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Shedding light on the debate
Mythbusting tax reform

#2

Mythbusting tax reform

The myths	The facts

Are our **superannuation** incentives fit for purpose?

Superannuation concessions cost more than the aged pension does.	Super concessions do cost a lot – but nothing like the pension. Treasury uses as a benchmark the biggest possible tax bill that could be levied if super were treated as wage income. More appropriate benchmarks point to costs which are significantly lower.
We can't change super rules now because the system needs a period of stability to win back the trust of members.	Stability and trust is important, but cost is important too. Governments can only truly promise stability if the system is sustainable.

One example of a potential improvement

We should consider making tax incentives for contributing to super the same for everyone at 15 cents in the dollar. That would put super on a simpler, fairer and more sustainable basis. And the resultant saving of taxpayers' money – at around $6 bn a year – would be large. It could, for example, pay for shifting the company tax rate down to 26% from the current 30%, thereby delivering a prosperity dividend to all Australians.

Negative gearing – cause or symptom?

Negative gearing is an evil tax loophole that should be closed.	The ability to deduct expenses incurred in earning revenue is an accepted principle of our tax system.
Negative gearing drives property prices through the roof, but ditching it would send rents soaring.	Housing prices and the associated overuse of negative gearing reflect the current mix of low interest rates, a lack of supply, and the overly generous tax treatment of capital gains. That says the overuse of negative gearing is a symptom of other factors, rather than a cause of huge house prices. Besides, ditching negative gearing wouldn't have a big impact on rents, because tax settings would only change housing rents if they had large enough impacts on the supply or demand for homes.

Is the **discount on capital gains** too big?

The discount on capital gains is an appropriate reward for savers.	There should be more generous tax treatment of capital gains than ordinary income, but the 50% discount is too big.

One example of a potential improvement

We should consider other options such as a lower discount of 33⅓% applied across a broader base.

For perspective, some statistics for high income earners

3% Taxpayers earning over $180,000 make up just under 3% of all taxpayers.	**10%** These taxpayers receive 10% of all reportable employer superannuation contributions (such as salary sacrifice contributions or extra employer contributions).	**13%** These taxpayers claim 13% of total rental losses and equally earn 13% of rental profits.	**53%** These taxpayers make about 53% of all capital gains.

Mythbusting tax reform #2

We've been overwhelmed by the positive reaction to our first Mythbusting tax reform report, which discussed bracket creep, GST and company tax.

I am pleased to present the second of our two Mythbusting reports on tax reform, covering superannuation, negative gearing, and the discount on capital gains.

These three issues are all shrouded in myths, so we've attempted to shed some light. As always our ultimate goal is to provide clarity to the national conversation about tax reform – to provide you with our clear view on the way forward.

Our conclusion is simple: a better tax system could be a big contributor to building the Lucky Country, if only a bunch of myths weren't getting in the way of that.

Our report has been prepared by our tax and superannuation specialists within Deloitte and by our economists in Deloitte Access Economics.

We trust you find it a perceptive and enlightening read.

Cindy Hook

CEO, Deloitte Australia

A better tax system could be a big contributor to building the Lucky Country.

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Executive Summary

Australia's tax debate is in need of a circuit-breaker, and this report aims to achieve exactly that. But if we are to make the right reform suggestions for this nation, we need to answer some key questions:

- Are we getting value for money from Australia's tax system?
- Is it delivering as much prosperity and fairness as it could?

Take super. If we were to strip away the myriad of concerns about it, they boil down to just one – are Australia's super concessions worth what they're costing? The answer depends on both elements of that equation: how much the concessions cost, and what they are achieving.

You won't be surprised to hear that the answers to both questions are shrouded in myths.

Myth 1: Superannuation concessions cost more than the aged pension does

Super concessions do cost a lot – but nothing like the pension. What you benchmark against is vital. Most Australians are short relative to basketballers, and the Treasury estimate of the dollars 'lost' to super tax concessions uses a particularly tough benchmark: the biggest possible tax bill that could be levied if super were treated as wage income. And that's not all – the Treasury measure also doesn't allow for any offsetting benefits via future pension savings, plus it doesn't allow for any offsetting behavioural changes. More appropriate measures of super concessions would point to costs that are still huge, but rather less than Treasury's costing.

So it's a furphy to argue super concessions outweigh the cost of the pension – that's a myth that should be well and truly busted. Yet the costs are still pretty big. Are they worth it? That depends on the benefits that super is achieving for Australia.

Economists see two possibilities:

- If we save more, we'll be **more prosperous in the future** – so super can help counteract a range of 'anti-saving' biases elsewhere in the tax system
- And super can reinforce **a fairer Australia** alongside our tax, pensions and benefit systems.

Yet the scorecard is modest. Yes, super does add to overall saving, but:

- Three-quarters of the money flowing into super is compulsory anyway, and therefore doesn't need big savings incentives
- Most of the cost of super concessions goes to higher income earners. Yet although those high income earners do save extra in super as a result, much of that comes via reducing other savings.

And the fairness scorecard for super is similarly skimpy:

- The Murray Review found that only $1 in every $200 of the cost of super concessions goes to the bottom 20% of income earners, whereas more than half goes to the top 20%
- Treasury's Intergenerational Report found the share of people getting pensions in 2055 will be much the same as today (although the portion on full pensions will be lower).

So although the costs of super aren't as huge as critics paint them, the benefits are modest. That says taxpayers should get a better deal. But that brings us to our second myth.

Myth 2: We can't change super rules now because the system needs a period of stability to win back the trust of members.

Stability and trust are important – all the more so after years of chopping and changing. But cost is important too, and the super system is very expensive for what it is achieving. Australians are spending a fortune on 'stability and trust' in super settings while actually achieving neither. Governments can only truly promise stability if the system is sustainable.

We can do better than that. There are plenty of potential improvements, but one example of a better super tax system would be an updated and simplified version of the contributions tax changes proposed in the Henry Review[1] – where everyone gets the same tax advantage out of a dollar going into super, with a standard concession of 15 cents in the dollar for both princes and paupers.

Making the tax incentives for contributing into super the same for everyone also comes with a pretty big silver lining. As current incentives are weighted towards the better off, there is a tax saving from making super better – **a reform dividend of around $6 billion in 2016-17 alone.**

- Even better, because this is a change to the taxation of contributions – when the money goes in – it avoids the need for any additional grandfathering. Nor does it add extra taxes to either earnings or benefits
- And because the incentives are simpler and fairer, the current caps on concessional (pre-tax) contributions can also be simpler and fairer. They could be abolished completely for everyone under 50, and the cap could be raised for everyone else (subject only to a safety net of a lifetime cap).

So, yes, this is an example in which super taxation would change; and we all hate change. But it would put super on a simpler, fairer and more sustainable basis. And, depending on how the super savings are used (to cut taxes that really hurt our economy, or to fund social spending, or to help close the Budget deficit), the resultant package could appropriately help Australians to work, invest and save. For example, **this reform alone would pay for shifting the company tax rate down to 26% from the current 30%, thereby delivering a prosperity dividend for all Australians.**

So that's super. But arguably the blackest hat in Australia's tax debate is worn by **negative gearing.** So you may be surprised to hear our next myth debunks that: the over-use of negative gearing is a symptom of other things, not a cause of problems in its own right.

Stability and trust are important - all the more so after years of chopping and changing. But cost is important too.

1. Australia's Future Tax System, Report to the Treasurer, December 2009.

Myth 3: Negative gearing is an evil tax loophole that should be closed.

No, negative gearing isn't evil, and it isn't a loophole in the tax system. It simply allows taxpayers to claim a cost of earning their income. That's a feature of most tax systems around the world, and a longstanding element of ours too. Yes, it is over-used, but that's due to

1. Record low interest rates and easy access to credit
2. Heated property markets, and
3. Problems in taxing Australia's capital gains.

Sure, the rich use negative gearing a lot, but that's because they own lots of assets, and gearing is a cost related to owning assets: no smoking gun there.

OK, so negative gearing should be part of our tax system. But isn't it guilty of something – anything? That brings us to...

Myth 4: Negative gearing drives property prices through the roof, but ditching it would send rents soaring.

Pick one of those two – if something sends housing prices up, then it would eventually send rents up too. Let's take the housing point first. Interest rates have a far larger impact on house prices than taxes. Housing prices are through the roof because mortgage rates have never been lower. Among tax factors, it is the favourable treatment of capital gains that is the key culprit – not negative gearing.

And while negative gearing isn't evil, nor would ditching it have a big impact on rents. Tax settings can only change prices if they change supply or demand. And, by lowering the cost of buying, negative gearing does raise demand for buying homes that are then rented out. Yet the impact on housing prices of negative gearing isn't large, meaning that the impact of it (or its removal) on rents similarly wouldn't be large.

Now for the home stretch – although we don't think negative gearing deserves its bad name, there is a case that Australia's capital gains discount is too generous.

Myth 5: The discount on capital gains is an appropriate reward to savers.

Err, no.

The basic idea is very much right. There should be more generous treatment of capital gains than of ordinary income, because that helps to encourage savings (and hence the prosperity of Australia and Australians), and because the greater time elapsed between earning income and earning a capital gain means it is important to allow for inflation in the meantime.

But we overdid it. We gave really big incentives for some taxpayers (such as high income earners) to earn capital gains, versus little incentive for others (such as companies). And the discounts Australia adopted back in 1999 assumed inflation would be higher than it has been – meaning they've been too generous.

So the 50% capital gains discount is no longer meeting its policy objectives. That not only comes at a cost to taxpayers, but to the economy as well.

Australia should consider other options such as a lower discount of 33.33% applied across a broader base. That would still compensate for the double taxation of savings, while at the same time working to reduce the distortion in investment decisions that the tax system currently creates.

Let's finish where we began

Both our initial Mythbusters report and this one come to the same simple conclusion: that a better tax system could be a big contributor to building the Lucky Country, but a bunch of myths and misconceptions are getting in the way of that.

Australia is in need of a circuit-breaker – and we'd like to think that some of the suggestions in here could provide one.

Are our superannuation incentives fit for purpose?

Australia's superannuation system has spawned more myths than Ancient Greece.

Perhaps that's no surprise – the system sits atop $2 trillion in assets, and both those who want change and those who defend the current system have been gilding the lily.

If Australia is to have the best policies around retirement, we must cut through that fog.

So the first myth we'd like to dissect is a golden oldie about costs.

Is the cost as big as critics claim?

Myth 1: Superannuation concessions cost more than the age pension does.

You have all seen the comparisons made between the cost of super concessions (which Treasury puts at $51 billion in 2018-19) and the cost of the age pension (which Treasury has at $50 billion in 2018-19)[2].

Dramatic, huh?

That comparison makes for a sexy headline, and a zinger in parliamentary debate.

But it is wrong. Super concessions do cost a lot – but nothing like the pension.

Treasury estimates the 'cost' of super by assuming that the income going into super is taxed as wages instead. Using such an income tax benchmark[3] generates a huge cost estimate.

But economists note there's an equally good case to use different benchmarks to assess the cost of super concessions. Using a pre-paid expenditure tax benchmark, Treasury estimates that the sum of super concessions in 2013-14 would be $11 billion – heaps lower than its published figure. And a 'post-paid' expenditure tax benchmark would give an even lower estimate.

You get the point. Benchmarks are vital. Most Australians are short relative to basketballers, and the Treasury estimate of the dollars 'lost' to super tax concessions uses a particularly tough benchmark: the biggest possible tax bill that could be levied if super were treated as wage income. Yet equally valid alternative cost estimates are a fraction of the figure Treasury publishes.

But wait, there's more. Arguing the toss on the benchmark to measure against is only one of the caveats. Treasury looks at current costs, which means leaving out future benefits. Such 'cost benefit analysis' is a cornerstone of economic assessments, but these benefits are not accounted for in the cost estimates provided by Treasury.

Of course, that's no surprise. As Treasury has long been at pains to stress, its estimates of the cost of superannuation concessions are designed to reflect the tax system alone - not the retirement system as a whole.

Furthermore, the Treasury calculations don't allow for behavioural change. Yet that's the thing about taxes: they change behaviour. Were super tax concessions to be abolished, the resultant reduction of money in super wouldn't show up in wages – some of it would move to the 'next best' tax option.

The costs of the super system (tax concessions) show up early, whereas the benefits (such as any pension savings) come decades down the track. That means all measures of its current cost will be bigger than its true eventual net cost.

2. See items C3 and C6 at page 4-21 of http://budget.gov.au/2015-16/content/bp1/download/BP1_BS4.pdf, versus income support for seniors at page 5-29 of http://budget.gov.au/2015-16/content/bp1/download/BP1_BS5.pdf.
3. Three broad types of tax benchmark can be applied to retirement savings:
   - **An income tax benchmark**, under which super contributions are taxed like any other income, earnings are taxed at personal tax rates, and benefits from superannuation are untaxed
   - **A pre-paid expenditure tax benchmark** has all returns to savings exempt from tax, so contributions are taxed at an individual's personal tax rate with both earnings and benefits tax-exempt
   - **A post-paid expenditure tax benchmark** has both contributions and earnings as tax-exempt, but benefits are fully taxable when received.

So the Treasury estimate of the costs of superannuation tax concessions is too high because:

- **It uses the biggest possible income tax benchmark**
- **It doesn't allow for any offsetting future benefits, and**
- **It doesn't allow for any offsetting behavioural changes.**

That's not to say taxpayers can't get a better deal from Australia's superannuation system. They can and they should. But it is a furphy to argue that existing concessions are so big that they outweigh the cost of the age pension – that's a myth that should be well and truly busted.

How big are the benefits?

OK, so the critics overstate the costs of super. But how big are the benefits?

Well… that all depends on what we are trying to do. However, there's a depressing degree of disagreement on exactly what Australia's superannuation policies are trying to achieve.

Yes, you read that right. Concessions for super cost a lot, but there is much disagreement on what those costs to taxpayers are trying to do.

The Murray Review[4] saw that, and suggested the aim to enshrine in legislation[5] is that the super system should "*provide income in retirement to substitute or supplement the Age Pension*", indicating that superannuation should not be an estate planning tool.

We'd put it a little differently. Our initial Mythbusting report noted that societies have the twin aims of prosperity and fairness:

- If we save more, we'll be **more prosperous in the future** – so super can help counteract a range of 'anti-saving' biases elsewhere in the tax system
- And super can reinforce a **fairer Australia** alongside our tax, pensions and benefit systems.

Super has a prosperity purpose – it can make us save more

If we screw up super, we hurt the economy. Alternatively, getting it right raises the incomes of Australians. But that 'prosperity purpose' underpinning super isn't well understood.

Imagine two people earning the same income. One spends it all, and the other saves some. But those savings earn income, which then gets taxed again, meaning one person ends up paying more tax than the other simply because they saved. This 'double taxation of savings' means the tax system encourages people to spend rather than save, because spenders pay less income tax than savers[6]. That is why a number of parts of the tax system provide concessions to savers. That's true, for example, of the taxation of capital gains. And it is true of superannuation itself.

And there are also prosperity reasons other than the 'double taxation of savings' to provide an incentive for Australians to save via super:

- **Taxes already hit savers more than spenders:** Governments essentially tax 'the rich' to spend on 'the poor'. And so they should. But the rich save more from a given dollar than the poor, so personal income taxes lower saving below where it would otherwise be – and super concessions can help restore that 'lost' saving
- **Helping families save because it is hard for governments to save:** Politics makes it hard for governments to 'save' – to run surpluses. So there is also a case for taxpayer subsidies for super, as they effectively lock up savings in a way that governments can't.

4. The Financial System Inquiry, Final Report, November 2014.
5. The government has agreed to this recommendation.
6. Yes, the saver pays more tax because they earn more income. But that doesn't change the fact that spenders pay less tax than savers do, meaning that the tax system is biased against saving.

These 'anti-saving' biases in the tax system are a problem. If we don't save enough, our prosperity will suffer. Australia has marvellous investment opportunities, but our population can't save up enough to finance all of them:

- We can and should be open to foreign investment or to borrowing from the world to finance those opportunities, because doing so lifts Australian living standards
- But the boost to our living standards is greatest when we don't have to funnel off too much as payments to foreigners as interest or dividends: that's one of the reasons why we should encourage saving by Australians
- That encouragement should apply equally to any dollar saved, whether that is by a prince or a pauper.

So, yes, even multi-millionaires should get a tax break when their money goes into super – all the more so given that putting money into super involves both (1) a degree of compulsion and (2) locking that money away for a long time.

If we want a prosperous Australia, then the debate shouldn't be over whether super gets concessionally taxed, but how big that concession should be.

But do these tax concessions mean that super is making us save more?

In turn, that raises another key question: **do our existing tax concessions mean that super is making us save more?** Economists long since concluded that compulsory super makes those with low incomes save more than they would otherwise have done, but that higher income earners fund their super savings by reducing other savings.

Various studies estimate the reduction in other savings for each extra dollar of compulsory super savings at between 30 and 40 cents:

- The Reserve Bank (2004)[7] puts this 'savings offset' at around 38 cents in the dollar
- Tulip and Stott (1994)[8] concluded that the offset to compulsory superannuation would be "*about a third*"
- Covick and Higgs (1995)[9] concluded their estimate of a savings offset of 37 cents may be on the high side, and that the Tulip and Stott value of about a third was reasonable.

The international evidence is more mixed, but similarly concludes there is an impact, but only a partial one[10]. So yes, super is lifting our saving. And that's the official view too, with Treasury's Intergenerational Report concluding "*Compulsory superannuation savings appear to have made a significant contribution to national savings (around 1.5 per cent of GDP in 2011 and rising to close to three per cent over the next few decades). This is despite some reduction in other forms of savings.*"[11]

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7. Connolly, E and Kohler, M, The Impact of Superannuation on Household Saving, Research Discussion Paper 2004-01, March 2004.
8. Tulip, P and Stott, D, The Effect of Compulsory Superannuation on Private Saving, Federal Treasury Seminar Paper, July 1994.
9. Covick, O and Higgs, B, Will the Australian Government's Superannuation Initiatives Increase National Saving?, 24th Conference of Economists, Adelaide, 1995.
10. For example, likes of Chetty, Friedman, Leth-Petersen, Nielsen and Olsen (2012) find "automatic employer contributions to retirement accounts increase wealth accumulation substantially", whereas "Subsidies for retirement accounts, which rely upon individuals to take an action to raise savings, primarily induce individuals to shift assets from taxable accounts to retirement accounts. We estimate that each $1 of government expenditure on subsidies increases total saving by only 1 cent". In the Australian context, that finding translates into the mandatory part of super raising saving, but voluntary contributions merely representing people chasing tax savings, rather than adding to savings overall. See Chetty, R, Friedman, N, Leth-Petersen, S, Nielsen, T, and Olsen, T, Active vs. Passive Decisions and Crowdout in Retirement Savings Accounts: Evidence from Denmark, 24th NBER Working Paper No. 18565, November 2012.
11. See page 66 of Treasury's 2015 Intergenerational Report. These results are based on a 2011 paper on Compulsory Superannuation and National Saving by D Gruen and L Soding which assumed a 30 cent offset (see page 8 of http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Speeches/2011/Compulsory%20superannuation%20and%20national%20saving/Downloads/CompulsorySuperannuationandNationalSaving.ashx).

But we are achieving this lift in national saving in an expensive way? The literature noted here implies:

- Most of the extra saving comes from the compulsory part of super – the 9.5% paid on behalf of all employees – and therefore doesn't need big savings incentives. The compulsory part accounts for three-quarters of all the dollars entering the super system
- Yet most of the cost of superannuation concessions comes from higher income earners as they juggle their savings to get the biggest tax benefits[12].

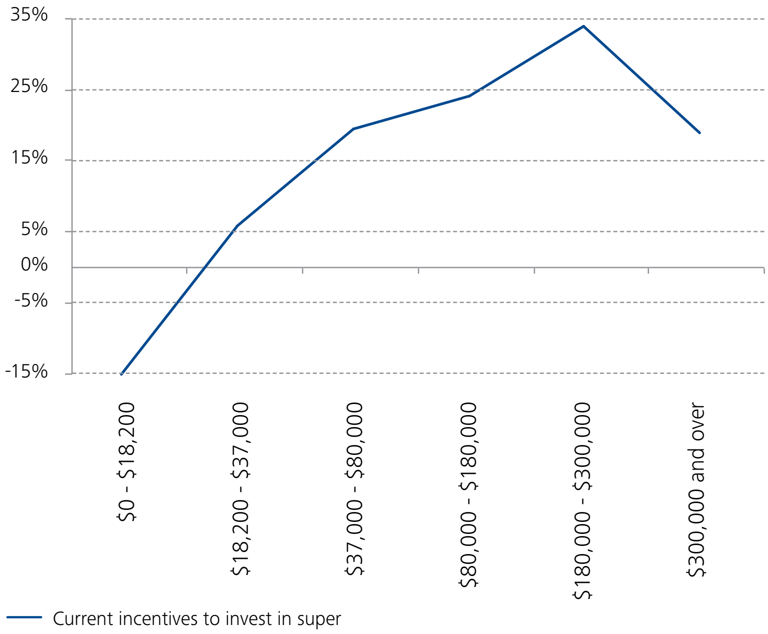
Is our super system making Australia fairer?

So super is a modest achiever at boosting our prosperity via boosting our saving. But how good is it at making Australia a fairer society?

Whereas our super system is largely a flat tax, our personal income tax system is a progressive one, and that mix means some unusual incentives. As Chart 1 shows, that means there's a Heartbreak Hill at the centre of Australia's taxation system: low income earners actually pay more tax when a dollar of their earnings shows up in superannuation rather than wages, whereas middle and high income earners get big marginal benefits.

If a key aim of the super system is to make Australia fairer, then we shouldn't start by providing bigger marginal benefits to middle and high income earners.

Chart 1: Tax benefit (loss) of diverting a dollar from wages to super



Source: Deloitte Access Economics

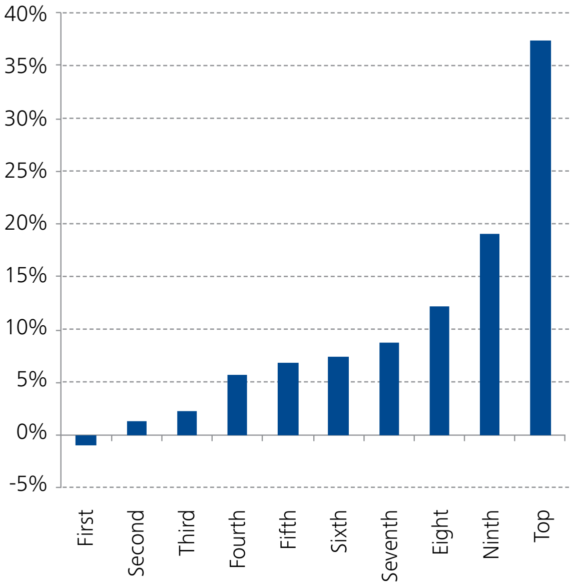
Or, if you like, **we give least tax incentive where superannuation has the biggest impact on fairness, and the most tax incentive where superannuation has the least impact on fairness.**

If a key aim of the super system is to make Australia fairer, then we shouldn't start by providing bigger marginal benefits to middle and high income earners.

12. That's not to say high income earners are 'rorting' the system. We summarise some of Australia's super tax concessions at Appendix 1. Higher income earners have the same concessional contribution cap as everyone else. The table in Appendix 1 shows the maximum benefit that any taxpayer can achieve for salary sacrificing super contributions is around $6,000, irrespective of income. But higher income earners do benefit from being able to contribute more after-tax dollars to super because they have greater wealth, and because they are able to earn income in the low tax environment of a super fund. They also benefit from higher compulsory super contributions because of their higher wages.

Not surprisingly, Australians have reacted to those incentives – as the Murray Review found, and as Chart 2 shows.

Chart 2: Share of total superannuation tax concessions by income decile, 2011-12



Source: Treasury, via Chart 6, page 138, The Financial System Inquiry, Final Report, November 2014.

That points to a problem – most taxpayer subsidies for super aren't well targeted. The Murray Review found that only $1 in every $200 of the cost of super concessions goes to the bottom 20% of income earners, whereas more than half goes to the top 20%[13].

That's why Australia's super system isn't really making much difference to future pension costs. Yes, the existence of an age pension means test tells us that there is a link: more money in retirement nest eggs means less money paid out by the government in pensions.

But that link between super and pensions is weaker than most Australians realise. Because most concessions go to higher income earners, Treasury's Intergenerational Report found the share of older Australians getting pensions in 2055 will be much the same as today[14].

So although the costs of the super system aren't as huge as critics paint them, the benefits are modest. Yes, super does add to savings and hence future prosperity, but not by much, and the cost of that is high. And at the same time the fairness scorecard is similarly skimpy.

In turn, that says taxpayers can and should get a better deal from Australia's superannuation system. But that brings us to our second myth.

Myth 2: We can't change superannuation rules now because the system needs a period of stability to win the trust of members

Australians are sick and tired of the chopping and changing in superannuation rules.

Superannuation tax surcharges have been playing the Hokey Pokey: they're in, they're out, and now they're in again as increased contributions taxes for high income earners. Subsidies for low income earners have been dancing the same dance – sometimes the government has put in extra dollars alongside low income earners, but more recently those incentives have been scuttled once more. Or take caps on contributions, which have also come in, been changed, been indexed, been not indexed, and then been changed once more. Meantime the taxes on benefits have changed more fundamentally than any other part of the mix.

In case you were wondering, a number of these changes contradicted or unwound changes made just a few years earlier. And that's just a partial list of actual changes. It ignores the changes that have been announced but were never actually implemented.

The damage of these dramas is cumulative – the more the system changes, the more that public distrust increases. After all, the super system asks them to tie up their money for a very long period of time, but they increasingly lack confidence that money will be 'safe' from further policy tinkering.

13. As we note elsewhere, fairness is the result of an overall system rather than its individual parts. Australia's pension and benefit system combines with progressive personal income taxes to generate fairness.

14. As page 65 of Treasury's 2015 Intergenerational Report notes, "*In 2013-14, about 70 per cent of people of Age Pension age were receiving the Age Pension. Of these pension recipients, around 60 per cent receive a full rate pension. Under the 'proposed policy' scenario, the proportion of people of Age Pension age receiving the Age Pension is projected to fall to around 67 per cent by 2054-55.*" However, the share of part-rate pensioners relative to full-rate pensioners is expected to increase.

Given regular changes to superannuation rules, it is only rational for individuals to factor the risk associated with adverse changes to their super into their savings plans. The result is a system in which long term savers are discouraged from making voluntary contributions, while those individuals who see a benefit from a particular policy change are quick to take advantage of what is seen as a short-term window of opportunity before the rules are changed once again.

That is a particularly poor outcome for taxpayers, as it poses Budget risks associated with those who can afford to contribute in order to achieve short-term goals, while reducing the effectiveness of incentives aimed at long term savers to secure future retirement incomes.

It's no wonder then that the public:

- Don't understand the superannuation system
- Fear further changes to it, and
- Lack trust that the spaghetti web of grandfathered rules will hold firm.

So we more than understand that there are those who argue that Australia can't change super rules now because the system needs a period of stability to win back the trust of members.

Yet there's another myth to be laid to rest here.

It is very true that stability and trust are important. But so is cost, and right now the impact of tax concessions means that the nation is spending a fortune on 'stability and trust' in superannuation settings while actually achieving neither.

To repeat – politicians can promise all they like, but so did King Canute. And just as there is inevitability around the tide coming in, there is inevitability about change to a superannuation system that is very expensive relative to the runs it is putting on the board.

Governments can only truly promise stability if the system is sustainable. Yet Australia's superannuation system is expensive for what it is achieving, and is riddled with holes. So let's not dabble. It's important to get the policy settings right now, so we avoid the need for further bandaid solutions.

Finally, one last myth for you: what of that old pub standard about super – that **the politicians should keep their mitts off, because "It's your money."**

At the risk of stating the obvious, lots of things are "your money", including your wages, the interest you earn on a bank deposit, and the rent you may earn from an investment property.

But someone has to pay to keep Australia going.

We all need to contribute to the society we live in and the services we rely on such as our hospitals, schools and roads. Most money going into superannuation would otherwise be paid as wages and therefore be taxed at higher rates.

Can Australia do better on super taxes?

Now it's time to cut to the chase.

Let's try to answer the key question – can we do better than the current super tax system?

- Although super concessions aren't nearly as costly as the critics claim, they also don't deliver much bang for the buck in terms of prosperity and fairness
- The Henry Review essentially recommended that Australia tidy up the concessions given at the contributions stage (when money goes into super in the first place), and wind back the taxes levied on super fund earnings
- That means the Henry Review was trying to move Australia closer to treating super as an income tax[15], but with lower rates than the personal income tax system so as (1) to provide the same incentive to save for everyone and (2) help some people to reduce or eliminate their reliance on the age pension in their retirement.

The type of system that we'd imagine would be an updated and simplified version of the contributions tax changes proposed in the Henry Review.

15. Appendix 2 covers the debate among economists as to whether super taxes should be income taxes (and so taxed upfront on contributions, with no tax on either earnings or benefits) or consumption taxes (and so taxed solely when benefits are paid out, with no tax on either contributions or earnings). The current system is much closer to an income tax, and there are fewer grandfathering dramas if policy heads in that direction.

Chart 3 is an updated version of Chart 1. It shows both the current tax incentive to switch a dollar from wages to superannuation at different income levels, and an example of an alternative – where everyone gets the same tax advantage out of a dollar when that dollar is saved into super (at a flat rate of 15 cents in the dollar)[16].

Fair, innit?

Making the tax incentives for contributing into super the same for everyone also comes with a pretty big silver lining. As current incentives are weighted towards the better off, there is a tax saving from making super better – **a reform dividend of around $6 billion in 2016-17 alone[17]**.

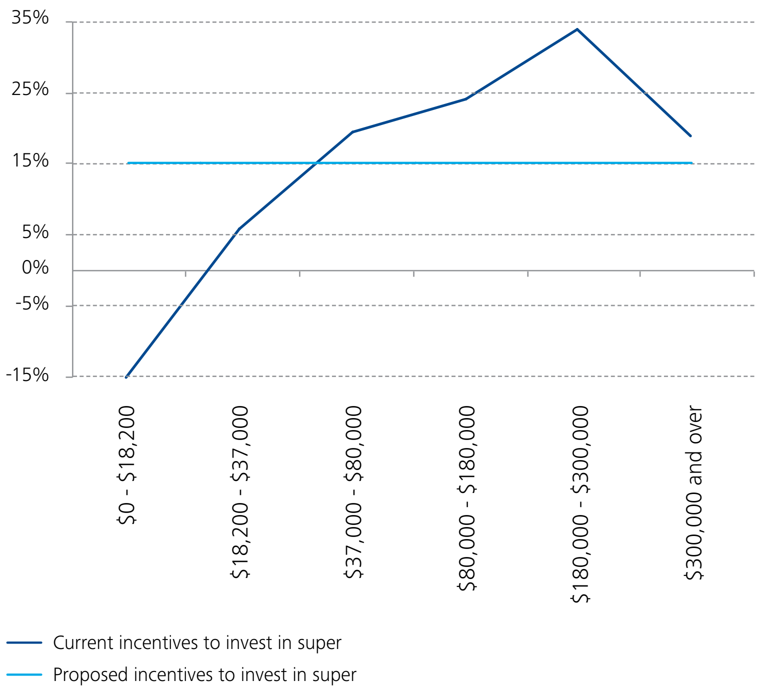
Even better, because this is a change to the taxation of contributions – when the money goes in – it avoids the need for any additional grandfathering. Nor does it add extra taxes to either earnings or benefits.

And there's more. Because the incentives are simpler and fairer, the current caps on concessional (before-tax) contributions can also be simpler and fairer too. They could be abolished completely for everyone under 50, and the cap could be raised for everyone else (subject only to a safety net of a lifetime cap).

So, yes, this is an example in which super taxation would change: and we all hate change. But it would put super on a simpler, fairer and more sustainable basis.

And, in part depending on how the super savings are used, the resultant package could appropriately help Australians to work, invest and save.

Chart 3: Tax benefit (loss) of diverting a dollar from wages to super



Source: Deloitte Access Economics

That saving of taxpayers' money could in turn be used for other possible purposes – it could:

- Help to finance the reduction or removal of Australia's most damaging taxes (such as State stamp duties and insurance taxes or company tax), and hence lift our living standards. **For example, this reform alone would pay for shifting the company tax rate down to 26% from the current 30%**
- Take some of the pressure off State spending, adding to 'the social wage' via a stronger health system, or via funding social infrastructure investments such as schools
- Help to fix a yawning Budget deficit, and make a future government more prepared to use the Budget to cushion unemployment impacts during recessions.

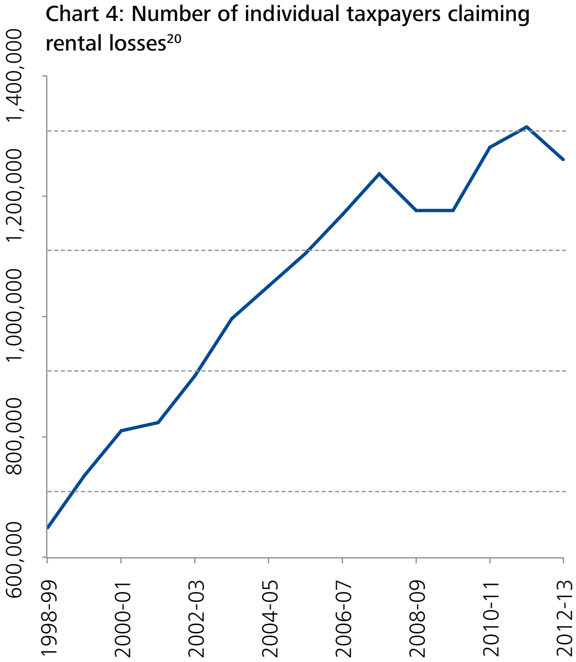
16. And yes, in case you were wondering – that means low income earners contributing to super will get a rebate, making this a truly level playing field.
17. The example here has everyone benefiting by 15 cents for each dollar contributed. The Henry Review considered a 20 cent incentive, but was devised at a time when the Budget was expected to return to better health. The calculated saving is around $6 billion in 2016-17, but there would be some leakage to the 'next best' tax option. Note the proportional difference in the 'revenue forgone' and 'revenue gain' estimates at page 124 of the 2014 Tax Expenditures Statement is just over 5% (see http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/Tax%20Expenditures%20Statement%202014/Downloads/PDF/TES_2014.ashx).

Negative gearing - cause or symptom?

"A property is said to be negatively geared when the mortgage interest repayments exceed the net income from the property ... The taxpayer can apply this 'loss' against their other income, such as salary and wages."[18]

Negative gearing is available for use with a range of assets such as shares as well as property, and it applies not only to individuals but also to companies and other taxpayers. Yet while deducting interest costs is common for businesses, its popularity among Mum and Dad housing investors dominates dinner table discussions. As Chart 4 below shows, the number of taxpayers claiming rental losses has risen over time, while new housing loans to investors now exceed those to owner-occupiers[19].

Chart 4: Number of individual taxpayers claiming rental losses[20]



Source: Australian Taxation Office, Taxation Statistics

Do we have a problem? Many people think we do.

Myth 3: Negative gearing is an evil tax loophole that should be closed.

You can understand that myth. Negative gearing is seen as a loophole, with the rich making out like bandits from it. Yet the ability to deduct expenses incurred in earning revenue is an accepted principle of our tax system – and most other tax systems too. It's the same principle that lets a chef deduct the cost of their uniform against their wages. In the same way, it allows an investor to deduct the cost of borrowing to earn the rent from an investment property.

So it isn't evil. And it isn't a loophole in the tax system. It is standard practice to allow taxpayers to claim a deduction for a real economic loss that they incur to earn their income.

Yes, negative gearing is being over-used at the moment, but that's due to

1. Record low interest rates and easy access to credit
2. Heated property markets, and
3. Problems in taxing Australia's capital gains.

Or, in other words, **negative gearing is a symptom of other things, rather than a cause of problems in its own right.**

Hang on though, isn't negative gearing used by the rich?

Yep, the rich use negative gearing a lot. But that's because they own lots of assets, and gearing is a cost related to owning assets: there's no smoking gun there.

Let's be clear. 'Evil' is not about whether it is middle income earners, high income earners, doctors, wharfies or werewolves who use this concession. Focussing on that is a distraction. It certainly isn't the right basis for deciding what is and isn't good policy.

It doesn't matter if it's high or low income earners who use negative gearing deductions. Our tax system addresses fairness by taxing higher income earners at significantly higher rates. If fairness were to be addressed via deductions as well (such as by limiting negative gearing), that would be (1) a double up of punishment that is (2) inconsistent with the treatment of almost every other deduction we allow all taxpayers to claim.

So negative gearing doesn't have a detrimental impact on the effectiveness of the tax system. But does it adversely affect the community some other way? Surely negative gearing is guilty of something – anything?

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18. Re:think Tax Discussion Paper, Australian Treasury, March 2015, at page 64.
19. Australian Bureau of Statistics, Housing Finance, catalogue 5609.0.
20. This chart picks up taxpayers with overall losses on their investment properties. That is a larger group than those negatively geared, but with reasonable overlap.

That brings us to...

Myth 4: Negative gearing drives property prices through the roof, but ditching it would send rents soaring.

Hmm. Pick one of those two – if something sends housing prices up, then it would eventually send rents up too[21]. After all, rents are a key part of the return on investing in housing, in the same way that dividends are for investing in shares. So, over time, higher housing prices would mean higher rents.

Let's take the house pricing point first. In brief:

- Negative gearing has been a feature of Australia's tax system during periods of both strong and weak house price growth
- Interest rates have a far larger impact on house prices than taxes do. Housing prices are through the roof mostly because mortgage rates have never been lower
- Among tax factors, it is the favourable treatment of capital gains that is the key culprit – not negative gearing.

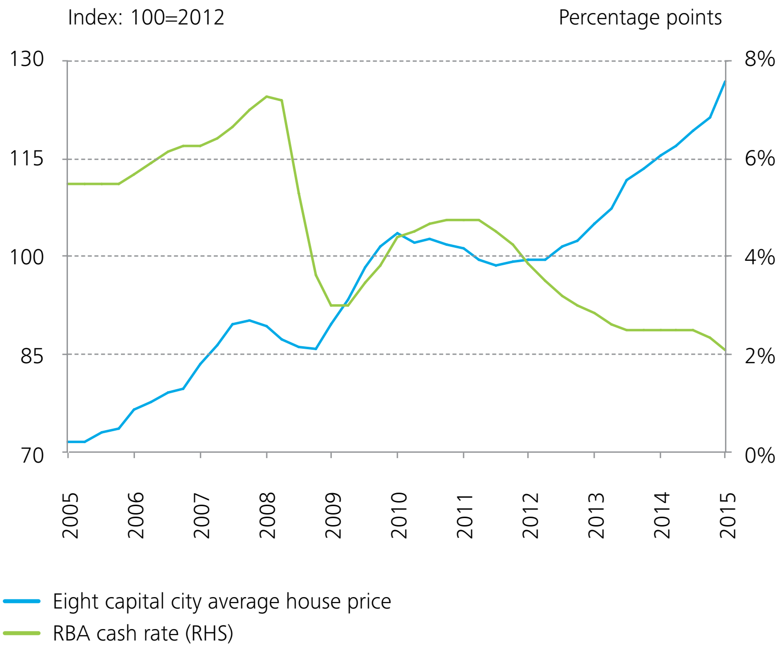
Why are interest rates the key to housing prices? Because the fundamental value of any asset equals (1) future earnings (2) discounted to today. Put simply, asset values should go up when expected earnings go up or when discount rates go down.

And it is not the first part of that valuation equation which has changed substantially over the years. Rather, it is the second, with mortgage rates at record lows.

That means houses are now worth more, which pushes up the amount that investors and owner occupiers are willing to pay. Lower mortgage interest rates mean that households can afford to service a larger loan, eventually leading to higher prices[22].

While interest rates are not the only factor in play, Chart 5 shows the strong reverse correlation between interest rates and house price growth – when one goes down, the other goes up, and vice versa.

Chart 5: Australian house prices versus interest rates



Source: Australian Bureau of Statistics

That's not to say that negative gearing has had no impact on housing prices. Other things equal, negative gearing cuts the cost of capital to investors, and markets load that into housing prices (and, for that matter, they factor it into most asset prices in the Australian and world economies – remember that deducting interest costs is a pretty standard allowance in tax systems across the globe).

Yet that change in price due to the availability of negative gearing occurred yonks ago. So feel free to blame high housing prices on everything from El Nino to interest rates. But if you are blaming negative gearing, it may be time to re-read the above.

21. Rental yields in Australia are below those in most other nations (and, within Australia, there's a wedge between rental and dividend yields). Yet those gaps are unlikely to be permanently large, as capital gains in Australian housing would have to be permanently higher than elsewhere for our rental yields to be permanently lower than elsewhere. Over time, the likely outcome is that rental yields rise from their current lows.

22. This 'wealth effect' is one of the main ways in which interest rates cuts by the Reserve Bank boost the economy.

Does negative gearing lead to either higher or lower rental costs?

And while negative gearing isn't evil, nor would ditching it have a big impact on rents over the longer term. Tax settings can only change housing rents if they sustainably change the supply or demand for homes. And, as long as investors are making their properties available for rent, then there will be little overall change in the number of homes available to live in (supply)[23] or the number of people looking for a place to live (demand).

The only change is the share of individuals who own their own home, but that doesn't need to make rent any more or less expensive – because it doesn't fundamentally shift demand or supply.

So we can't say that we are surprised that rents didn't accelerate across the board when negative gearing was temporarily dumped in the 1980s – some cities saw moderating rental growth, while those that saw large increases in rents (Sydney and Perth) were responding to other things, including low vacancy rates.[24]

It isn't who owns homes that determines the cost of renting them. It is the number of homes available for both owners and renters to live in, versus the number of households needing accommodation.

CGT as a factor

At this point you might be asking yourself an obvious question: why would losing money on something be a good investment? A loss is still a loss, isn't it? What's the upside in that?

That's where the discount on capital gains comes in:

- Among tax factors, it is the favourable treatment of capital gains that is the main culprit[25]
- Appendix 3 sets out an example. In brief, because capital gains are taxed at half the rate that income is taxed, investors who make a loss can still be better off on an after-tax basis if their after-tax capital gain exceeds their after-tax income loss.

So for those who think that housing prices in Australia are still good value – and so have the potential to generate further good capital gains – negative gearing makes sense.

(And we have a bridge in London that we'd love to sell to you too.)

Other factors have more impact on housing prices and rents than negative gearing

The above has looked at things other than negative gearing which affect housing prices (and rents), including interest rates and taxation of capital gains. But there are a number of other factors which also affect the supply and demand of housing, and hence housing prices and rents. The Henry Review[26] noted "*Higher house prices are likely to result from restrictions on the supply of housing that result from zoning, lengthy approvals processes and building code and other standards imposed on building quality*".

So, negative gearing isn't the tax system pariah it is made out to be. And nor is it responsible for the large increases in house prices of late. Rather:

- It is the current mix of low interest rates, a lack of supply, and the overly generous tax treatment of capital gains which have led to the large increase in house prices and an associated burst in reliance on negative gearing
- Negative gearing (and, more widely, the ability to deduct expenses incurred in earning revenue) is an accepted principle of our tax system – and most other tax systems too.

Don't want to take our word for it? You may be surprised that Treasury has the same view. Its Tax Discussion Paper says that "*Negative gearing does not, in itself, cause a tax distortion … Contrary to popular perception, negative gearing is not a specific tax concession for taxpayers with investment properties — it is simply the operation of Australia's tax system allowing deductions for expenses incurred in producing assessable income. Expenses incurred in producing income from other types of investments are also generally deductible*."[27]

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23. In practice the tax benefit from negative gearing was long ago split between prices and quantities (the latter meaning construction of extra housing). The first factor (higher housing prices) will have tended to raise rents over time. The second factor (increased construction) will have tended to lower rents over time.
24. Were negative gearing to be abolished, then the short term impacts may be greater than the longer term impacts, as there would need to be a partial shift away from an existing business model that sees developers package up properties to be sold to investors who often negatively gear them.
25. That favourable treatment includes the exemption of a homeowner's main residence from CGT, as well as the CGT discount that is the focus of the discussion here.
26. Australia's Future Tax System, Report to the Treasurer, December 2009, Volume 2, at page 422.
27. Re:think Tax Discussion Paper, Australian Treasury, March 2015, at page 64.

Is the discount on capital gains too big?

Vatican watchers long ago figured out how to interpret the colour of the smoke billowing from the Sistine Chapel on the election of a new pope in Rome.

Treasury watchers cultivate the same skills. A moment ago we quoted Treasury's Tax Discussion Paper saying that "*Negative gearing does not, in itself, cause a tax distortion.*" The phrase "*in itself*" is a pointed one. Treasury goes on to note that making use of negative gearing by borrowing for property investment "*is encouraged by the CGT discount, as larger investments can result in greater capital gains and therefore benefit more from the CGT discount*[28]*.*"

Cue drumroll. Treasury spies a villain, and so do we.

It's no surprise that taxing capital gains is fraught. If you don't tax capital gains at all, then there would be a huge incentive for people to:

- Speculate rather than work (speculative gains wouldn't be taxed, whereas wages are), and
- Artificially turn income (which is fully taxed) into capital gains (which wouldn't be taxed).

Now consider the other extreme – what if capital gains were taxed just like ordinary income?

- Our discussion of super earlier made the point that the tax system tends to be biased against saving, and that would be a problem here too – you can only make capital gains on an asset if you've saved up to buy it in the first place
- Worse still, the tax system would assume that the gap between the price you bought at and the price you sold at should all be subject to income tax, forgetting that a chunk of that 'gain' would actually be due to inflation, rather than a genuine profit.

So the taxation of capital gains in Australia has attempted to steer a middle path between taxing too much and taxing too little. The original capital gains tax (CGT) regime adopted in 1985 allowed for inflation effects to be netted out of taxable gains, while the current system – largely still that adopted after the 1999 Ralph Review – switched instead to simply discounting the tax rates applied to capital gains. As shown in Table 1:

- Individual taxpayers pay taxation on capital gains at half their marginal personal income tax rate
- Super funds pay taxation on capital gains at two-thirds their income tax rate
- Companies get no discount on their capital gains.

Table 1: CGT discount rates by type of taxpayer

Entity	Discount	Entity tax rate	Effective tax rate on capital gain
Complying superannuation fund	33 1/3%	15%	10%
Company	0%	30%	30%
Individual – at top marginal rate	50%	47% (MTR)[29]	23.5%
Individual – between $37k-$80K	50%	32.5% (MTR)	16.25%
Individual – between $18.2K – $37K	50%	19% (MTR)	9.5%

28. Re:think Tax Discussion Paper, Australian Treasury, March 2015, at page 64.
29. Marginal tax rate on excess. Includes Temporary Budget Repair Levy.

All of which brings us to our final myth.

Myth 5: The discount on capital gains is an appropriate reward to savers.

Err, no.

The basic idea is very much right. There should be more generous treatment of capital gains than of ordinary income, because that helps to encourage savings (and hence the prosperity of Australia and Australians), and because the greater time elapsed between earning income and earning a capital gain means it is important to allow for inflation in the meantime.

But we've got the detail wrong:

- Table 1 shows there are really big incentives for some taxpayers (such as high income earners) to earn capital gains, versus little incentive for others (such as companies)
- The discounts Australia adopted back in 1999 assumed inflation would be higher than it has been – and so they've been too generous.

By the way, 'overdoing it' on the CGT discount doesn't just come at a cost to taxpayers. It hurts the economy too. As the discount does not target particular sectors or types of assets, it provides stimulus to invest in both productive and unproductive assets. That's part of the reason why Chart 6 shows an enormous leap in investor activity in housing markets since the discount was introduced.

It is also part of the reason why Chart 7 shows that those who earn more than $180,000 a year account for a much bigger share of net capital gains (53% of the capital gains earned by all individual taxpayers) than they do of:

- The overall share of personal tax that they pay (at 28% of the total net tax)
- Their share of taxable income (at 16%)
- Their share of interest deductions against rent (at 12%)
- Or their share of the number of taxpayers (at 3%).

As the discount does not target particular sectors or types of assets, it provides stimulus to invest in both productive and unproductive assets.

Chart 6: Investor activity in housing markets

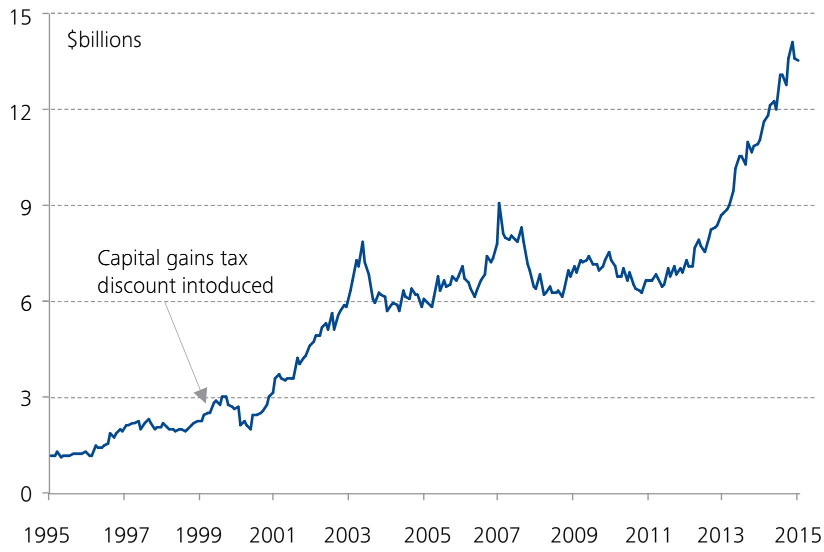
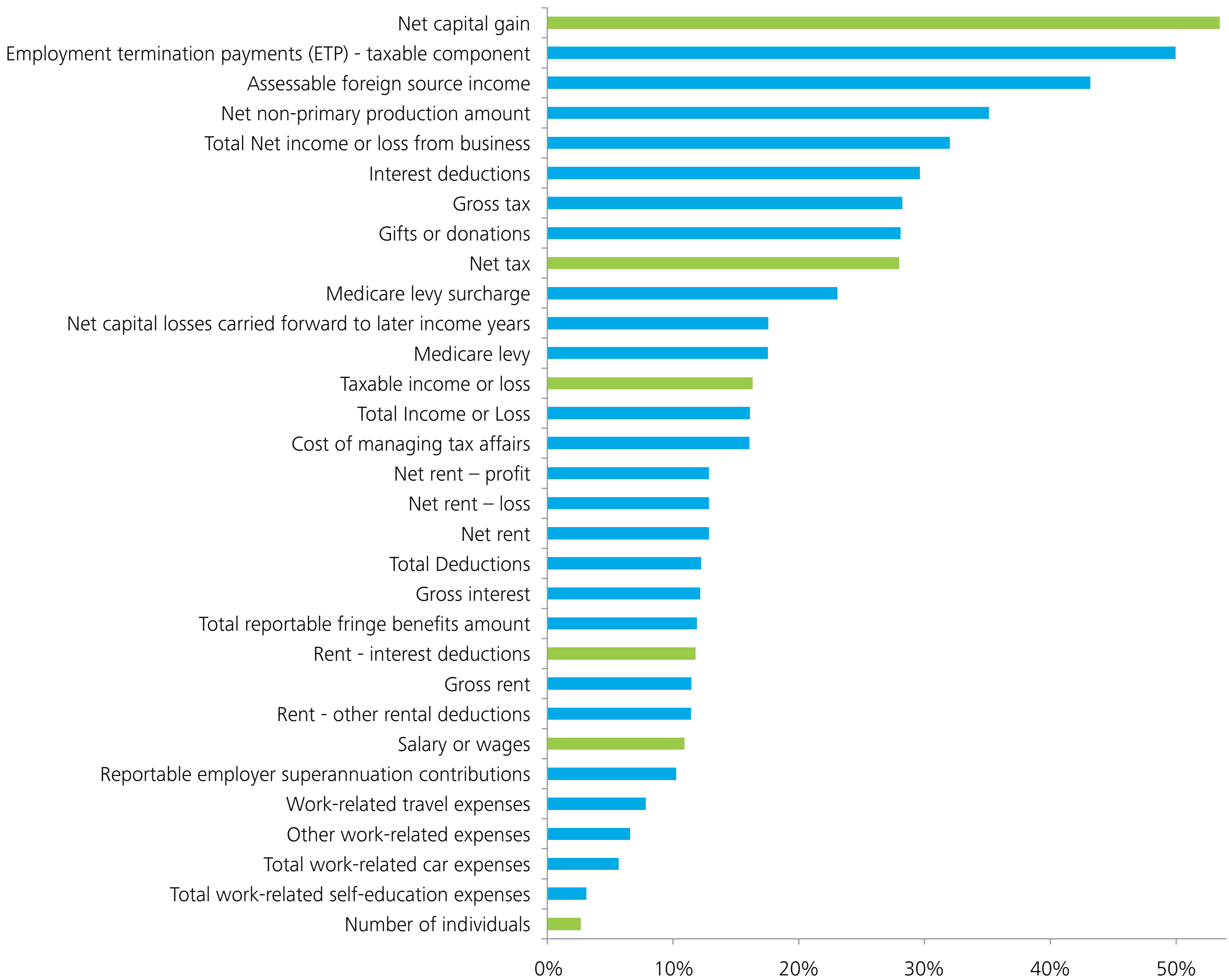


Chart 7: Share of dollars (those earning over $180,000 as % of total)



Source: Australian Taxation Office, Taxation Statistics 2012-13

In particular, that contrast between shares of interest deducted against rent (at 12%) versus net capital gains (at 53%) is indirect evidence of the policy culprit here: it suggests the blame lies more with the favourable treatment of capital gains than it does with negative gearing.

So, what should we do about that?

Options for reform

Possible CGT reforms range from small to big. They include:

- **Freeing up the small fry:** Australian Taxation Office data shows that one in every eight capital gains is less than $10,000 and this income represents a tiny portion (0.2%) of the overall dollars claimed as capital gains
- **Simplifying by letting go of the past:** Because taxation of capital gains came in during the 1980s, there are grandfathering provisions for some 'pre-September 1985 assets'. One way to cut complexity would be to remove the exemption for some pre-1985 assets. To help ensure that simplification didn't then mess with fairness, the cost base for those old assets could be reset at current market value (or within a range of dates if the market value is volatile)
- **Slowing things up:** At present a capital gain on an asset sold within 12 months is not eligible for the CGT discount. One way to wind back the over-reliance of Australians on earning capital gains is simply to shift that dividing line from 12 to 24 months (or longer)
- **Revisiting the untouchables:** There are other alternatives too, including revisiting specific provisions that limit some of the existing generosity of capital gains treatment for housing and for small businesses.

All of the above are worth considering. And yes, the above list skates over a bunch of detail. For example, a skeleton in the closet of the CGT system is carried forward capital losses. The ATO lists[30] carried forward losses as at 2012-13 as $8 billion for individuals, $35 billion for companies, and $33 billion for super funds. Any reform which led to these losses being rapidly utilised might be expensive, even if those reforms were otherwise worthwhile.

Or, in other words, there's plenty of devil in the detail.

But the focus of this report is on the big picture, so we concentrate here on the two main alternatives for CGT reform in Australia – either we go back to some form of indexing for inflation, or we cut back on the generosity of the existing tax discount.

Back to the future – indexation versus discount

These are just two different ways of doing the same thing. The advantage of indexation is that it rewards 'patient capital'. But indexation can exacerbate a 'lock in' effect, restricting the movement of capital at a time when the wider tax reform debate wants to encourage capital to move.

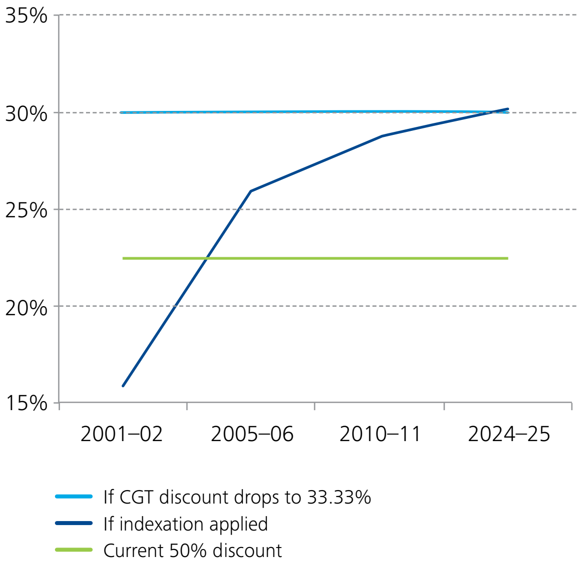
The discount approach avoids the latter risk, but whether it meets its twin goals (of providing some reward for saving, and of adjusting for inflation) partly depends on:

- How long the asset is held – the CGT discount may do either too little (if the asset has been held for a long time) or too much (if the asset has been held for a short time)
- How high inflation is – the discount may either be too little (if inflation is high) or too much (if inflation is low).

30. Australian Taxation Office, Taxation Statistics 2012-13

History can shed a little light. Assume an asset was bought at 30 June 2000 and that its value has grown in line with national income.

Chart 8: Tax paid as a share of capital gains



Source: Deloitte Access Economics

Chart 8 maps out estimates of tax paid under three alternatives – the current system, a return to an indexation regime, or moving to a smaller CGT discount:

- The current 50% discount is generous relative to the indexation option – inflation has been low, whereas capital gains have been great, so you would have to have held an asset for some years before the effective tax rates under these two alternatives equalised
- The discount could be cut to, say, 33.33%[31]. This would 'add back' some of the incentive for long term rather than short term saving that low inflation has eroded. It would also help tackle the difference in tax rates applied to income and capital gains from different sources. For example, income earned from bank deposits is taxed at a person's full marginal rate, while income earned from capital gains is taxed at half the person's marginal rate.

Our conclusion? The current CGT discount is too generous, to the extent that it undermines the very principles of this nation's progressive personal income tax system. It's time for a change. Reform of the concession is long overdue.

Myth 5 is busted, and Australia should consider options such as a lower discount applied across a broader base. That would still compensate for the double taxation of savings, while also reducing the distortion in investment decisions that the tax system currently creates.

Cutting the discount rate would also remove some of the unfairness in the current CGT regime, while still providing a benefit to those who save for the long term. Finally, it also maintains the relative simplicity of the discount compared to the previous indexation approach.

Let's finish where we began

Both our initial Mythbusters report and this one come to the same simple conclusion: that a better tax system could be a big contributor to building the Lucky Country, but a bunch of myths and misconceptions are getting in the way of that.

Australia is in need of a circuit-breaker – and we'd like to think that some of the suggestions in here could provide one.

31. The Henry Review recommended cutting the discount on capital gains from 50% to 40% as part of an overall reset of the taxation of savings. As noted with respect to superannuation reforms, the Henry Review recommendation came at a time when the Budget was expected to be healthier than it has been.

Appendix 1: Superannuation – what incentives or concessions are we talking about?

Superannuation is often called the 'best game in town'. But what exactly is its tax treatment?

- Income earned in super funds is taxed at 15%: great if you are otherwise going to invest in your own name outside of superannuation and on a high tax bracket, but not so great if you are earning under the tax free threshold at a zero tax rate
- Superannuation fund assets that support a retirement income stream for those aged 60 or more are tax exempt
- Superannuation Guarantee contributions (SG) are currently 9.5%. They must be paid by employers on salaries up to $203,240. That cost is deductible by the employer, and taxed as income in the fund at 15%. SG is compulsory, so it isn't a choice by taxpayers. But when compared against receiving as salary, it is great if you are a mid- or high income earner, but not so good if you are paying tax at low rates
- Most employers allow employees to 'salary-sacrifice' contributions to a super fund. These employees can make additional super contributions up to a limit of $30,000 (if under 50) or $35,000 (if 50 or over) less the amount already contributed via the SG. This is taxed as income in the fund at 15%. As a choice by taxpayers, salary sacrifice is limited due to the SG whatever your income. The maximum that could be salary sacrificed (assuming the taxpayer is 50 or over) would be:
- Taxpayers with an adjusted taxable income of more than $300,000 also pay an additional 15% of contributions tax on all their SG and salary sacrifice contributions (see above)
- Taxpayers may also make after-tax contributions of up to $180,000 a year (or $540,000 every three years). This contribution is neither tax deductible to the taxpayer nor assessable in the fund. The advantage of doing this is the tax on earnings within super (at 15%) is usually less than that outside super. This, combined with earlier rules which were far more flexible as to the amount that could be contributed to super, is the main superannuation setting which allows for some fund balances to be very large.

Table A1: Maximum salary sacrifice amounts and tax saving for those aged over 50

Salary package	SG @ 9.5%	Maximum salary sacrifice (rounded)	Maximum tax saving[32]
$60,000	$2,386	$32,500	$4,531
$120,000	$8,085	$26,800	$5,874
$250,000	$19,307	$15,693	$5,336
$400,000	$19,307	$15,693	$2,982

32. Calculated at the marginal tax rate, plus Medicare levy, plus Budget deficit levy, less 15% contributions tax. Note 'salary package' includes super. The SG is payable on the package net of super.

Appendix 2: Should super tax be an income tax or a consumption tax?

Considering possible super tax reforms cuts to the heart of an old debate – whether we should tax super via an income tax or a consumption tax.

If superannuation is best seen as an income tax, then it should be taxed at the point the money is earned (usually the same time it is contributed to super funds), with the tax concessions operating both while the money is in the super fund and when it is withdrawn.

This 'income tax' approach to taxing super would suggest that all the taxes be upfront. It is known as a TEE system, with tax (T) applying to contributions, but both earnings and withdrawals being exempt from tax (E).

In contrast, an 'expenditure tax' approach to taxing super would suggest that all the taxes be when the money is withdrawn. That is called an EET system, with both contributions and earnings exempt from tax (E), and withdrawals being subject to tax (T).

Although the economists can get excited about which of these is better, the most important point is that our current system is a mishmash of both these two approaches (think of it as 'ttE', with taxes on contributions and earnings, and a number of policy proposals to once more subject withdrawals to tax as well).

To use the technical jargon, Australia's current approach to taxing super is neither an 'income tax' nor a 'consumption tax', but a 'confused tax'.

Appendix 3: An example of negative gearing and the discount on capital gains

Scenario 1: Emma is a doctor who earns $200,000 a year. Emma's salary puts her in the top marginal tax bracket. Excluding the Medicare Levy and Temporary Budget Repair Levy, that means she pays 45 cents for every dollar she earns above $180,000. This means that she pays $63,547 a year in tax or 31.8% of her income. Over two years she earns $400,000 and pays $127,094 in tax, leaving her with an after-tax income of $272,906.

Scenario 2: Emma buys an apartment for $350,000 as an investment. She borrows $280,000. Emma earns $17,500 a year from renting out the apartment, but it costs her $25,200 a year in interest. That leaves Emma with a $7,700 loss each year. She writes this loss off against her employment income, which reduces it to $192,300. This cuts her tax to $60,082, giving her an average tax rate of 31.2%.

The apartment's value has grown by 2% a year for two years, to reach $364,140. Emma sells the apartment, leaving her with a capital gain of $14,140. Emma again earns $200,000 from her work as a doctor. In that second year, Emma earns $206,440 in total. Due to the CGT discount, her taxable income is a reduced $199,370 (her salary, plus half the capital gain, less the investment loss from that year). Therefore she pays $63,264 in tax, leaving her with an after-tax income of $143,177.

Over the two years, Emma earns $398,740, which is less than the $400,000 she earns in the first scenario. However, because of the discounted taxation of capital gains, she only pays $123,346 in tax. This gives her a total after-tax income of $275,394, which is $2,488 higher than in the first scenario (Table A2).

So even when housing prices are only increasing modestly – in this case, 2% a year – there are tax advantages in borrowing to earn that modest capital gain, because the CGT discount is generous enough to make that a strategy that pays off.

Table A2: Income with or without a negatively geared housing investment, 50% CGT discount

	Pre-tax income	Taxable Income	Tax paid	After-tax income	Average tax rate on Pre-tax income
No Apartment	$400,000	$400,000	$127,094	$272,906	30.9%
Apartment	$398,740	$391,670	$123,346	$275,394	30.9%
Difference	-$1,260	-$8,330	-$3,748	$2,488	-0.9%

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