventy percent of Australian households are owner-occupiers, the housing wealth in many cases is simply transmitted inter-generationally. However, the houses vary enormously in value. Moreover, for the other thirty percent of households who are not homeowners, their exclusion from sharing in housing wealth through inheritance is also perpetuated inter-generationally. If a tax on inherited wealth existed, the revenue generated could be distributed in ways that help to overcome these housing-based inequalities, *e.g.* by financing more public housing.

What about the economic case for inheritance taxation? Surprisingly, even orthodox economists concede that it is strong. This is primarily because taxing inherited wealth does not have the adverse economic consequences that are sometimes said to result from other forms of taxation. Income received from inheritance is a windfall gain. It has no relationship to the economic efforts of the recipient/s (unless you count the effort of 'choosing your parents wisely'!). So inheritance tax is unlikely to have significantly adverse effects on economic productivity. A paper by Andrew Leigh and other political science academics at the ANU and his colleagues summarises these considerations by stating that 'there is a strong case to be made that inheritance taxes are more efficient than other forms of taxation'.

Inheritance tax can also produce a good revenue stream for the government, taking the pressure off other forms of taxation and/or financing socially desirable government expenditures (such as public housing provision, the education of young people, child care services or hospitals). In the UK, for example, official statistics show that the inheritance tax generated £3.6 billion in 2006 (approximately A$6.4 billion at the current exchange rate). While this was less that one percent of total tax revenue, the aggregate amount is sufficient to finance major government expenditure programs.

Designing an Estate Tax

The amount of revenue that would be generated by a new tax on inherited wealth in Australia would depend on its precise form, of course. There are five practical issues to be considered here:

- whether to tax the estate left by the deceased person (generally known as estate tax or 'death duty') or the income received by the beneficiaries of the will (generally known as inheritance tax);
- what threshold level to set, *i.e.* how much income can be received tax free;
- what rate of tax applies and whether it is set on a sliding (progressive) scale or at a flat rate;

- what mechanisms are put in place to reduce tax avoidance, such as ensuring that assets passed on to beneficiaries before death are also taxed; and
- what exemptions are permitted, *e.g.* for assets willed to charitable institutions or as donations to political parties.

Taxing the estate is the most administratively straightforward option. Combining the estate tax with a gift tax is essential to stop early wealth transfers evading tax. Keeping exemptions to a minimum is also necessary to prevent tax avoidance, although the exemption of legitimate registered charities could encourage socially desirable transfers.

The question of the appropriate threshold is understandably contentious. There is a trade-off between politics and economics there - between the political acceptability to a broad 'middle class' within the electorate and raising substantial tax revenue. A threshold set at $5 million, as the Australian Greens currently propose, is at the politically cautious end of this trade-off. According to ABS statistics, only 0.5% (or one in two hundred) of Australian households had wealth above $5 million in 2005-6. A rather lower threshold would net a substantially higher number of payees. If the threshold were set at $2 million, for example, it would apply to the 3.7% of households who had wealth above that level in 2005-6. Still only a small elite would be effected but the revenue would be considerably more substantial.

An estate tax that exempted the first $2 million of wealth would seem to be an effective compromise between a tax that generates good revenue and a tax that is politically acceptable. It would probably impact on about 5% of households, allowing for a modest inflation rate that would have pushed some more households above the $2 million threshold in the last couple of years. A $2 million threshold would be substantially higher than the one currently applying in the UK, as previously noted. The paper by Andrew Leigh and his co-authors, cited earlier in this article, puts the case for a lower threshold of only $1 million for an Australian inheritance tax.

The Politics of an Estate Tax

New taxes are never popular, even when they restore taxes that previously existed, when similar taxes exist in other countries and when they have a strong socio-economic rationale, as is the case with estate taxation. However, they can be made more palatable if they address major social problems and injustices, such as the growth of unearned incomes and the way inheritance is currently making Australian society ever more unequal. Political acceptability is also enhanced if there is a link between the tax revenue and specified socially desirable expenditure. If estate taxes financed free tertiary education, for example, or a substantial boost to public housing, that would markedly change the politics. The first step is to get the issues talked about: but that won't be happening as the result of the official Henry tax review. That is why it is important for journals like **Australian Options** to get the necessary conversations started.

How the tax could operate in practice – and the political acceptability of the specific tax to be implemented – would also depend on detailed considerations relating to indexation, exemption of the family home and family farms. Careful attention to these matters could further reduce some of the expected political flak.

Indexing the tax threshold to the annual rate of inflation would enhance its political acceptability but reduce future revenues, of course. It is pertinent to note that few other taxes are indexed. It is the absence of indexation on income tax, for example, that continues to generate higher levels of government revenue even when governments claim to be making tax cuts. The absence of indexation for a new estate tax would generate massive political concern though, because it would then be difficult to present the tax as only ever applicable to a wealthy elite.

Whether the family home should be exempt from an estate tax is another matter with both economic and political implications. Providing that exemption would help to head off claims about the dreaded 'tax on the family home' that have featured strongly in conservative political propaganda in relation to land tax and capital gains tax reforms in past years. However, because housing is normally the largest item in inherited wealth, generalising that family home exemption would severely curtail estate tax revenue. Of course, when the legatee is the spouse, it is axiomatic that the estate should be exempt from the tax. In other cases, however, the grounds for exemption are relatively weak because there is no general reason to favour people who keep their wealth in one particular form of assets. As the orthodox economists would say, the owner-occupied housing exemption would create a market distortion.

Indeed, Australian housing problems are accentuated by existing biases in the income tax and land tax systems that privilege owner-occupied housing. The exemptions encourage over-investment in housing, with corresponding problems of housing affordability and diversion of funds from other potentially productive investments. Moreover, given people's current average life-span, most offspring who inherit the family home do so when they are already middle-aged and own their own home. So, exempting owner-occupied housing would not have particularly positive effects in helping those actually in need of housing. For a new estate tax the broadest possible coverage of assets combined with a relatively low tax rate is probably the best mix.

The family farm question is more delicate. Proponents of this particular exemption argue that inheritance tax can create a danger of farms being broken up to pay tax liabilities, with adverse consequences for agricultural productivity and the cohesion of rural communities. Indeed, this is a potentially significant problem that warrants sympathetic consideration. The lower real property values in non-metropolitan areas would result in lower payments of estate taxes in general. So there is no general bias against 'rural and regional Australia' here, but it is important to avoid potentially adverse impacts on family farms - and family businesses generally. Of course, there are matters of political judgment, as well as economic calculations, in dealing with all of these concerns.

Conclusion

The Australian tax system is conspicuously lacking any tax on inherited wealth. There are taxes on income from labour and capital (PAYE income tax; company tax; capital gains tax), taxes on consumption (GST; liquor, cigarette and petrol excises), tax on wealth (land tax on property that is not owner-occupied), tax on financial transactions (stamp duty) and tax on employment (payroll tax). But no Australian inheritance tax. It is a lacuna that needs careful reconsideration as part of a progressive tax reform process.

Further sources of information:

On the distribution of wealth from different sources see F. Stilwell and K. Jordan, *Who Gets What? Analysing economic inequality in Australia*, Cambridge University Press, 2007, Chapter 3.

For ABS data on wealth in Australia see

www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/6554.02005-06?OpenDocument

For analysis of the effects of a possible inheritance tax in Australia, see the paper by Andrew Leigh and his colleagues from the ANU at www.cpd.org.au/article/bring-back-inheritance-tax