

Budget Repair

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I

Fiscal challenges for Australia

Overview

Grattan Institute's 2013 report, *Balancing budgets: Tough choices we need*, concluded that without structural reforms Australian Governments could face a decade of deficits. Subsequent events suggest this may have been optimistic.

The Commonwealth Government has run deficits for six years, largely due to a rapid increase in net spending on older households. The costs of repaying these deficits will fall primarily on younger households.

The next ten years are likely to be even more difficult. Falling terms of trade and lower nominal economic growth will drag on revenues at the same time the Commonwealth Government intends to fund substantial new policy initiatives.

The Commonwealth Government is yet to respond to the scale of its budget challenges. In office, both major political parties have hoped that bracket creep and favourable economic conditions would deliver a surplus. Hope is the key word: over the last six years, outcomes have consistently been worse than these projections. The latest short- and medium-term projections rely on optimistic assumptions about organic revenue growth and spending restraint. If any of them fail to materialise, the burden on younger generations will increase.

The biggest worry is that budget projections assume that growth will return to "trend". The International Monetary Fund recently joined a growing group of economists who believe that long-run economic

growth in developed countries was trending lower even before the financial crisis, and future expectations should be lower again.

State budgets are also under pressure. Spending in health and education and other vital areas is growing faster than GDP. States' revenues are threatened because the Commonwealth has alleviated some of its own budget pressures by substantially reducing promised transfers to state governments for hospitals and schools. Recent state government budgets provide no insight into how they will respond to the looming funding gap.

Hoping for the best is not a budget management strategy: it simply shifts the costs and risk of budget repair onto future generations. More active policy measures to achieve budget repair are required. While containing spending will be important, both the politics of budget repair and the sheer size of the budget gap mean that governments will not be able to restore budgets to balance without also boosting revenues.

In a series of papers over the next two months, the Grattan Institute will set out four priority reforms for repairing Commonwealth and state government revenues. Our proposed policies – reducing superannuation tax concessions, changing capital gains tax and negative gearing, broadening the GST, and introducing a broad-based property levy – would all materially increase government revenue with limited collateral damage to the economy and the most vulnerable in our society.

These changes are politically difficult, particularly as governments do not have the money to “buy” reform. But if they are serious about tackling the looming budget gap governments will need to tackle some of them. Sustainable budgets depend on tough choices, not hope. Making these choices will be vital so that future generations do not have to foot the bill for today's inaction.

1

Why do deficits matter?

If current policy settings persist, both Commonwealth and state governments are likely to post significant deficits for many years.

Deficits force future generations to pay for the spending of current generations. Our report for Grattan in 2014, *The wealth of generations*, showed that each \$40 billion deficit would increase the lifetime tax burden for households headed by a person aged 25 to 34 today by \$10,000.¹ So the deficits run by the Commonwealth over the last five years represent a future tax burden of \$50,000 for an average young household. More years of deficits by Commonwealth and state governments will magnify this burden.

Deficits can be justified if they fund productive spending that will increase future economic growth. Yet recent deficits have largely funded growth in net spending on older households, particularly through health services, welfare payments and tax cuts for retirees.² While much of this increased spending is valuable, it is unfair to ask future generations to pay for it.

Addressing the structural concerns with the budget sooner rather than later is important for the future welfare of today's young Australians. But as the median voting age nudges 50,³ there is likely to be strong resistance to policies that reduce entitlements for older Australians. Yet older Australians undoubtedly care about the welfare of the next generation. Older voters may be persuaded that change is necessary if the dividend for younger Australians is clear.

There are also good economic reasons to repair the budget position. Governments can use deficit funding to smooth economic activity over the business cycle, as the Rudd Government did in 2009. Yet this requires governments to deliver surpluses when growth has recovered. Sustained budget deficits incur interest payments and limit future borrowings, reducing the capacity of governments to respond to adverse economic shocks. The Australian economy is particularly exposed because, with interest rates at historical lows, the Reserve Bank can do little more to stimulate the economy, and so the Commonwealth budget will be the primary defence in an economic downturn.

Both main parties espouse a medium-term fiscal objective of a balanced budget over the economic cycle. But ten years is a long cycle. There are real concerns that the can is being continually kicked down the road, justified by the claim that in the absence of perfect economic conditions, it is “not yet” the time for fiscal repair.

2

A decade of Commonwealth deficits

In five of the last six years, the Commonwealth Government has posted headline deficits of more than 2 per cent of GDP. Assuming revenue and spending projections are correct, Australia is on track for more than a decade of deficits between 2008 and 2019, with Commonwealth net debt projected to peak at 18 per cent of GDP in 2017,⁴ higher than any year since the mid-1990s.⁵

These deficits may have helped to maintain economic activity and minimise unemployment while economic growth was relatively slow. However, structural deficits are less defensible.

Budget balances will always follow a cycle – surpluses tend to occur when economic growth is strong, boosting tax receipts and reducing welfare spending. High prices for our exports relative to our imports – the terms of trade – can also boost tax receipts and make a favourable budget position more likely. The structural budget balance is the underlying budget balance after allowing for these fluctuations in the business cycle and the terms of trade.⁶

As well as a headline deficit, the Commonwealth Government also had a *structural* budget deficit of more than 2 per cent of GDP for the past five years (Figure 1 on the following page). The drag of slower global economic conditions was generally outweighed by the temporary boost to revenues from the mining boom.

Both higher spending and lower revenue caused these headline and structural deficits. Commonwealth revenues fell sharply during the

Figure 1: The Commonwealth Government budget will deliver a decade of deficits

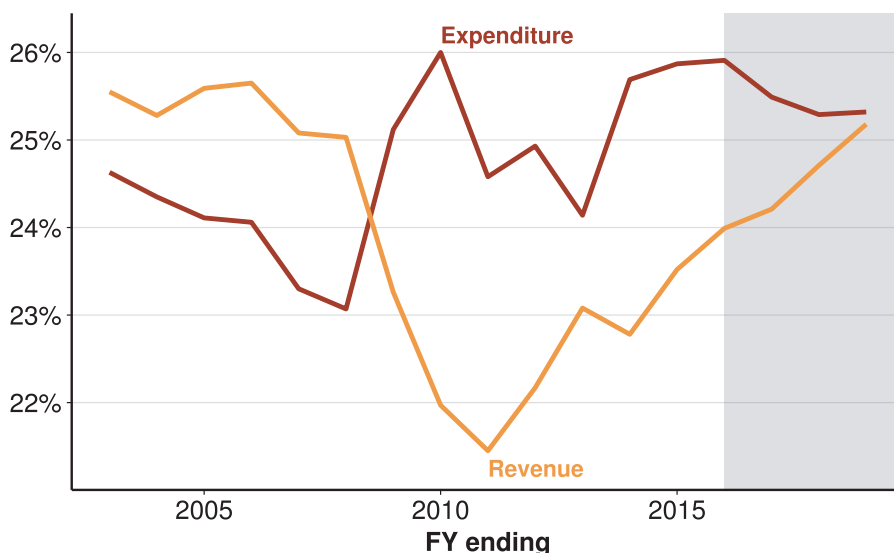
Per cent of nominal GDP



Fiscal-challenges/figure/b5-Figure1-1.pdf

Source: Minifie et al. (2013); Grattan analysis.

Figure 2: Commonwealth revenues fell while expenditures remained high
Commonwealth revenue and expenditure as percentage of nominal GDP



Notes: See page 393.

Source: Treasury (2015a); Grattan analysis.

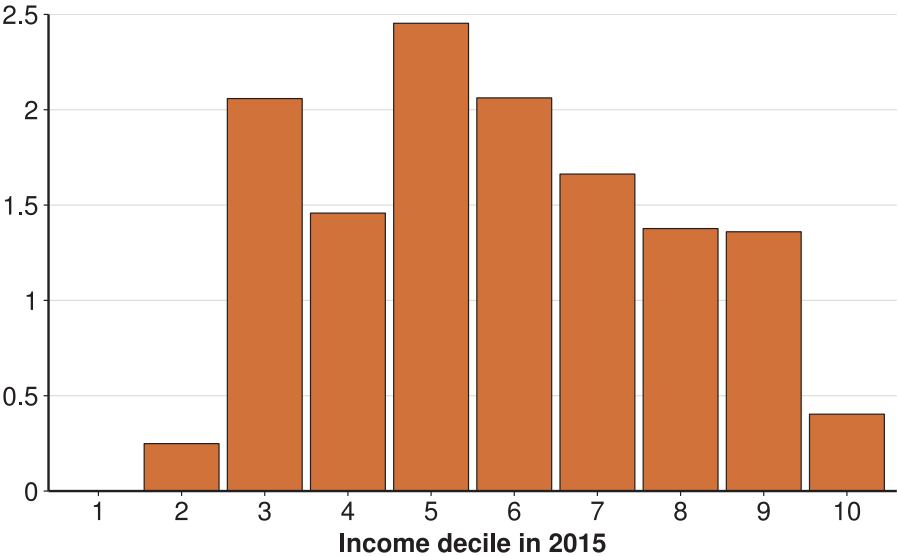
GFC but steadily rose after 2010-11 (Figure 2). Yet policy changes did not cause this rise. The Abbott Government's Temporary Budget Repair Levy boosted revenues by about \$1 billion a year over three years, and reindexing the fuel excise in line with inflation will raise \$1 billion in 2017-18. But at the same time, the Government cut off revenue streams by abolishing the carbon and mining taxes. These were forecast to raise \$2.9 billion and \$1.1 billion respectively in 2014-15.⁷

Instead, most of the revenue increase over the last four years, and the increase projected over the next four years, results from existing taxes growing faster than GDP. Fiscal drag – growth in income tax collections as a share of wages – accounts for most of the planned improvement in the budget position (Figure 4 on page 20).

When fiscal drag is not returned through periodic personal income tax cuts then average tax rates for most taxpayers increase. Growth

Figure 3: Bracket creep will increase average tax rates most for middle income earners

Percentage point increase in average tax rates 2015 to 2019



Source: Treasury (2015a) and ATO (2015i).

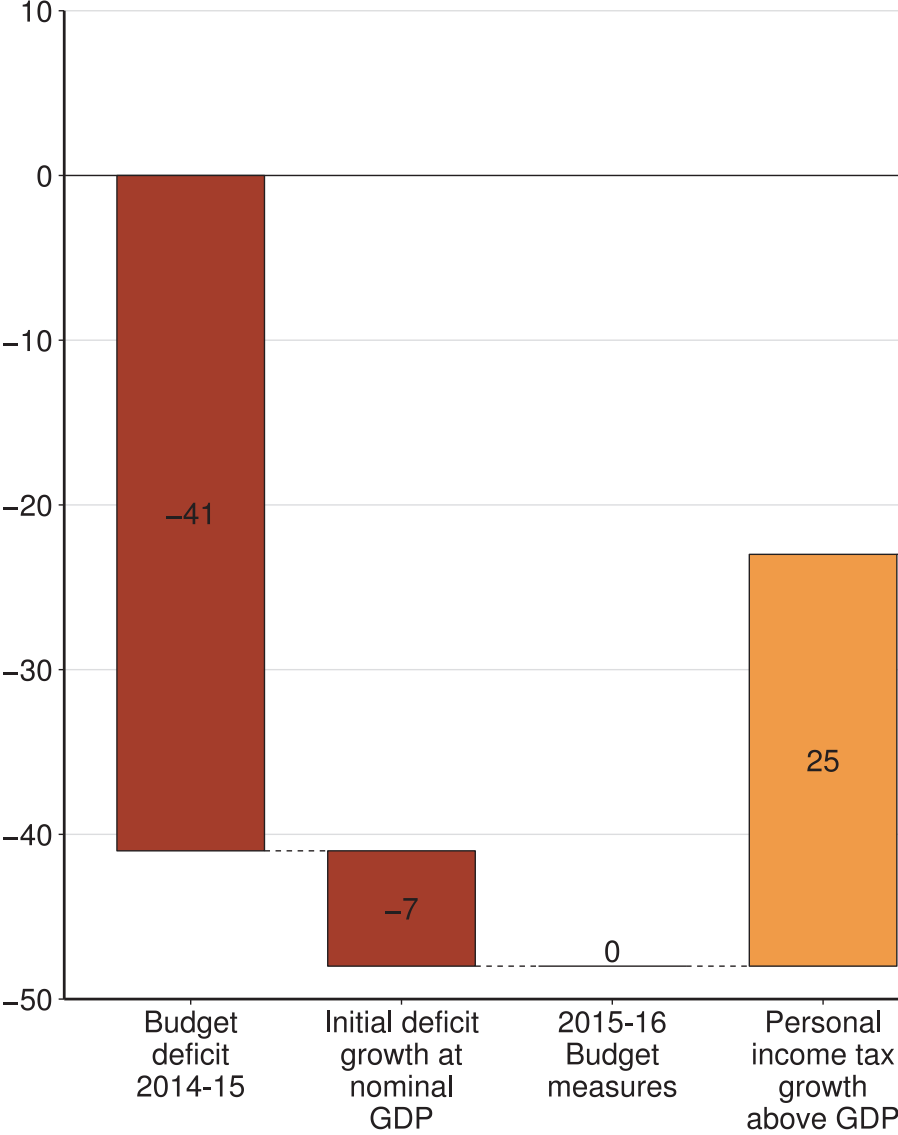
in nominal wages results in taxpayers paying their top marginal tax rate on a great proportion of their income. This is exacerbated for taxpayers pushed into higher tax brackets. Middle-income earners are particularly hurt. Figure 3 shows that on the wages growth projected in the 2015-16 budget, the average tax rates for people in middle-income groups will increase by between 1.5 and 2.5 percentage points. For example, a person in the sixth income decile, earning \$50,000 a year, will go from paying an average tax rate of 17.1 per cent in 2015 to 19.1 per cent in 2019. Such higher marginal tax rates can significantly affect incentives to participate in the workforce, particularly for women with children in childcare.⁸

On the **spending** side, the Commonwealth's stimulus package increased spending during the GFC. That was meant to be a one-off boost to the economy, yet since then spending has been maintained at these

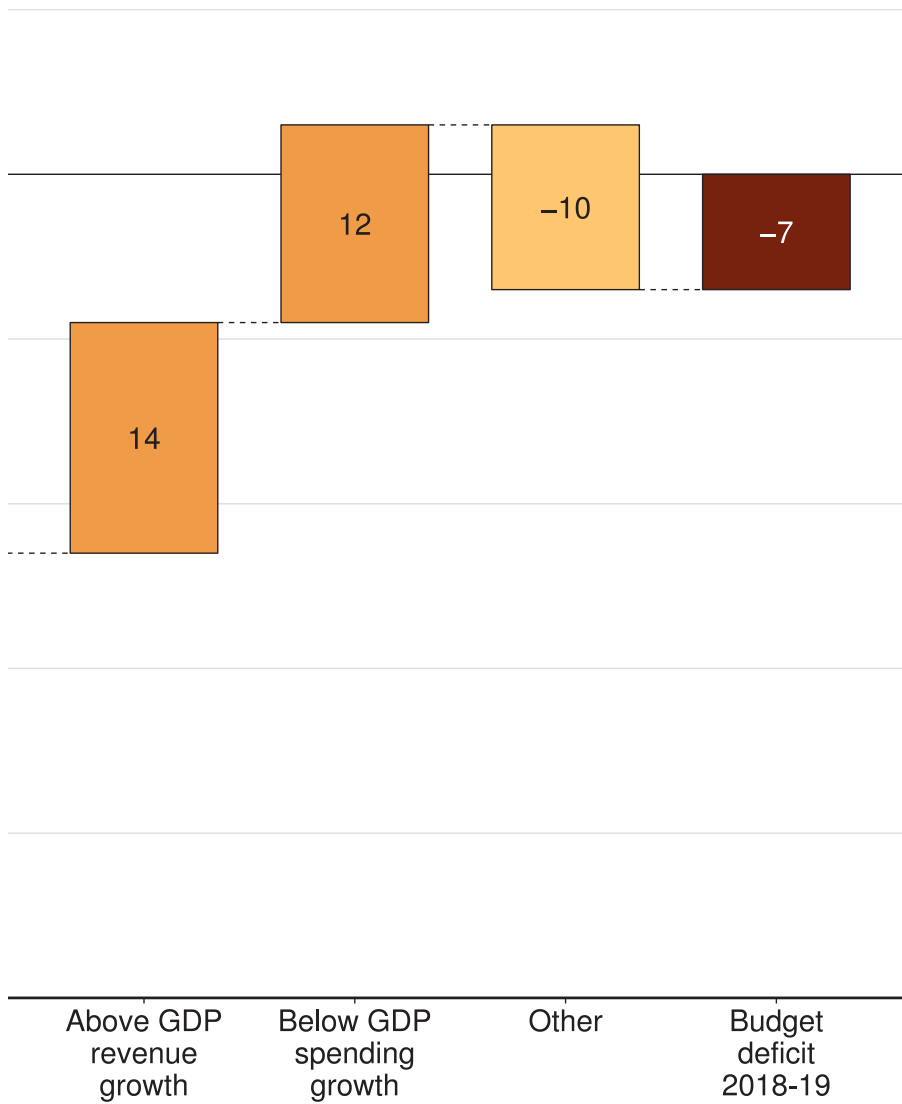
higher levels. Social security and welfare spending contributed about a third of the growth in spending over the decade. Growing Age Pension payments are the biggest contributor, but health, education and general public services, all of which grew faster than GDP,⁹ also increased significantly.

In contrast, over the next four years outlays are forecast to grow slower than GDP. But explicit policy measures only explain some of this slower spending growth. Spending measures introduced in the Government's 2014-15 Budget were projected to save \$14.2 billion in 2017-18.¹⁰ Of these, \$5.9 billion have been passed, \$5.8 billion are stalled in the Senate (but are included in the budget projections)¹¹ and a further \$2.5 billion have been abandoned.¹² The Government has booked another \$2.3 billion in savings in the 2015-16 Budget. If all the measures passed, they would only restrain spending growth by about 0.8 per cent a year. Even on these forecasts, spending will remain a larger share of the economy than at any point between 2003 and 2008 (Figure 2).

Figure 4: Fiscal drag is doing most of budget repair work
Change in budget position from 2014-15 to 2018-19, \$ billions



Source: Treasury (2015a); Grattan analysis.



3

Future pressures on Commonwealth budgets

Commonwealth Government revenues will struggle over the next decade if the terms of trade continue to fall and if economic growth remains sluggish. At the same time, the budget will need to make room to fund significant new spending initiatives.

3.1 Slowing income growth and tax revenues

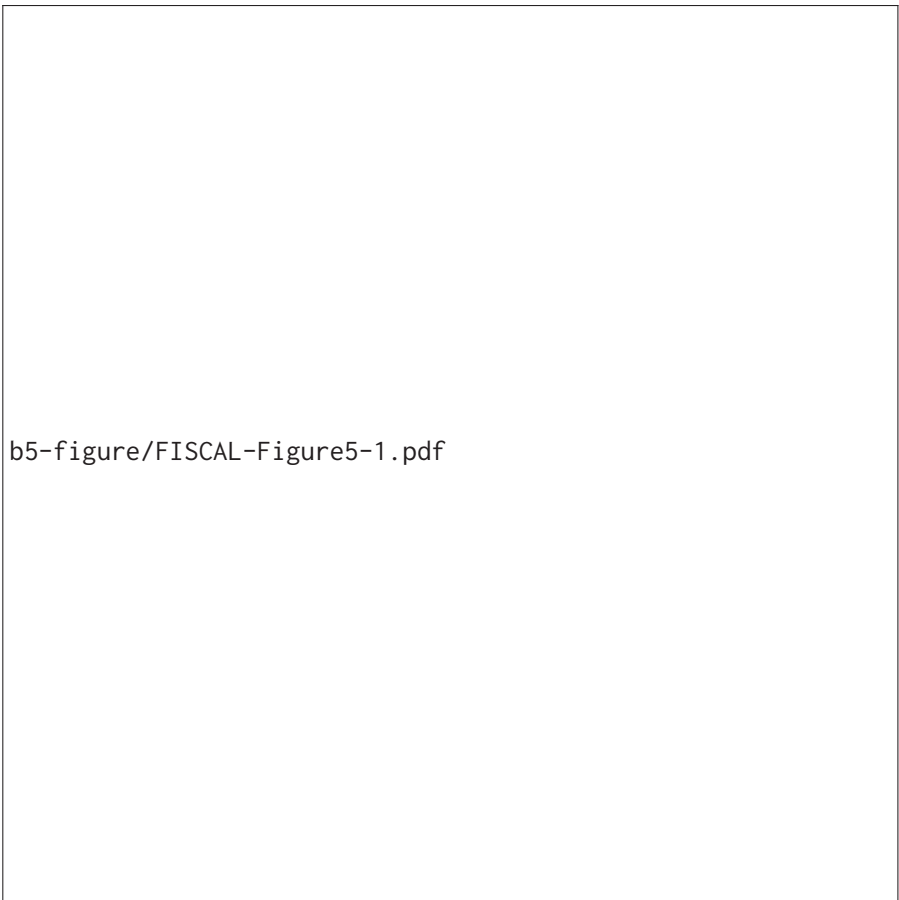
Australian government revenues are strongly linked to the performance of the economy and the terms of trade. When national incomes are growing strongly, personal and corporate income tax receipts increase. About two thirds of Commonwealth Government revenues come from these volatile direct taxes.¹³ The projected slower growth in Australian living standards over the next decade is therefore a problem for Commonwealth revenue.¹⁴

In the 2000s, record terms of trade led to incomes rising quickly.¹⁵ But falling terms of trade are expected to drag on future income growth. Minerals prices are falling as past mining investments increase supply.¹⁶ Australia's terms of trade are forecast to fall by 9 per cent next year, and then stabilise.¹⁷

Other projections suggest a longer and deeper fall in the terms of trade.¹⁸ The drag on per capita incomes will be material – about 0.5 percentage points over the next decade, when the terms of trade return to long-run levels (Figure 5 on the following page).

Figure 5: Terms of trade added to income growth in the 2000s, but will drag in the next decade

Average annual percentage point contribution to per capita GNI



b5-figure/FISCAL-Figure5-1.pdf

Notes: Assumes labour productivity for 2025-2055 is at historical average of 1.5%.

Source: Hockey (2015, p. 33)

Labour force participation over the next few decades will also stop boosting growth, instead dragging on growth as the baby boomer generation reaches retirement age. Treasury estimates that the labour force participation rate for people aged 15 years and over will fall from 64.6 per cent in 2014-15 to less than 62.4 per cent by 2054-55, as a smaller proportion of the population will be of traditional working age.

The annual impact is estimated to reduce national income growth by 0.1 percentage points, compared to the boost of 0.2 percentage points from rising participation over the past 40 years.¹⁹

Labour productivity may also fall. A decline in the number of mining construction employees will reduce average labour productivity because other industries generate much less value per hour worked.²⁰ This effect is likely to outweigh the 'productivity dividend' from past investments in the mining industry beginning production.²¹

Over the longer-term, technological change is the main driver of higher labour productivity. But some economists warn that technology will not improve living standards as dramatically as it has done in the past.²² Therefore national incomes and individual living standards are likely to grow less quickly. Terms of trade are falling; participation is likely to be flat to decreasing; and there is more risk that labour productivity growth will be lower, rather than higher, than its long-term average (Figure 5). As a result, Commonwealth revenues will be under pressure. Treasury has warned that Australia is highly unlikely to achieve the real rate of growth required to return the budget to surplus by relying on economic growth alone.²³

3.2 Spending demands are not going away

The Commonwealth budget will also face increasing pressures on spending from population ageing²⁴ and from new policy initiatives such as the National Disability Insurance Scheme (NDIS), the Families Package, and the Direct Action policy to address climate change, and commitments to increase defence spending. Together these signature policies are likely to add more than 1 per cent of GDP to spending over the decade.²⁵ Funding for these commitments will need to come through some combination of increases in revenues or cuts to spending in other areas.

The NDIS in particular will be a significant cost to the budget within the decade. The Parliamentary Budget Office (PBO) forecasts that spending on the scheme will rise to \$32 billion in 2025-26.²⁶

3.3 Projections may understate the problems

Short and medium term projections of the Commonwealth budget position, although far from rosy, may understate the challenge of budget repair. They embody optimistic assumptions about revenue and spending growth. Individually, any one of the assumptions may be defensible. Collectively, they seem unlikely. The history of the last six years is not encouraging: budget outcomes have consistently been much worse than the original projection four years earlier.

3.3.1 Revenue projections

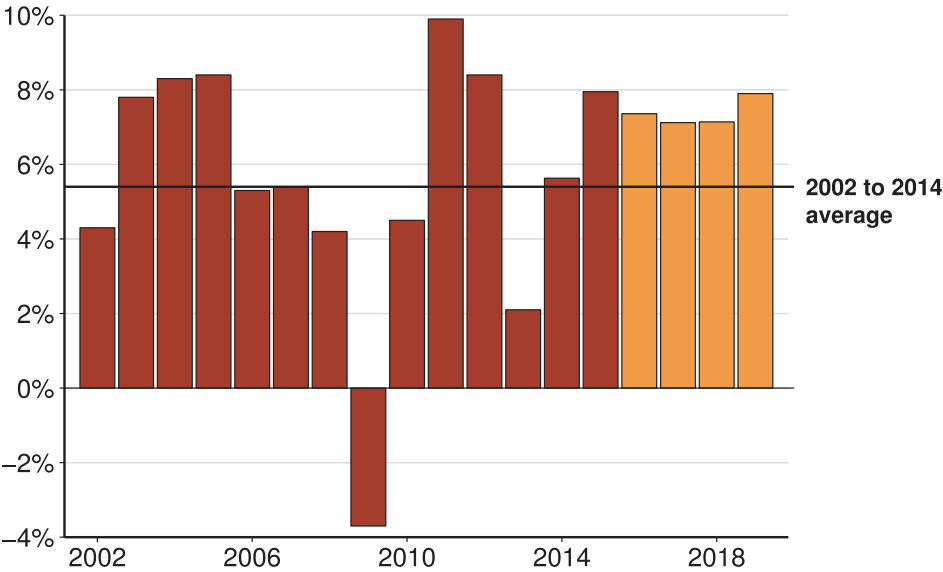
Treasury's projections of revenue and expenses over the four years of the forward estimates rely on income taxes rising from 11 per cent of GDP in 2014-15 to 12.1 per cent in 2018-19.

The increase primarily reflects fiscal drag from rising nominal wages but also assumes a rapid recovery of capital gains tax receipts from 0.6 to 0.9 per cent of GDP. On these projections, personal income tax will grow faster than the historical average for each of the next four years (Figure 6 on the next page).

This may be plausible if there are no changes to income tax rates and thresholds. But as average income tax burdens increase, the government is likely to face strong pressure to return some of the fiscal drag by changing the tax scales. In most years in the 2000s, governments reduced tax rates or increased tax thresholds (or both), limiting the effects of bracket creep.

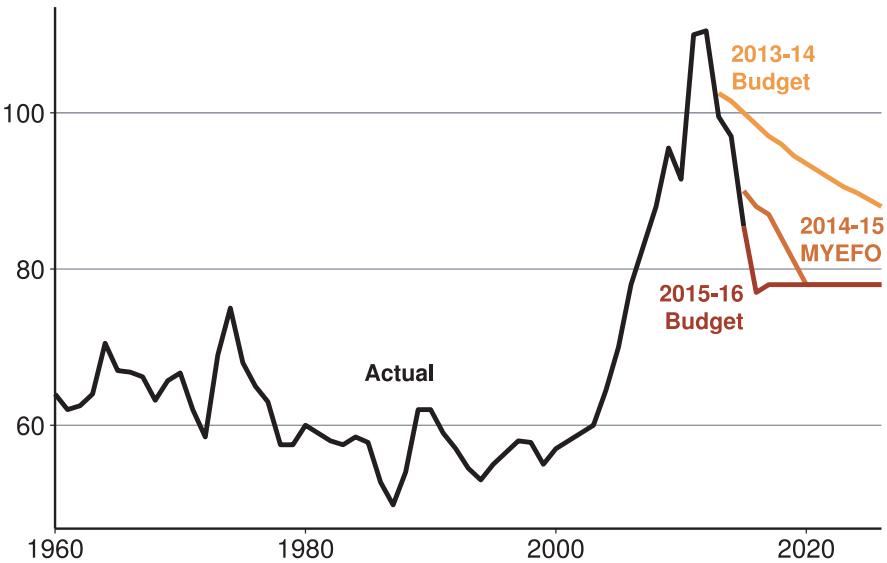
Other revenue projections also seem optimistic. The 2015-16 budget projects that the terms of trade will fall by 9 per cent in 2015-16 and then stabilise at a level about 50 per cent higher than their long-run average (Figure 7 on the facing page). However, terms of trade shocks around the world in the last few decades have typically been symmetrical. In other words, the terms of trade have tended to revert to their long-run average.²⁷

Figure 6: Personal income tax growth is projected to be higher than the last decade
Annual growth in personal income tax revenues, historical and forecast



Source: ATO (2015h) and Treasury (2015a).

Figure 7: Terms of trade are projected to stabilise above their long-term average
Terms of trade, 2013-14 = 100



Source: Eslake (2015)

The budget also projects healthy economic growth of 3.25 per cent in 2016-17 and 3.5 per cent after that – including non-mining investment growth of 7.5 per cent in 2016-17.²⁸ In contrast, ABS and Reserve Bank survey data suggest non-mining investment could remain subdued for some time.²⁹

These revenue projections are underpinned by an overarching assumption that by the end of the two-year estimates period the economy will return to the medium- to long-term growth rate.³⁰

The assumption begs the question of what long-term growth rate is appropriate. Since the global financial crisis economic growth has been much slower in developed countries. In the 20 years leading up to the GFC (1988-2007), real GDP grew by an average of 2.8 per cent a year across the OECD. Since 2010, the average growth rate has been 1.6 per cent.³¹ The IMF has warned that potential output growth rates in advanced economies are likely to remain below pre-GFC rates for at least the next five years because of the negative effects of demographics and the slow recovery in business investment.³² On this basis, it suggested Australia should expect slower growth for several years.³³

The longer-term prognosis is not yet clear: it may just be a sluggish recovery, typical for a finance-induced recession, that will ultimately pass, although the global increase in debt levels may foreshadow a lot more adjustment to come.³⁴ Or it may reflect gloomy predictions that economic growth in coming decades will be slower than for the last few decades.³⁵

Whatever lies ahead, the overall Commonwealth budget projections seem optimistic and unlikely to be realised. A PBO report concluded that the risks to the budget from economic shocks are weighted to the downside. It identified a real risk that labour productivity growth and the terms of trade will be less favourable than projected, significantly reducing tax collections.³⁶ Company tax receipts could also well be lower than forecast given slower business capital expenditure and losses carried forward from the GFC.³⁷

3.4 Spending projections

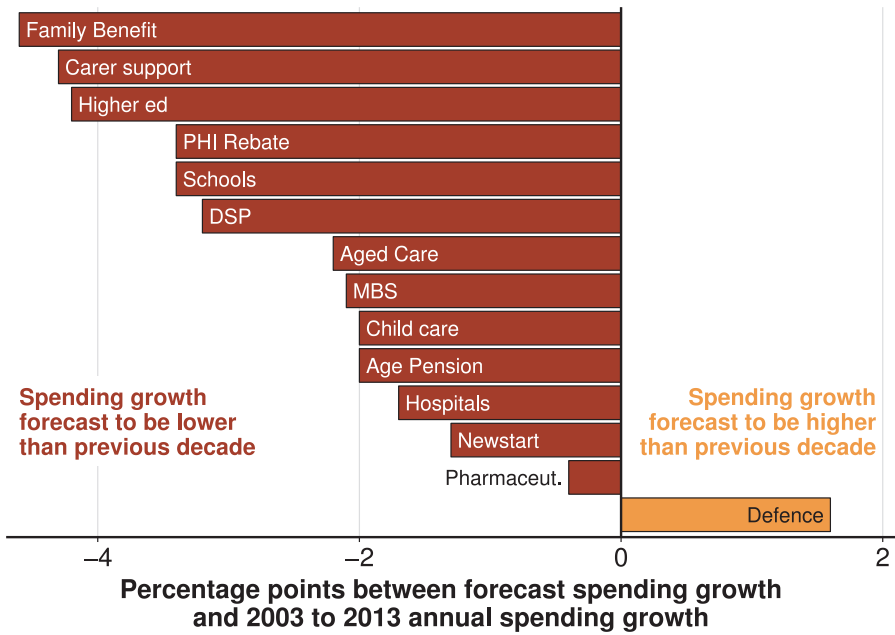
The Commonwealth's spending projections also seem optimistic. They assume tight spending restraint, with government spending falling as a share of the economy (Figure 2).³⁸ The projections forecast spending to grow at just 2.6 per cent a year on average between 2014-15 and 2025-26, far below the 3.6 per cent average growth rate of the last decade.³⁹ Consistent with this spending restraint, the Commonwealth Government forecasts that spending will decline to 24.2 per cent of GDP in 2024-25, below its long term average.⁴⁰

Spending is forecast to be below the historical average in all program areas other than defence, as is shown in Figure 8 on the next page, which compares the projected growth in the Commonwealth's largest spending programs over the next 10 years with the history of the last 10 years.

Some of these estimates seem improbable. For example, it seems unlikely that spending on demand-driven programs such as the **Medicare Benefits Schedule** will moderate without significant policy changes. The PBO attributes the strong historical growth in Medicare payments to policies (such as the Bulk Billing Incentive and the Extended Medicare Safety Net) that have made Medicare services more attractive or accessible. New policy measures such as the freeze in Medicare scheduled fees are forecast to produce lower growth. Yet for more than 20 years the ageing of the population, medical science and technology improvements and rising expectations of the health system have put relentless pressure on the health budget.⁴¹ These pressures will not abate, and the forecasts almost certainly understate them.

The decline in spending growth for hospitals and schools may be credible given the decision in the 2014-15 Budget to limit spending increases to inflation and population growth. This of course does not mean that spending growth will decline in these program areas – merely that the states will have to bear all of the cost of real per capita growth.

Figure 8: Spending forecasts rely on lower growth in almost all major programme areas



Notes: The defence estimates do not factor in the commitment to increase defence spending to 2 per cent of GDP by 2023-24. Rather they are based on the long-term funding commitments made in previous Defence White Papers and government announcements.

Source: PBO (2014)

The 2015-16 budget assumes even tighter spending growth than have previous budgets. Except for welfare spending, mainly driven by the NDIS, no category is expected to grow materially faster than inflation.⁴²

In other programs, lower forecast growth rates are tied to measures from the 2014-15 and 2015-16 Budgets that are unlikely to be passed by the Senate. Therefore spending on the Carers Payment, higher education and Newstart benefits is likely to be more than forecast. Even the forecast growth in defence spending – the only program area where spending is forecast to grow faster than in the last decade – does not put Australia on a path to spend 2 per cent of GDP on defence by 2023-24 as the Government has promised.⁴³

Spending projections also assume there will be no new spending initiatives promised at elections or in response to natural disasters or community demands for more assistance to the disadvantaged. Experience over the last decade suggests that such spending restraint will be difficult (Box 1 on page 35).

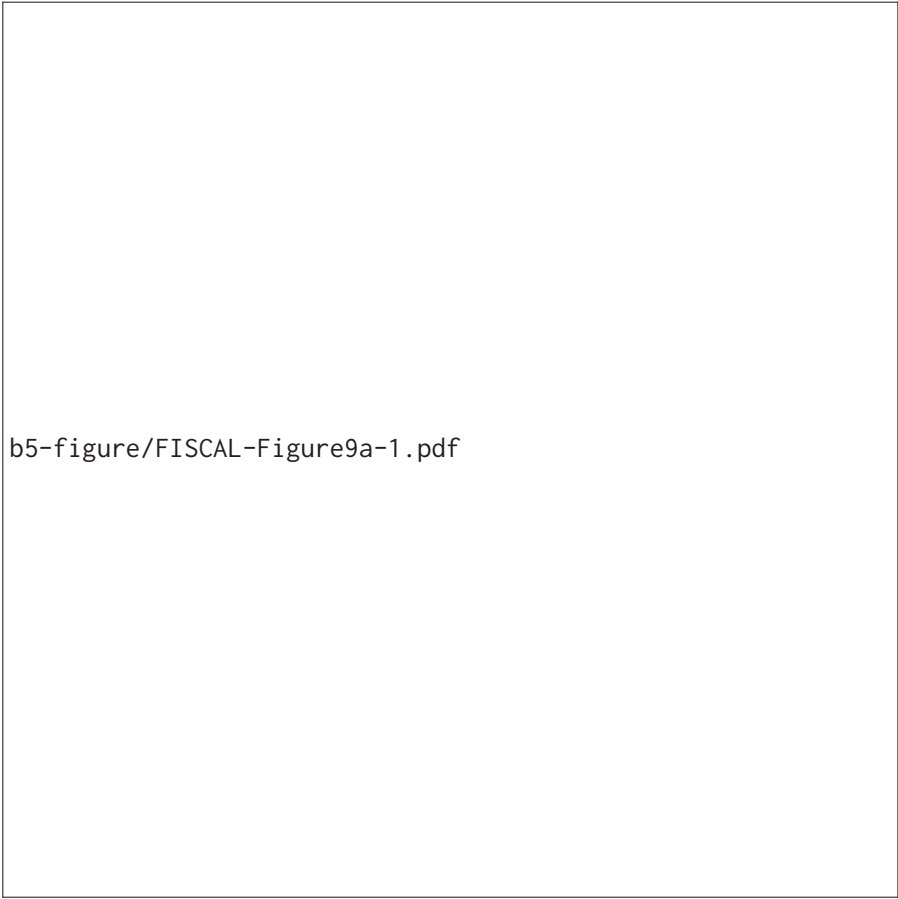
Given all the number of things that need to go right, moderating spending growth to 24.2 per cent of GDP in 2024-25 seems extremely unlikely without further explicit budget measures to cut expenditure.

3.4.1 Experience of budget forecasts and outcomes

The government's fiscal strategy relies heavily on these optimistic projections. The measures introduced in this year's budget will make no net improvement to the budget position in 2018-19 (Figure 4). The government justifies its inaction by saying that the projections suggest it is on a "clear and credible path back to surplus." But projections over the past five years have consistently overestimated the position of the budget four years out (Figure 9 on the next page).

Figure 10 on page 34 shows why. In the years leading up to the global financial crisis, forecasters underestimated the budget position by failing to anticipate the large spending and tax bonuses delivered in response to the crisis. These spending and revenue policy measures generated

Figure 9: Commonwealth Budget forecasts have persistently missed the mark
Underlying cash balance / GDP, forecasts and actual, coloured by year of forecast



Source: Commonwealth Budget papers 2009-10 to 2015-16

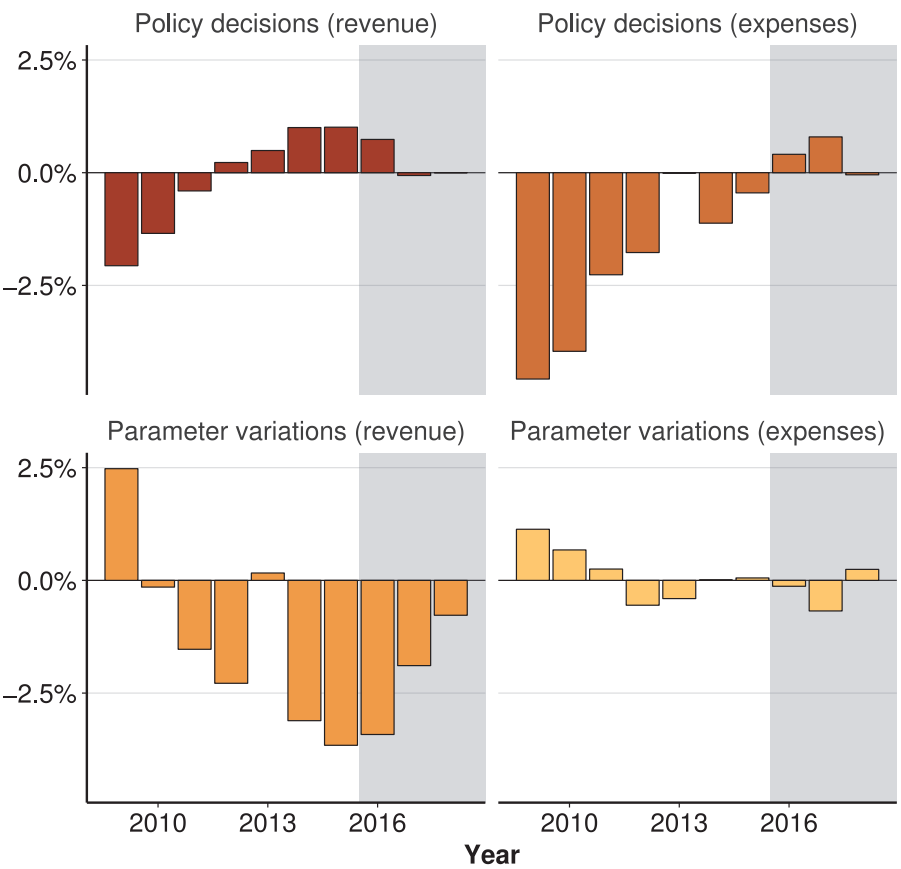
cumulative forecast errors in excess of six per cent of GDP for 2009. They were offset by higher revenues due to the unexpected increases in mining prices from 2006-2009.

But just as the earlier estimates failed to foresee the surge in revenue in the years leading up to the GFC, later estimates have failed to capture its decline. For the last two years, declines in revenue parameter estimates, particularly the terms of trade, have reduced budget balances from the original projections by more than 3 per cent of GDP. Policy decisions have not helped – new spending policies were not always matched by new revenue measures so budget positions deteriorated further from the projections in most years.

The scale of these errors – larger than the ultimate deficit in most years – calls into question a do-nothing budget strategy that justifies deficits on the basis of a projected surplus or near surplus at the end of the forward estimates period.

Figure 10: Budget outcomes have disappointed due to spending decisions and revenue shocks

Cumulative change over 4 years to budget balance projection as percentage of GDP



Notes: See page 393.
Source: Commonwealth Budget Papers, Mid-year Economic and Fiscal Outlook statements, Pre-Election Economic Outlook and Economic Statements (various years).

Box 1: Electoral sweeteners – a recent history

Governments of both persuasions like to promise to lift welfare payments, cut taxes and improve government services, especially in election years.

In the last decade, Age Pension recipients have been the greatest beneficiaries of discretionary top ups. Increases in pension payments over and above the normal indexation arrangements were made in 2007 in the Simpler Superannuation changes, in the 2008-09 and 2009-10 Budgets, and in late 2011 as part of the carbon pricing compensation package.

Recipients of Family Tax Benefit Part B, the Disability Support Pension, Carer Income Support and childcare payments also received one or more discretionary increases

In 2009-10 higher education received a significant funding boost for teaching and research and reforms to the student income support system. In primary health, funding was boosted by the Bulk Billing Incentive and Extended Medicare Safety Net in 2004, by increasing GP benefits payments in 2005 and by the inclusion of dental services in 2007.

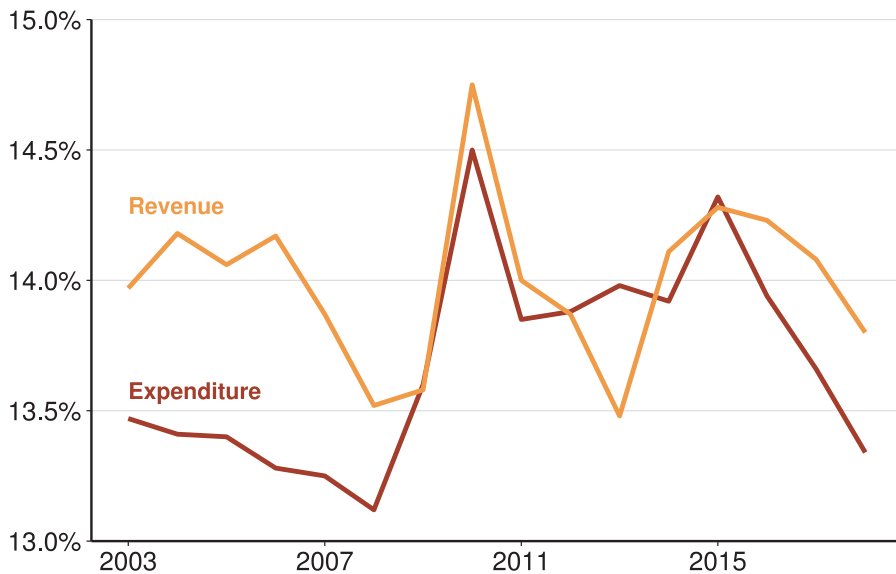
Sources: PBO (2014); Commonwealth Budget Papers 2002-03 to 2012-13.

4

State government budgets also face growing pressures

In contrast to the Commonwealth, state government operating revenues have generally exceeded expenses over the last decade (Figure 11). Yet states spent more over the last six years than over the previous six. State revenues and spending are both forecast to fall over the forward estimates.

Figure 11: State government budgets have been largely in balance
Per cent of nominal GDP



Notes: See page 393.

Source: Treasury (2014a) and ABS (2014b, Table 1); Grattan analysis.

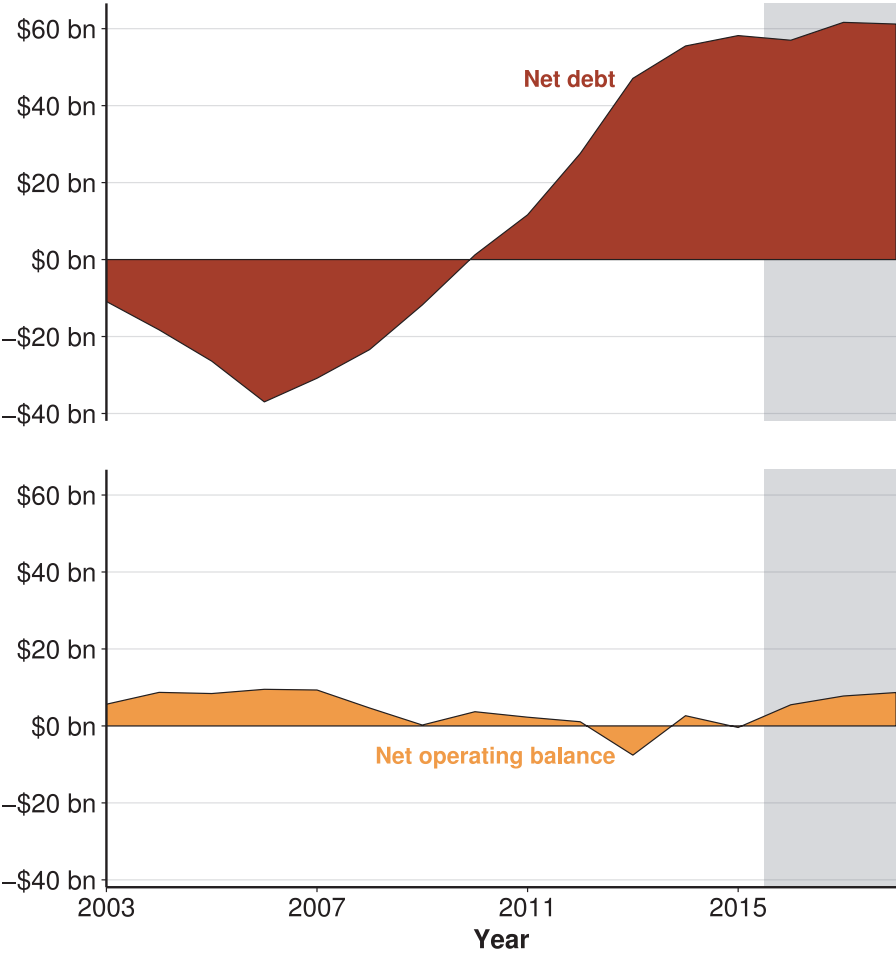
These aggregates obscure variations between states. Tasmania and South Australia ran operating deficits after property market turnover declined and stamp duty revenues fell in 2010-11. Their budget positions have since improved. In Queensland, deficits were larger when revenues were hit by the 2011 floods, but the return to surplus was faster. The NSW, Victoria and Western Australia Government operating budgets were largely balanced over the period. More recently, Western Australia went into deficit when royalty revenues from iron ore fell sharply. This was exacerbated by the fall in their share of GST revenues as the Grants Commission process redistributed record state mining royalty revenues from previous years which had already been spent by the WA Government.

Unlike the Commonwealth, the states also have significant capital spending that does not immediately affect net operating balances.⁴⁴ Capital spending increased substantially after 2005, and far exceeded the offsetting depreciation of previous capital spending. State governments funded this increased infrastructure spending largely through borrowing, and so net debt increased (Figure 12 on the facing page). In the decade to 2013-14, higher interest and depreciation costs increased subsequent operating budget expenses from six to more than nine per cent of state revenues.⁴⁵

4.1 Future pressures on state government budgets

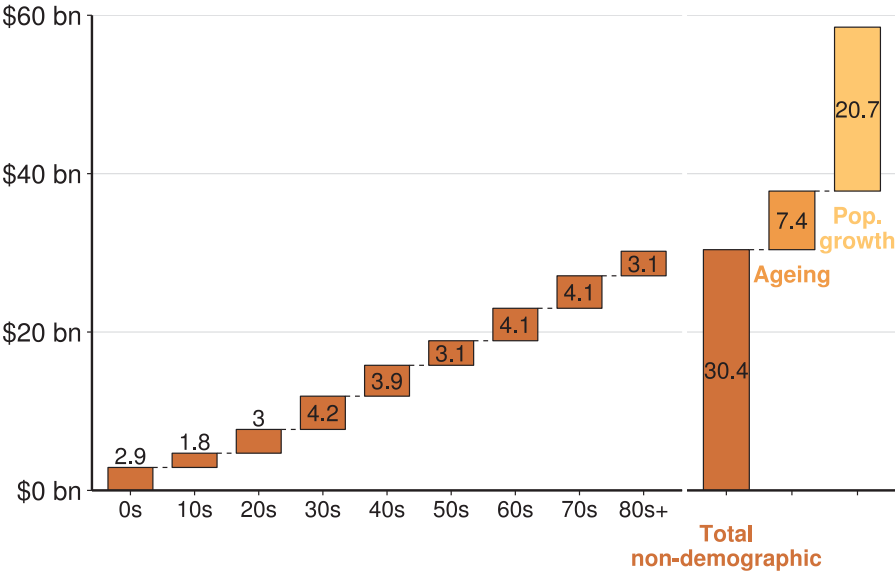
All state governments will face more significant budget pressures beyond the forward estimates. Health and education spending are forecast to grow strongly over the next decade. At the same time, the Commonwealth has stated that from 2017-18 it will no longer contribute to growth in real spending per person in these areas. Health and education make up almost half of state government expenditure. If spending per person continues to grow faster than inflation, then it is unlikely that other areas can be cut enough to make up the gap. Instead, state governments will need additional revenues to keep their budgets balanced.

Figure 12: State and territory net debt increased rapidly
Total state and territory net operating balances and debt, (2014 dollars)



Notes: See page 393.
Source: State government Budget Papers and Mid-Year forecasts.

Figure 13: All age groups contributed to increased health spending
 Increase in real government health spending, 1989 to 2010



Notes: See page 393.

Source: ABS (Various years[b]) and ABS (2014c, Table 59); Grattan analysis.

4.2 More spending on hospital, schools, and infrastructure

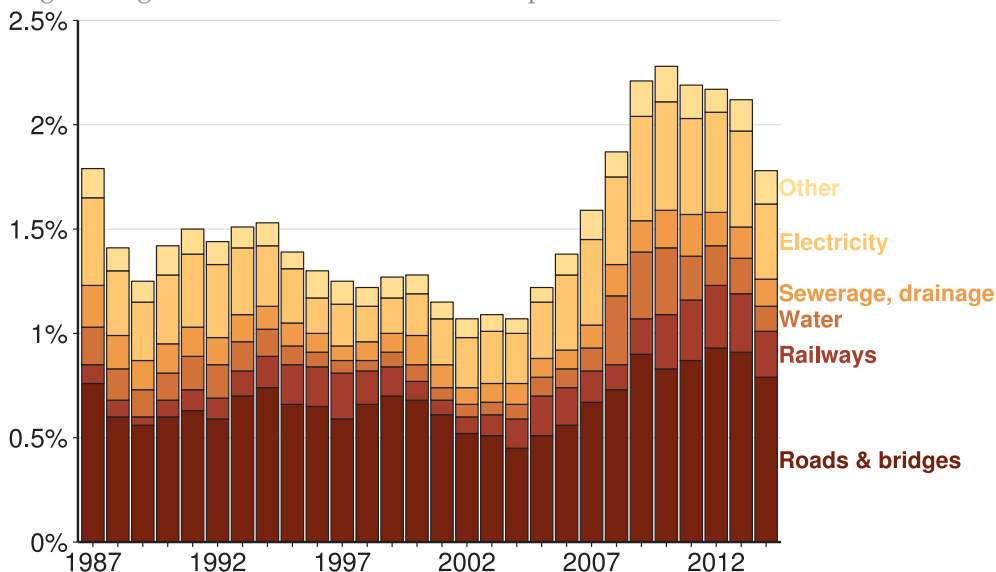
Growing healthcare costs are the most significant spending pressure on state governments. Spending on health, primarily hospitals, is about 25 per cent of state recurrent expenditure.⁴⁶

State government health spending grew considerably faster than the economy over the last two decades. Increased use of services rather than population ageing was the main cause of health spending growth (Figure 13).⁴⁷ As the economy grew, governments spent more of their income providing more and better health treatments, including those using new technologies.⁴⁸

This strong non-demographic growth is forecast to continue.⁴⁹ Population ageing will also contribute more to spending growth as the large baby boomer cohort reaches the age brackets when health spending per person is much higher.⁵⁰

Figure 14: Government spending on infrastructure rose from 2007, but is now falling

Engineering construction work done for the public sector, % of GDP



Notes: By financial year. Excludes telecommunications, insignificant after Telstra sale.

Source: ABS (2015b)

State government spending on schools is also forecast to rise faster than GDP in years to come. The increase is partly a result of commitments to increase funding for schools with disadvantaged students between 2014 and 2019 under the National Education Reform Agreement.

State governments spent more on infrastructure – particularly in transport – over the last decade (Figure 14).⁵¹ Much of it was effectively unfunded. Although state spending on infrastructure is now falling, there will be significant pressure to maintain or increase spending on infrastructure to cope with increasing population and concerns about congestion.⁵²

Higher infrastructure spending can be justified if it generates increases in the productive capacity of the economy sufficient to justify the cost. But Australian governments could do a lot better in their project choices.

An overhaul of project selection processes – including greater reliance on independent and transparent cost-benefit analysis – would significantly improve the returns to this spending.⁵³

4.3 The Commonwealth has substantially reduced planned funding for the states

Under Commonwealth policy adopted in the May 2015 budget, state governments will have to fund all increases in real spending per person for hospital and schools.⁵⁴ The change abandoned previous Commonwealth undertakings, set out in the COAG National Education Reform Agreement and the National Health Reform Agreement, to contribute to real increases in spending per person.

The shift in spending responsibility back to the states is very significant. The Commonwealth estimates that by 2024-25 the changed policy will reduce its real spending by \$11 billion on hospitals and \$5 billion on schools.⁵⁵ By 2054-55, the reduction in real spending for hospitals could be as large as \$78 billion (Figure 15 on the next page).

4.4 Other State revenues are also under pressure

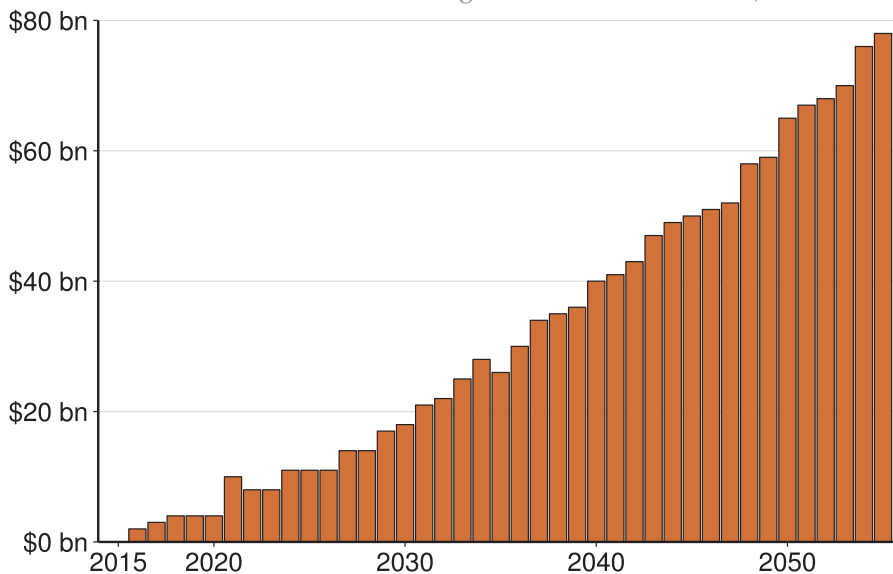
State revenues may also come under renewed pressure. Relatively constant revenues over the last decade may have masked increased vulnerabilities in individual revenue sources.

In particular, untied revenues from the GST fell over the decade, from almost 4.0 per cent to 3.2 per cent of GDP in the decade to 2013-14. The main causes were people saving more and spending more on untaxed goods and services, particularly rent and mortgage payments.⁵⁶ Unless these trends reverse, GST is unlikely to increase as a percentage of GDP.

Conveyance stamp duties also fell. They averaged about 1.2 per cent of GDP between 2002-03 and 2007-08, but only 0.9 per cent of GDP since then.⁵⁷

Figure 15: Commonwealth will provide much less funding to the states for health than previously agreed

Forecast Commonwealth health funding withdrawn from states (2014 dollars)



Notes: Estimates of health funding withdrawn from states based on the difference in Australian Government spending under the 'proposed policy' and 'previous policy' scenarios modelled in Hockey (2015, Tables 2.10 and C.2).

These falls over the decade were offset by rises in royalties and small increases in property and payroll taxes. Yet state royalties are now falling as price falls outweigh volume increases.⁵⁸ All states effectively benefited from the rise in royalties, and will feel the pinch if they fall. Revenue redistribution determined by the Commonwealth Grants Commission and implemented through the carve up of the GST means that changes in one state's royalties are effectively shared among all states.

5

What should governments do?

Australian governments are running substantial budget deficits. Future pressures are likely to make the problems worse. A drift back to surplus is unlikely, and relies on best case assumptions that have often disappointed in the past.

There have been a range of justifications for inaction. Governments have taken advantage of the wriggle room provided by the vagueness of where Australia is in the economic cycle. For several years they have played St Augustine: “let us be chaste and run a surplus – but not yet.” And while they have pointed to sluggish economic growth to justify deficits, they have glossed over the temporary boost to revenues from the mining boom. Finally, they have talked up their position by pointing to surpluses or near surpluses towards the end of each budget’s forward estimates. These surpluses have continued to recede to the horizon as optimistic projections have run aground on reality.

To bring their budgets back to balance, governments will need to undertake reforms on both the revenue and the spending side. But recently the Commonwealth Government’s energy has been focussed on cuts to spending. There have been large reductions in the budget for foreign aid⁵⁹ and sizeable savings have also been proposed (and in some cases reversed) for higher education, primary care, and welfare through changes in eligibility thresholds and indexation arrangement for benefits.⁶⁰ The Commonwealth Government has deferred any significant changes in its revenue mix until after its *Tax White Paper*.⁶¹

Most state governments have also shown a lack of enthusiasm for new revenue measures.⁶² These governments, after benefiting from high mining royalty revenues, have offered no plan to fill the gap as these volatile revenues wane.

But there are revenue measures that could make a meaningful contribution to budget repair with little collateral damage. In a series of forthcoming papers, we set out four policy proposals – reducing superannuation tax concessions, changes to capital gains tax and negative gearing, broadening the GST and the introduction of a broad-based property levy – that we think governments should adopt to improve their fiscal position.

These reforms will be politically difficult. To build the public case, governments should adopt budget projection methodologies that provide a more realistic picture of the pressures on Australia's medium term budget outcomes. These will make it more obvious that we cannot rely on the hope that our luck will improve. Tougher decisions are needed.

II

Property taxes

Overview

The previous part, *Fiscal Challenges for Australia*, originally published in July 2015, shows how Commonwealth and state government budgets are under pressure. The Commonwealth Government has run deficits for six years, largely because its spending on older households has increased rapidly.

State government spending on health and education and other vital areas is also growing faster than GDP. State revenues are threatened by the Commonwealth's decision in the 2014-15 Budget to ease some of its own budget pressures by substantially reducing promised funding to the states for hospitals and schools. Recent state government budgets provide no insight into how they will respond to the looming funding gap.

This part shows how a broad-based property levy could help repair state government revenues without damaging the economy or the most vulnerable in our society.

Property taxes – which are levied on the value of property holdings – are the most efficient taxes available to the states. If they are designed well and applied broadly, property taxes do little to change incentives to work, save and invest. Unlike capital, property is immobile – it cannot shift offshore to avoid higher taxes. Concerns about the risks of multinational tax avoidance, the increasing mobility of capital around the world, and the increasing value of residential property relative to incomes, should make property taxes a priority in any tax reform.

The property tax base is large and growing fast. A low-rate, broad based property levy using the council rates base could raise about **\$7 billion** a year for state and territory governments through an annual levy of just \$2 for every \$1000 of unimproved land value, or \$1 for every \$1000 of capital improved property value.

The costs to property owners would be manageable. A home-owner would pay a levy of \$772 a year on the median-priced Sydney home, valued at \$772,000, or \$560 a year on the median-priced Melbourne home valued at \$560,000. People with low incomes and no wealth would pay nothing. Low-income retirees with high value houses could defer paying the levy until their house is sold.

Higher property taxes could also be used to fund the reduction and eventual abolition of state stamp duties on property. Stamp duties are among the most inefficient and inequitable taxes available to states, and their revenues are inherently volatile. Although abolishing stamp duties is not the focus of this report, shifting from stamp duty to a broad-based property tax would provide a more stable tax base for states, spread the tax burden more fairly, and add up to \$9 billion annually to GDP.

Calls to reform property taxes are not new. Property taxes are often unpopular precisely because they are highly visible and difficult to avoid. Yet they are also efficient and fair, and don't distort behaviour. Greater use of property taxes would be the best way for state governments to meet the growing pressures on their budgets.

1

State government budgets face growing pressures

The Commonwealth is not the only government under significant budgetary pressure. The previous part shows that all state governments face growing budget pressures beyond the four-year forward estimates.

State government spending on health and education and other vital areas is growing faster than GDP. Most states significantly increased infrastructure spending over the last few years, and largely funded this through borrowing, so that future budgets must spend more to service the debt and depreciation.

Other pressures are threatening state revenues. Relatively constant revenues over the last decade may have masked increased vulnerabilities in individual revenue sources. In particular, untied revenues from the GST fell over the decade.* These falls were offset by rises in mining royalties and small increases in property and payroll taxes. Yet state royalties are now falling as commodity price falls outweigh volume increases.⁶³ As a result of GST distributions, all states effectively benefited from the rise in royalties, and all will suffer if they fall.

State revenues are also threatened because the Commonwealth has eased some of its own budget pressures by substantially reducing promised transfers to the states for hospitals and schools. The Commonwealth's decision to no longer contribute to growth in real spending per person in these areas beyond 2017-18 presents the states with a potential \$16 billion

*See Section 4.4 on page 42.

revenue shortfall by 2024-25, and a big problem.[†] If spending per person continues to grow faster than inflation, then it is unlikely that other areas can be cut enough to make up the difference.

Recent budgets provide no insight into how state governments will respond to the looming funding gap. Most have shown a lack of enthusiasm for new revenue measures or substantive tax reforms.⁶⁴

Hoping for the best is not a budget management strategy: it simply shifts the costs and risk of budget repair onto future generations. More active policy measures to achieve budget repair are required. While containing spending will be important, both the politics of budget repair and the sheer size of the budget gap mean that governments are unlikely to be able to restore budgets to balance without also boosting revenues.

Sustainable budgets depend on tough choices, not hope. To ensure that future generations do not have to foot the bill for today's inaction, these choices must be made.

[†]See Section 4.3 on page 42.

2

Property tax reform should be the states' priority

Greater use of property taxes is the best way for the states to meet their budget challenges. Property taxes – which are levied on the value of property holdings – are the most efficient taxes available to the states. If they are designed well and applied broadly, they do little to change incentives to work, save and invest.

The property tax base is large and growing fast. A low rate broad property levy using the council rates base could raise about **\$7 billion a year** for state and territory governments through an annual levy of just \$2 for every \$1000 in unimproved land value, or \$1 for every \$1000 in capital improved values. Although it would have marginally more impact on economic decisions, a levy on capital improved values would still have low economic costs, and may be simpler to implement since capital improved property values are easier to track.

A broad-based property levy might provide a path to longer-term reform of taxation on property, by funding the reduction and eventual abolition of state stamp duties for property. The Commonwealth Treasury nominates stamp duty as Australia's least efficient tax.⁶⁵ Stamp duties deter people from buying and selling property, and therefore can prevent them moving closer to jobs or upsizing and downsizing homes as their needs change. Stamp duties raised \$16 billion for the states in 2013-14. Their costs to the economy and jobs are large.⁶⁶

The ACT is phasing out stamp duty over 20 years, and replacing the revenues with higher municipal rates.⁶⁷ South Australia plans to abolish

stamp duties on commercial property, but has ruled out extending land taxes to owner-occupied housing. The government seems to be relying on higher GST revenues in order to abolish stamp duty, rather than relying more on efficient state taxes.⁶⁸

Once a broad-based property levy becomes large enough, it might also be possible to phase out land taxes as currently designed. The states raised \$6.4 billion from land taxes in 2013-14, but carve outs from the land tax base (via exemptions for owner-occupied housing), thresholds, and progressive rates make them much less efficient taxes than they should be.

Property tax reform would also support reforms to the fiscal arrangements of the Australian federation. These reforms are under consideration through the Commonwealth's *White Paper on Reform of the Federation*. A broad-based property levy would boost states' revenues and give them greater control over their own destinies, with minimal drag on their economies. Other options to increase revenues include sharing in Commonwealth income tax receipts, or broadening or increasing the GST. Relative to these options, a broad-based property levy would do more to increase state government responsibility for funding their own spending.

3

Property taxes can generate substantial revenues

Australian governments derive less revenue from property taxes as a share of GDP than they should. Australia's property tax take is far below that of some comparable countries (Figure 16).

3.1 The property tax base is large and growing fast

Property is potentially a very large tax base, worth \$8.3 trillion in June 2014. Australian land in aggregate is valued at \$4.3 trillion, and buildings and other improvements to land are worth \$4 trillion, with residential land and improvements worth about two-thirds of the total (Figure 17).

Land values tend to rise at least as fast as GDP. Over the past 25 years land values almost tripled, growing much faster than GDP, other state taxes, and the GST since its introduction in 2000 (Figure 18).*

Over the longer term, property values are likely to keep rising, even if the pace of growth is slower than over the past two decades. Some of the growth over the last two decades resulted from the long-term decline in interest rates. In future, property values, and therefore revenues from property taxes, may grow more slowly. In the long run, property prices are likely to at least keep pace with incomes, and may well rise faster, depending on population growth, household size and whether supply of new properties keeps pace with the growth in demand.⁶⁹

*For more detailed analysis of historical trends in individual state tax revenue growth and revenue volatility, see Appendix A on page 99.

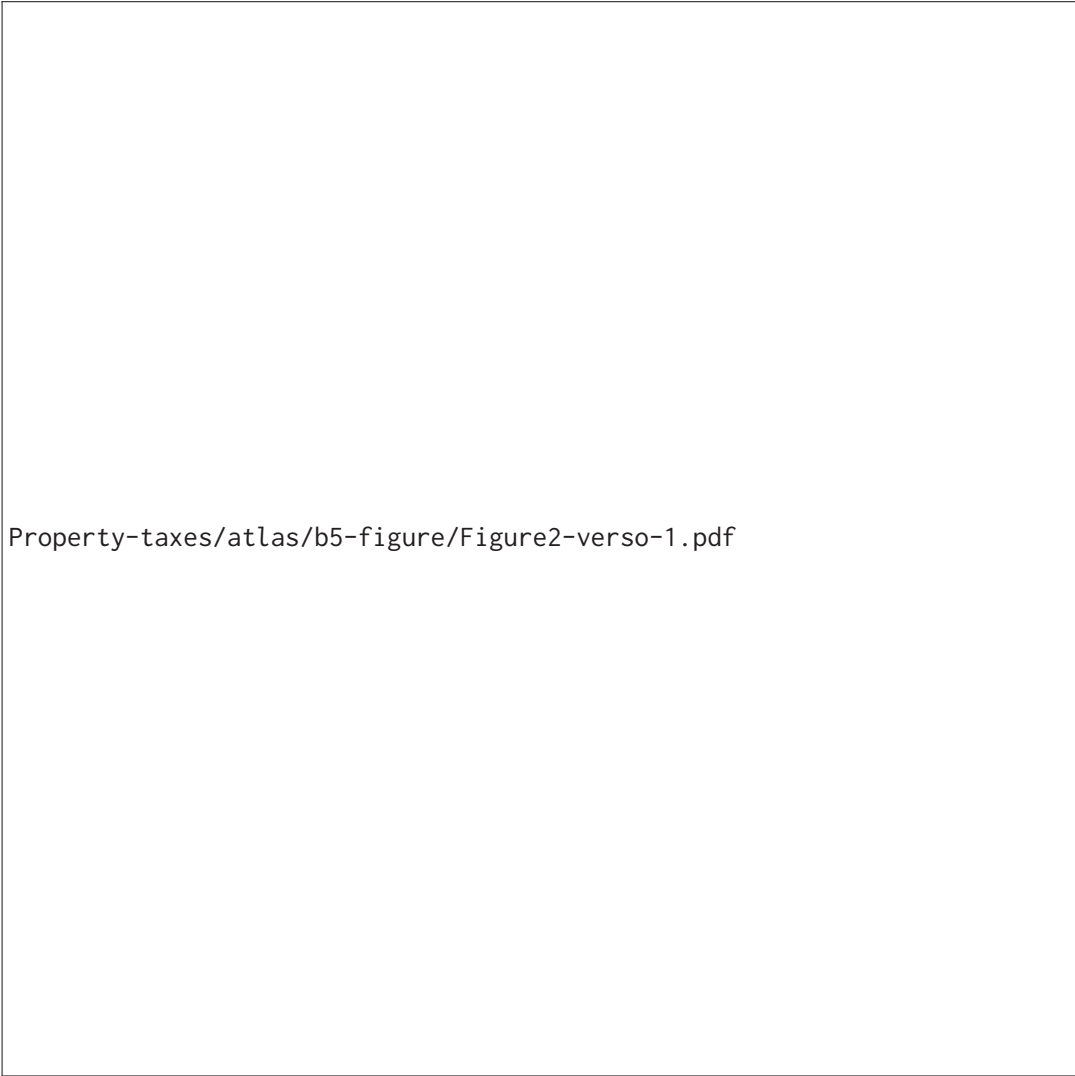
Figure 16: Some countries raise more tax from property than Australia does
Tax revenues from property as a percentage of GDP, 2012



Notes: See page 393.

Source: OECD (2015); Grattan analysis

Figure 17: Australian property values grew quickly this past decade
Real market value of Australian property in trillions (2014 dollars)



Source: ABS (2014d) and ABS (2014f); Grattan analysis.

Figure 18: Property taxes are one of the few ‘growth taxes’
Percentage change in tax revenue for each 10 per cent increase in national GDP, 1990-91 to 2013-14



Property-taxes/atlas/b5-figure/Figure3-recto-1.pdf

Notes: See page 394.
Source: ABS (Various years[c]); Grattan analysis.

Revenues from property taxes tend to be less volatile than stamp duties on property sales (Figure 19). State Treasurers dislike volatility because it makes budgeting more complex. Volatility in property tax revenues can be reduced by levying taxes on the average of recent property valuations.

3.2 Potential revenue from a broad-based property levy

A levy applied to the existing council rates base would generate substantial extra revenues for states. A relatively modest property levy, charged at a rate of \$2 for every \$1000 of unimproved land value, could raise about \$7 billion a year from 2015-16 (Figure 20 on page 65). A similar amount would be raised by a property levy charged at \$1 for every \$1000 of capital improved property value.⁷⁰ In comparison, state land taxes raised \$6.4 billion in 2013-14.⁷¹

However, the property levy would reduce Commonwealth revenues by about \$0.5 billion, since property investors and firms would deduct the levy as an expense against their incomes.⁷²

3.3 GST redistribution due to a property levy would not excessively reduce any state's revenue

The Commonwealth Grants Commission (CGC) distributes GST revenues among the states to achieve what is known as horizontal fiscal equalisation. The goal is to enable each state to deliver the same level of government services and infrastructure to its residents as other states.⁷³ The CGC assesses the funds that each state would need to spend to provide the average level of services and the revenue each state would collect if it applied the average tax settings of all states. Each state then receives GST revenues to fill the gap, after accounting for other transfers it receives from the Commonwealth.

When state governments lift their spending, it usually alters the redistribution of GST revenues. Increases in state government spending, however funded, tend to shift GST revenues towards those states and territories, such as Queensland, SA, Tasmania and the NT, where it

costs more to deliver services because populations are more remote or tend to use more public services.⁷⁴ As a result, when total spending increases across all states, net donors such as New South Wales and Victoria tend to receive a smaller share of GST revenues, while the share of the smaller states and territories grows. The precise GST impacts depend upon how states allocate their additional spending.

GST distributions would be altered if states raised revenues through a property levy. If all States implement a property levy, then NSW, Victoria, and WA would in effect give up some of their revenues through GST redistribution, while other states and territories would receive additional GST revenues. This redistribution reflects how property levies would raise more per person in NSW, Victoria and WA, as the value of property in these states is higher.

However, for a given scale of expenditure (and therefore revenue), a property levy would result in relatively less extreme GST redistribution than other state taxes, as Figure 21 on page 66 shows. A property levy would distribute less GST money away from NSW than an increase in stamp duties would. Victoria would give up about the same percentage of new revenue, whether it raised the revenue through a property levy or through land taxes. Relative to increases in either land or payroll tax, a property levy would distribute much less GST money away from WA.

For all states, the GST amounts redistributed would be small relative to the amount collected by a property levy. Figure 22 on page 67 shows the combined effect on GST redistributions of increased spending (assuming current spending patterns), funded by a property levy imposed by all states. NSW and Victoria, with low service delivery costs and high property values, could lose at most 15 per cent of the revenues they raise via the levy to other states. These extra revenues would mostly flow to Queensland, Tasmania, and the NT.

Because of the CGC's methodology, GST impacts would be much smaller if only one state or a subset of states introduced the levy. For example, if NSW alone funded higher spending via the levy, it would forego about

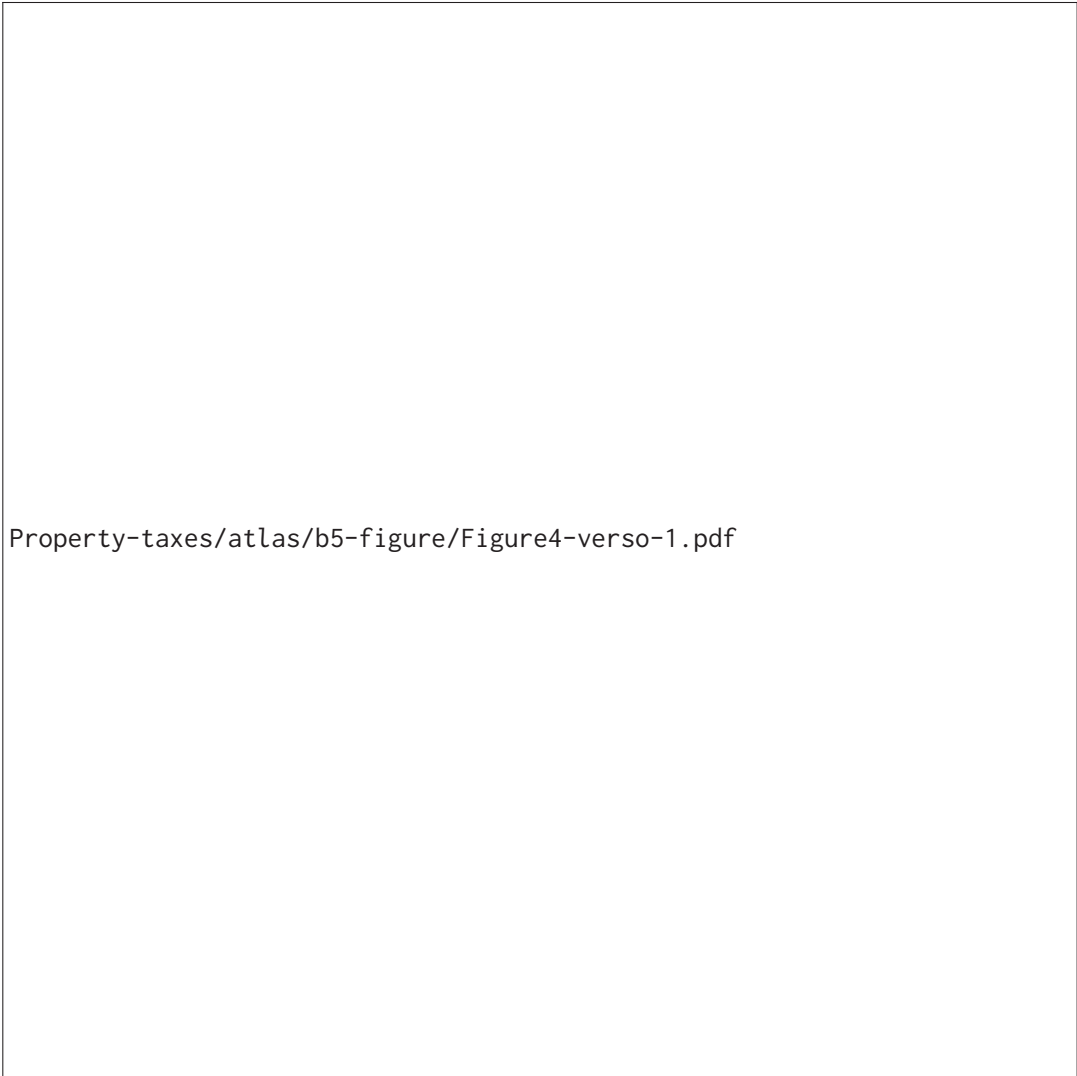
5 per cent of the revenues it raised. If the property levy revenues were used to fund the abolition of state stamp duties in a revenue neutral way, the GST impacts would be even smaller. NSW would replace one tax where it can raise more revenue per head (stamp duty) with another (property levy), while there would be no redistribution that reflected higher spending.

State tax policy changes normally have a delayed effect on GST distributions. The 2015-16 GST distributions, for example, are based on data from the 2011-12, 2012-13 and 2013-14 financial years. A state property levy introduced in 2015-16 would not begin to affect GST distributions until 2017-18, and the full impact would only be incorporated in 2019-2020.

However, if all states introduce the levy, the CGC may instead treat the new levy as if it had been in place for all of the three years of historical data used by the CGC. The CGC used this approach in 2006 when the states agreed to abolish certain state taxes.⁷⁵

Figure 19: A broad based property tax would generate more stable revenues than other property taxes

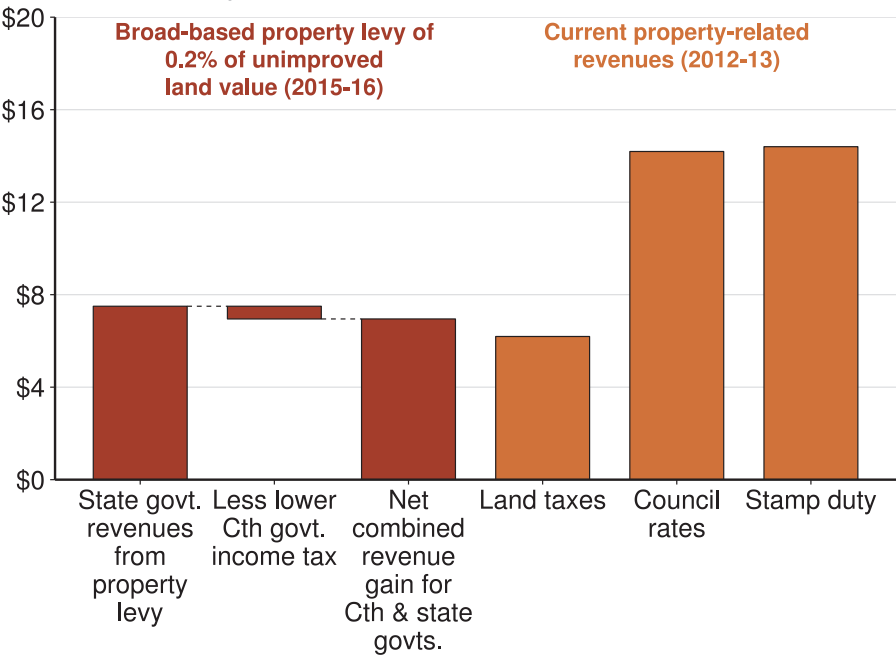
Standard deviation between annual revenue growth and long run average growth in Australia, (1990-91 to 2013-14), per cent



Notes: See page 394.
Source: ABS (Various years[c]); Grattan analysis.

Figure 20: A property-based levy could generate significant revenues from a modest rate

Forecast annual levy revenue and 2013-14 actual collections, billions

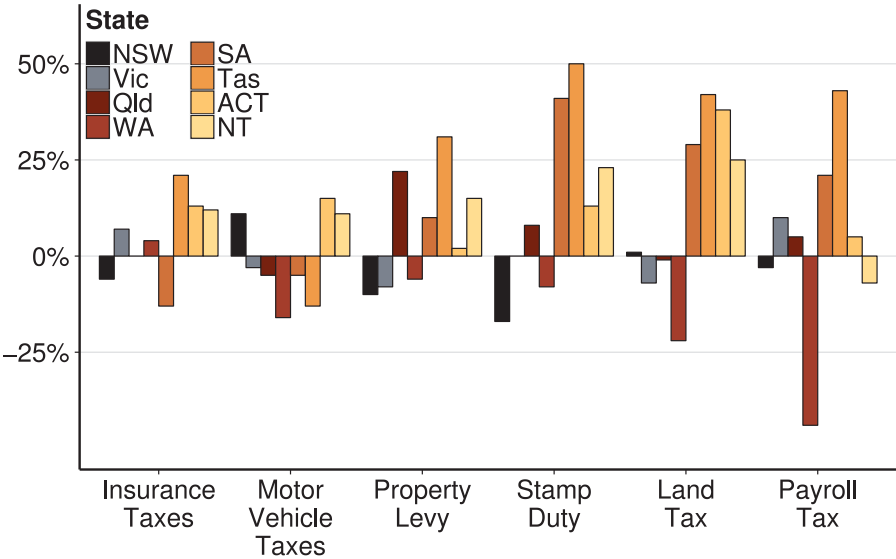


Notes: See page 394.

Source: ABS (2014d) and ABS (2014g); ATO (2014b).

Figure 21: A property levy generates less extreme GST redistribution than other major state taxes

GST redistribution as a percentage of revenue raised, 2015-16

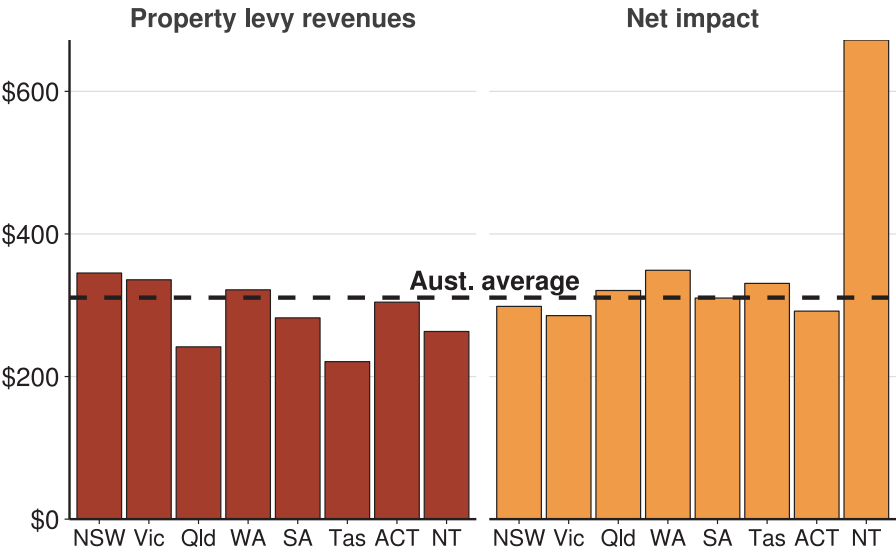


Notes: Assumes all states introduce the property levy; excludes any expenditure side impacts on GST revenues from states spending any extra revenues raised.

Source: Commonwealth Grants Commission (2015a); Grattan analysis.

Figure 22: A property levy would raise slightly more per person in NSW and Victoria, but CGC redistribution would lead to similar outcomes in all States

Simulated per capita annual property levy revenue, GST redistribution and net revenue impact, 2015-16



Notes: Assumes a levy of 0.2% applied uniformly to unimproved land values in each state and territory; levy is fully captured by the CGC’s methodology, and applied in 2015-16; states spend the revenues proportionate to their current expenditures; CGC assesses property levy revenues separately from state land taxes (if property levy revenues are incorporated into existing land tax assessment, this could have flow on impacts by altering the assessed land tax base).

Source: ABS (2014a), ABS (2014d) and Commonwealth Grants Commission (2015b); Grattan analysis.

4

Property taxes are relatively efficient

Property taxes – which are levied on the value of property holdings – are the most efficient taxes available to the states. Governments that want to increase the amount of revenue they raise will harm growth less with property taxes than with most other taxes. Unlike capital, property is immobile – it cannot shift offshore to avoid higher taxes. The risks of multinational tax avoidance, the increasing mobility of capital, and the increasing value of residential property relative to incomes, should make property taxes a priority in any tax reform.

4.1 Broad-based land taxes are the most efficient taxes

All taxes drag on economic growth. But some taxes do so less than others (Box 2 on the following page). Broad land taxes are the most economically efficient taxes because they do not discourage working or investing. Unlike capital or labour, the supply of land is fixed. Someone must use the land: it cannot be moved away.

Land taxes do not distort decisions about land use, provided they apply in a way that the landowner can't avoid.⁷⁶ For example, a constant rate land tax applied to the unimproved value of all land prevents landowners from reducing their liability to such a tax by changing how they use their land. An empty block of land would pay the same tax even after it was developed.

Broad-based land taxes are much more efficient than stamp duties (Box 2 on the next page). Given estimates of the inefficiency costs of stamp duties, abolishing stamp duties in all states and replacing them with a broad-based land tax could add \$9 billion a year to GDP.⁷⁷

Box 2: Taxes and economic growth

All taxes reduce growth because they distort decision making by households and firms.

Taxes influence household decisions about how much to save and spend, how many hours to work and what to invest in. Similarly, taxes affect the decisions of companies about how much and what to produce, how much labour and capital to employ and where to locate.

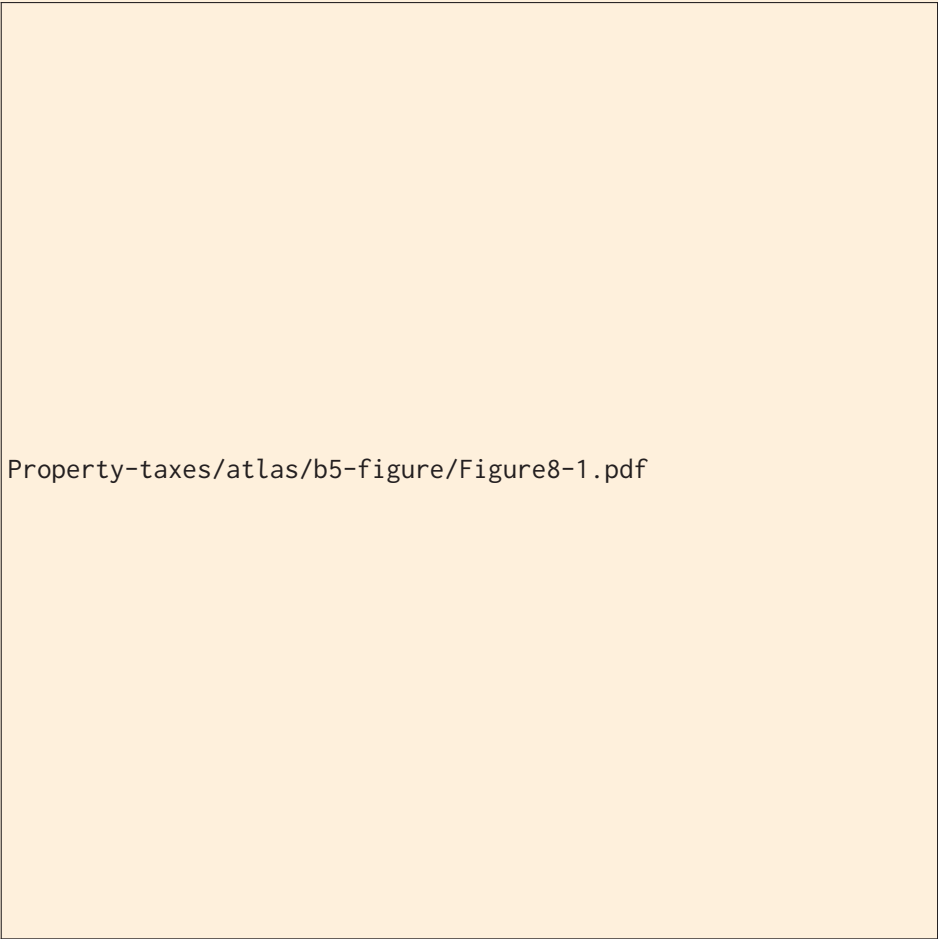
Welfare is reduced when people and firms make decisions different to the ones they would have made if taxes were not in place. This is measurable as a loss in economic output. Taxes also generate an administrative burden and encourage people to expend effort trying to avoid them. The diversion of resources to these unproductive activities reduces economic growth.

But some taxes drag on growth more than others. As a general rule, taxes on more mobile assets such as foreign financial capital are more likely to change behaviour and therefore harm growth compared to the taxation of less mobile assets such as land. Taxes on transactions, such as stamp duties, are particularly inefficient taxes. They distort the decision to buy and sell assets and so distort the optimal allocation of resources.

Economic models have been used to estimate the loss of efficiency from a range of taxes. Figure 23 on the facing page shows the estimated loss of economic activity, or marginal excess burden, from each dollar increase in each tax.

There are potentially sizeable gains to productivity and economic growth if governments shift some of the tax burden towards more efficient taxes.

Figure 23: Some taxes drag less on economic growth than others
Loss of economic activity



Property-taxes/atlas/b5-figure/Figure8-1.pdf

Notes: All marginal excess burden estimates are from KPMG Econotech (2011) other than council rates that come from the KPMG modelling for Treasury (2010). These estimates are broadly consistent with Treasury estimates which evaluated a smaller range of taxes Cao et al. (2015). This more recent work suggests that the economic burden of broad-based land taxes may be even lower, with a marginal excess burden of –10 c, since the revenue from foreign owners of land would exceed the economic costs imposed on Australian residents.

Land is typically valued in its unimproved state.⁷⁸ The unimproved value of a parcel of land does not include the value of improvements, such as the construction of buildings on it. Instead, it depends on the most valuable use of the land that would generate the highest return – as residential housing, farmland, an office tower, an industrial site, and so on – subject to the land uses permitted under planning laws.⁷⁹

Economic theory predicts that a tax on unimproved values – applied equally to all land – would result in land prices being lower than otherwise. Yet rents should remain constant as the land tax doesn't affect how land is used (see Section 7.1).⁸⁰

Land taxes can also capture some of the value created by public investment such as transport infrastructure. These gains are today taxed very lightly. Owner occupied housing is exempt from the two taxes that would capture some of the value of these gains: capital gains tax and land tax.

Property prices in major Australian cities have risen faster in suburbs closer to the CBD than in those located further out, which mainly reflects increases in the price of land, not what has been built on it.⁸¹ Faster growth in land values in inner-city locations in Australian cities reflect, in part, the value of public transport, government-funded schools, parks and other public amenities, as well as proximity to employment opportunities.⁸²

4.2 Property taxes at low rates are a little less efficient than taxes on land, but are still attractive

Although they are less efficient than land taxes, property taxes – which include the value of capital improvements such as buildings – are still very efficient taxes. An OECD report found that reducing income taxes by 1 per cent of GDP, and increasing taxes on immobile property (both land and buildings) by the same rate would improve long run GDP per head by 2.5 percentage points.⁸³

Property taxes are a little less efficient than land taxes because property taxes also tax the returns on capital invested to improve the property. This results in fewer improvements being made to land, such as fewer buildings, than would otherwise be the case. In the longer term, a portion of the property tax will be passed on to property users through higher rents for rental housing or for firms leasing premises, for example. The effect will flow on to other prices.

4.3 Economic costs are particularly small with low tax rates

Under the low property tax rate we propose, any economic costs are likely to be very small. The economic costs of a tax tend to be much lower for low tax rates.⁸⁴ On plausible assumptions, a property tax of 0.1 per cent of property value would tax the return on capital improvements at about 0.8 per cent.⁸⁵ To put this in context, a landlord doing capital improvements of \$100,000 would need to collect a mere \$8 extra a month in rent to recoup the costs of the tax.⁸⁶

Unlike many other forms of capital investment, which can move to avoid higher taxes, most existing capital improvements to land, such as buildings, cannot be moved. Therefore taxing improvements on land would be unlikely to affect the existing stock of capital improvements. Along with the low tax rate we propose, this means that the effect of a property tax on new capital invested would be modest, as Box 3 on the following page illustrates.

While there are no estimates from Australia, several overseas studies have found that property taxes have relatively low economic costs. A survey of US property taxes found that every dollar collected reduced economic output by just 6 to 16 cents. On these estimates, property taxes are efficient relative to other state taxes such as payroll tax and stamp duty, as Figure 23 on page 71 shows. Since taxes tend to be more efficient when levied at low rates, even these estimates overstate the economic costs of a proposed property tax of 0.1 per cent of property value – a tax rate 16 times smaller than those investigated in the US studies.⁸⁷

Box 3: A modest property tax has a similar impact on property development returns as a land tax

To understand how a property tax would affect returns on property development compared to a land tax, we consider a hypothetical investment.

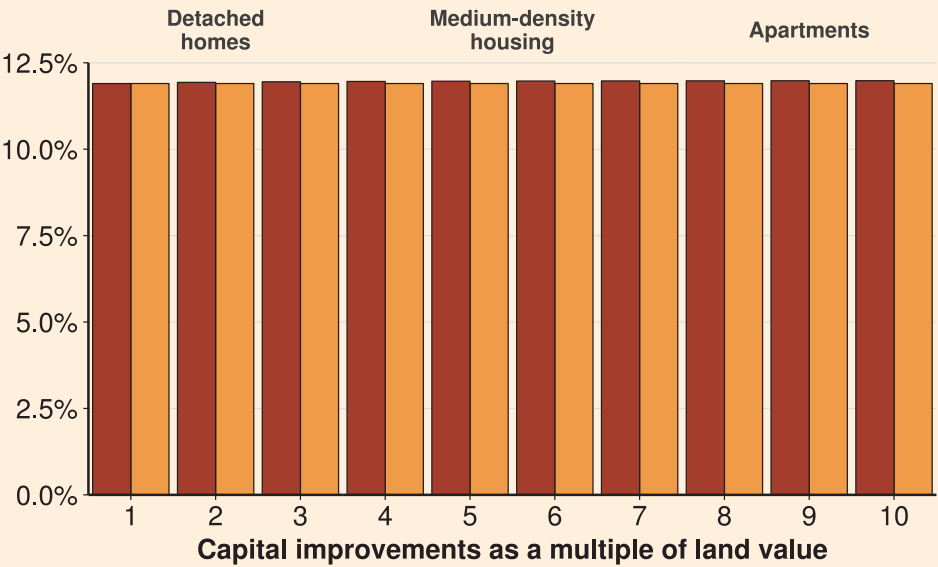
We compare a property tax of 0.1 per cent on improved value with a land tax of 0.2 per cent on unimproved value. These taxes would raise about the same revenue each year.

We consider an investor who buys land intending to develop it by investing in new capital improvements. We calculate the rate of return on the total investment given various levels of new capital improvement. Figure 24 on the facing page shows that returns are very similar under the alternative regimes, even in cases where improvements account for most of the property value after redevelopment.

The differences only become material at much higher rates of tax. For example, comparing a property tax rate of 1 per cent to a land tax rate of 2 per cent (both of which would raise about \$70 billion), the annual rate of return on new improvements worth twice the value of the land would be 0.3 percentage points lower. The difference in the rates of return would be greater – about 0.8 percentage points – for capital investment typical for apartments, where the building cost can be 10 times the land value.

Figure 24: A low rate tax on improvements has little impact on returns on the total investment

Annual rates of return after taxes on property for redeveloped property



Notes: Based on a property tax rate of 0.1 per cent, and a land tax rate of 0.2 per cent. Assumes a pre-tax rate of return on the total investment of 12 per cent.

Source: Grattan analysis.

5

Legislative basis for property tax reform

Additional property taxes should build upon existing tax bases. State and local governments already levy two types of property taxes: land tax and council rates.

All states and territories except the Northern Territory levy land taxes. They base the taxes on the value of the land without capital improvements such as buildings. Land taxes exempt owner-occupied housing and most agricultural land – more than half of all land by value (Figure 17 on page 59).

The other property tax base is the municipal rates levied by local councils, usually based on improved values. Because very few properties are exempt from this tax it is a much better base from which to charge a property levy.⁸⁸ Some States have already levied emergency services levies on this municipal rate base.

5.1 State land taxes are a compromised tax base

Existing state land taxes generate much less revenue than a broader-based land tax would. States raised \$6.4 billion from land taxes in 2013-14.⁸⁹ Exempting the family home from land tax excludes about 75 per cent of the value of residential land, and state government budgets forgo about \$5 billion in revenue.⁹⁰ Exemptions for agricultural land remove almost a further 10 per cent of land by value from the land tax base (Figure 17).⁹¹

States also apply substantial tax-free thresholds based on total landholdings before any tax is levied. These thresholds range from \$25,000 in Tasmania to \$600,000 in Queensland and further reduce state revenues from land taxes.⁹²

Land taxes are also levied on a progressive scale so that people with larger land holdings pay a higher rate of land tax per dollar value of land owned. Progressive rates reduce the efficiency of the ideal land taxes that were discussed in Section 4. They discourage larger landholdings and partly explain why small investors dominate Australia's rental housing market, with relatively few landlords owning a large number of properties.⁹³

For example, a small investor with a single investment property in Sydney built on land valued at \$750,000 pays land tax of \$5,508 in 2014. By comparison, a large investor owning ten such properties pays \$133,432 in land tax, or \$13,343 per property.⁹⁴

Land tax exemptions also make the system more difficult to administer and for landowners to comply with.⁹⁵ Tax-free thresholds and progressive rate structures provide landowners with incentives to break up their land holdings and adopt complex ownership structures in order to reduce their land tax payments. Time and resources spent by firms to manage more complex structures are a burden on productivity.⁹⁶ Tax authorities use grouping provisions to overcome incentives to fragment land holdings, but impose additional costs in administering them.

Exempting owner-occupied housing is also very regressive. The exemption for the family home benefits households in the top income quintile by almost \$2000, while households in the bottom income quintile benefit by just \$400.⁹⁷

State land taxes could be an efficient tax base provided that exemptions, thresholds and progressive tax rates were abolished. Yet extending the existing land tax base to cover owner-occupied residential property and agricultural land would be politically difficult, and is likely to be portrayed as favouring businesses at the expense of consumers.

Table 1: Approaches to valuing properties for council rates vary
Property value bases that can be used to set council rates in each state

State	Basis for council rates
NSW	Unimproved
QLD	Unimproved
VIC	Either unimproved or capital improved
WA	Capital improved
SA	Either unimproved or capital improved
TAS	Either unimproved or capital improved
NT	Unimproved
ACT	Unimproved

Notes: 'Unimproved' refers to a set of land valuations that capture the value of the land only. 'Capital improved' refers to valuations that capture the value of the land and significant capital improvements made to that land, such as buildings.

Source: Productivity Commission (2008), Mangioni and Warren (2014) and NSW Treasury (2014).

Similarly, removing tax free thresholds and shifting to a single flat land tax rate assessed at the property level would result in much lower tax liabilities for large landholders. Again, such a reform could well be portrayed as unfair: favouring a small number of wealthy landlords while increasing land tax liabilities for smaller landholders.

Municipal rates regimes vary across councils. Councils may levy a fixed charge, a variable rate based on property values, or a combination of the two. In some states, councils determine the tax base for rates by choosing between measures of unimproved or capital improved property values (Table 1).⁹⁸ Despite these differences, a state government levy added to council rates would be relatively simple to administer. In practice a government could set a state-wide rate, with the council rate as an additional charge that varies by council.

There are no constitutional barriers to states adopting the council rates base to raise revenues. Although councils set and often collect rates, they are ultimately levied under the authority of state government legislation.

Governments in Victoria, South Australia, Western Australia and the ACT already use the council rates base for state-wide property-based levies to fund fire and emergency services. These levies provide a template for reform. They are charged as a share of land or property values. The levy rates are set at the state level. In Victoria and Western Australia (but not South Australia), notices of liability are issued as part of council rates notices, and levies are collected by councils and passed on to state governments (Table 2). Over time a large state property levy might lead to centralised collection of both property levy and council rates through state revenue offices.

Table 2: Property-based emergency services levies are a template for property tax reform

Structure for state property-based emergency services levies

State	Property value used		Levy structure		Collection authority
	Land only	Land & building	Fixed charge	Variable rate	
Vic					Councils
WA rural					Councils
WA metro					Councils
SA					State govt.
ACT					State govt.

Notes: The ACT funds fire services via a levy based on unimproved property values for commercial property only, with a fixed charge for residential and rural land. The ACT also uses the average of unimproved land values over the past 3 years; WA sets minimum charges for the total levy collected on each property, which act as a de facto fixed charge for some ratepayers.

Source: Victoria (2014), SA (2015), Rates Act 2004 (ACT) and Western Australia (2015)

5.2 Council rates are a better taxation base than state land taxes

Local councils levy rates on the value of unimproved land, and in some states, on capital improved values. Rates are applied to all properties within a council area with few exemptions. There are no exemptions for owner-occupied housing or agricultural land and constant rates apply from the first dollar of property value with no

minimum threshold. The largest exemption from council rates is for some non-profit, non-government organisations such as charities, schools and public hospitals.⁹⁹

Council rates are levied at the same rate per dollar of land value of a property, regardless of the overall size of ratepayers' total property holdings, and so do not discriminate against large property investors.¹⁰⁰

6

Key design choices for a property levy

A modest levy on property values could generate significant revenues for states and territories, with less drag on economic activity than other available state taxes.

6.1 A flat rate levy on property values, with no fixed charge, is the simplest approach

The levy could be designed in a number of ways. A flat tax rate on property values would be the simplest. The levy would consist of a flat rate charged per dollar of property value, with no fixed charge per property. It would apply equally to all land, regardless of land use, and from the first dollar of property value with no minimum threshold. It would be assessed separately on each property owned, as currently occurs with council rates, using existing Valuer-General valuations.

A flat rate with no fixed charge would be more equitable than council rates and the existing state emergency services levies which both include a fixed or minimum charge. These reflect the fee-for-service implicit in charges for council services and emergency services. Yet these levies are inherently regressive as they fall more heavily on the less well off.¹⁰¹ A state property levy aimed at raising general revenue should have no fixed charge.

Recent Commonwealth and state tax reviews have considered levying land tax with higher tax rates for land with a higher value per square

metre.¹⁰² Yet the problems with progressive rates probably outweigh the benefits.

On the plus side, a progressive rate structure captures more of the spill-over benefits of public investments in infrastructure, such as transport infrastructure, parks, schools, and libraries that increase nearby property values. Higher taxes on vacant property in expensive inner-city locations might also speed development as higher property taxes increase holding costs.¹⁰³ A progressive tax rate would also be popular with politically powerful farming lobbies, since most farmland would be taxed at a low rate.

The progressive rate also reflects – albeit very approximately – the progressive nature of state stamp duties. If a property levy aims not only to raise additional revenue but to replace existing stamp duties, a progressive rate on the levy might provide less of a bonus to the owners of highly priced properties that currently incur high stamp duties when purchased.

However, a progressive rate property levy would still lead to different tax treatments for properties that at present incur the same stamp duty. For example, with tax calculated on the price of land per square metre, the owners of small inner city apartments would pay much more than they do under the replaced stamp duties. The owners of similarly priced outer suburban houses would pay much less.

To the extent that a property levy is a tax on wealth, a levy charged at a progressive rate would treat people with similar wealth differently.

An increasing marginal tax rate based on the value of land per square metre would make a property levy more complex to administer. It would require more accurate and reliable land valuations since higher levy rates would compound any errors in the land valuation process.

A progressive tax rate should only be applied to unimproved land values, as otherwise it would significantly discourage investing in improvements. However, a progressive rate compounds the administrative complexities of taxing unimproved values: unimproved values

are hardest to determine accurately where land values are highest, and hence the consequences of disputed valuations are worth more.

6.2 A levy rebate would reduce the burden on low wealth property holders, but would significantly reduce revenue

Providing an exemption, or rebate, for the first portion of property tax liability would make the levy more progressive with respect to household wealth.¹⁰⁴ Households with lower wealth tend to own lower value homes, so the rebate would reduce the average property tax rate applied to low wealth property owners.

However, such a rebate could easily halve the revenue raised from the levy. A \$500 rebate on a property levy applied to unimproved land values would mean that no landowner would pay the property levy on landholdings worth less than \$250,000. Such a rebate would exclude about half of all residential properties in NSW, even if property owners could only claim the rebate in respect of one property.¹⁰⁵

A rebate would also provide incentives for landowners to fragment holdings across different legal entities in order to make use of multiple rebates, as currently occurs with state land taxes.

6.3 The levy should be applied to land values, but a levy on capital improved property values is a good alternative

The property levy could be applied to only the unimproved value of land, or to the combined value of land and buildings. Although a tax on unimproved value is theoretically better, it increases implementation problems, and the practical impacts on investment of a levy on capital improved values would be small.

A levy on unimproved land values is preferable because it does not discourage investing in improvements. While many councils levy rates on capital improved values, state Valuer-Generals maintain comprehensive registers of unimproved land values to determine state land tax liabilities.¹⁰⁶ A levy on unimproved land values could be applied

universally, with the levy listed as a separate item on ratepayers' council rates notices.

A levy on unimproved values would also make it easier to use increased levies to replace stamp duties over time. Replacing stamp duties would require higher rates of tax – potentially about 0.4 per cent of unimproved values.

While it is less economically efficient, a levy based on property values is easier to administer and would be a good alternative. A tax on improved values would still be much more efficient than a stamp duty, and most other state taxes. Capital improved property values are easier to determine since market sales and rental data are more readily available. Effective property taxes require up-to-date, transparent and accurate property valuations. The recent shift towards capital improved values for council rates in some states reflects difficulties in determining the unimproved value of land, especially in dense urban areas where there are few, if any, market sales of unimproved land.¹⁰⁷

6.4 An annual charge is simpler than a capitalised charge collected on sale

Some have suggested capitalising the property tax for all landowners, and collecting the capitalised charge (potentially including accrued interest) only when the property is sold. This would mimic the political advantages of current stamp duties: they are paid less often, and only when the vendor is cashed up from a recent sale. Because the amount payable depends on how long the vendor has owned the property, a capitalised charge would reduce the problems of the current stamp duty regime, which discourages more frequent property turnover.

Yet this design has a number of problems. Above all, it would be complex to explain, and therefore unattractive to politicians.

A capitalised charge would also lead to significant increases in state gross debt as governments would collect promises of future payment rather than cash, unless interest was charged.

The approach also presents problems similar to those that arise with capital gains tax. Unless there is an interest charge on accrued tax then the property holder receives an interest free loan until the property is sold. The investor has large incentives not to sell, which locks people into holding properties – the precise problem that makes stamp duties so inefficient.

6.5 Levy deferral for pensioners: managing the impact for income-poor, asset-rich owner-occupiers

However, capitalising the charge may be a good option to manage the impact on the relatively small number of income-poor, asset-rich owner-occupiers.

A property levy would pose difficulties for people who are asset-rich but income-poor, especially retirees who have limited incomes but own their own home. Retirees who want to stay in their homes should be able to do so. Many are emotionally attached to them. They provide continued access to social networks, and leaving them often carries large financial and emotional costs.

One option is to provide concessions to property owners with low incomes. State governments typically provide rebates on council rates to pensioners and other concession cardholders.¹⁰⁸ Similar concessions also apply in those states that charge property-based fire services levies.

Yet exempting or providing concessions to asset-rich but cash-poor landowners would be unfair to younger taxpayers. It also ignores the substantial resources of some retirees. Concessions based on pension eligibility are already poorly targeted: many wealthier Australians receive the Age Pension. Of mature age households with a million dollars of net assets, about 80 per cent receive welfare benefits.¹⁰⁹

A fairer approach would be for state governments to allow asset-rich, income-poor households to defer paying the levy until they sell their property. Deferral arrangements are already available for seniors paying

council rates in South Australia, Western Australia and the ACT (Box 4 on the facing page).¹¹⁰

The amount could accrue as a debt against the property, with an appropriate caveat registered at the Land Title Office. Interest should be charged on the balance to reflect the cost of deferral. A safety net might be provided by a stipulation that the debt cannot account for more than 20 per cent of the value of the property, and would be non-recourse.¹¹¹ This would protect ratepayers from longevity risks – where individuals live longer than expected and the debt comes to exceed the value of the property as interest charges continue to compound over time.

In reality, very few retirees would use this safety net. At the tax rates proposed, 30 years of deferred levy and the accumulated interest would still only be 5 per cent of the property value.¹¹²

Yet the safety net could become more important if the levy rate were raised in future – to fund the abolition of stamp duty, for example.

Levy deferral schemes should be statewide since state governments would ultimately receive the revenues. A statewide scheme could also incorporate existing council rate deferral schemes and be extended to state-based emergency services levies.¹¹³

Box 4: The Postponement of Rates Scheme (SA)

The Postponement of Rates Scheme, operated by South Australian councils, allows retirees to postpone payment of council rates. Similar schemes operate in Western Australia and the ACT. The scheme is designed to help elderly ratepayers to finance their rates payments by unlocking the value of home equity. Such households may own their own homes and are therefore asset-rich, but on low incomes.

Eligible ratepayers can postpone a portion of the rates applied to their principal place of residence. Any rates after the first \$500 each year can be postponed. The scheme is only available to ratepayers that own their property alone, or with their spouse.

Ratepayers incur interest on the outstanding debt, which compounds monthly. The interest rate is set at the average borrowing costs for councils in that year, which was 6 per cent in 2013-14. Ratepayers receive an update on their postponed rates debt, and any accrued interest, as part of their rates notices each year. The accrued debt is payable when the property is sold or transferred to someone else and no surviving spouse remains living in the house.

To be eligible, a ratepayer must be over 60 years of age and work less than 20 hours a week in paid employment. Ratepayers must also have at least 50 per cent equity in their property after accounting for any outstanding mortgage debt if the mortgage was registered before 25 January 2007.

7

The levy would not impose unreasonable burdens

7.1 The levy would reduce property values, but would have little impact on rents

An increase in property taxes usually reduces property values, all else being equal, with little impact on rents. Potential buyers of property will reduce how much they are willing to pay by the future cost of property tax payments.¹¹⁴ Therefore the tax liability is capitalised into the property value. For example, a 0.2 per cent levy on unimproved land values would be expected to reduce land values by between 3 and 6 per cent.¹¹⁵

A levy on unimproved land values would have no impact on rents. If a landowner tried to pass on the tax by charging higher rents, some people would decide not to rent, thereby lowering rental demand and causing rents to fall back again.

A levy on capital improved property values might lead to small rent rises, since it would discourage some investment in new improvements and therefore affect the supply of housing. Over time, landlords are likely to pass on to renters some of the additional costs that the levy imposes on improvements. Yet as Figure 24 on page 75 shows, the impact on rents is likely to be small as the levy would have only a very small impact on the returns that accrue from investing in new improvements. For example, if a landlord sought to pass through the full cost of the levy after investing \$500,000 in developing improved land priced at \$500,000, it would increase the annual rent by 1 per cent,

or \$10 a week.¹¹⁶ In reality the impact would be smaller as only a small share of the levy would be passed through because new improvements are a small share of the total housing stock.

7.2 Costs for property owners would be manageable

A homeowner would pay a levy of \$772 a year on the median Sydney house valued at \$772,000, or \$560 a year on the median Melbourne home valued at \$560,000. The average levy burdens on households in other major Australian cities would be lower (since property prices are lower), and lower still in regional areas (Table 3 on the facing page).

The average burden of the levy on each property owner would be smaller than existing council rates for most owners (Figure 25 on the next page).¹¹⁷ Property holders with higher incomes would pay more in absolute terms than those with lower incomes. Those with higher incomes tend to own more valuable homes, and are more likely to own an investment property.

7.2.1 Impact on those worst off

The impact of revenue measures on the poorest households is a particular concern.¹¹⁸ While measures of inequality traditionally focus on income, material wellbeing depends upon both income and accumulated wealth. Assessing taxpayers' capacity to pay should consider the ability of households to draw on their net wealth, or generate income from their assets.¹¹⁹ This approach is especially important when considering wealth taxes such as a property levy. Consequently, the distribution of both wealth and income are relevant in assessing the impact of a property levy. A particular concern is the impact on households that are in the bottom 20 per cent of the income distribution and have low net worth.¹²⁰

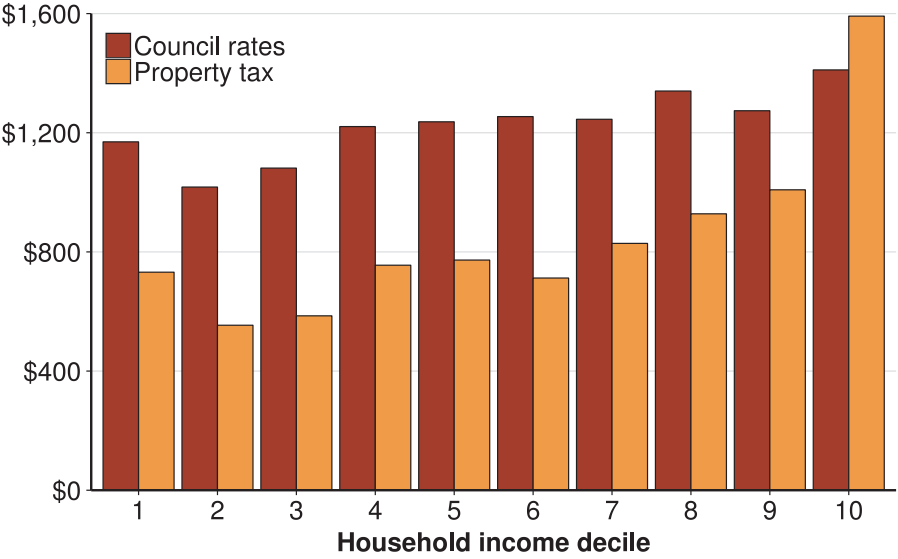
A property-based levy would fall largely on households with higher net worth, reflecting their greater property holdings (Figure 26 on page 96). Households that are both income and asset poor would, on average, pay almost no levy. By contrast, households ranked among the top 20 per cent by net worth – of at least \$640,000 – would pay an average

Table 3: Costs for property owners would be manageable
 Property levy payable on the average home by capital city, (2015-16 dollars)

City	Median dwelling price	Property levy per year
Sydney	\$772,200	\$772
Melbourne	\$560,000	\$560
Brisbane	\$455,000	\$455
Perth	\$510,000	\$510
Adelaide	\$405,000	\$405
Hobart	\$315,500	\$316
Darwin	\$515,000	\$515
Canberra	\$535,000	\$535

Notes: Based on a 0.1 per cent levy on capital improved property values, applied to the median prices of homes in major Australian cities, as at June 30, 2015.
 Source: RP Data Core Logic (2015); Grattan analysis.

Figure 25: The property levy would be less than council rates for most property owners
 Expected property taxes payable by income decile (2011-12 dollars)



Notes: See page 394.
 Source: ABS (2013b); Grattan analysis.

of \$1933 annually.¹²¹ About a quarter of all revenues raised by the levy would come from the 7.5 per cent of households that are in *both* the top disposable income quintile and top net worth quintile.

Within each wealth quintile, households with higher disposable incomes would pay a higher property levy. Yet given the nature of a property levy, liability depends more on wealth than income. Some households in the bottom 20 per cent of the income distribution but with significant net assets would pay a significant levy. For example, low-income households in the top 20 per cent of households by wealth would pay about \$1250 a year.¹²² This category includes a significant number of retirees.¹²³ The proposed levy deferral schemes would support such asset-rich, income-poor households by allowing them to use their property assets to finance the levy.

The impact of the levy on households with low net worth would be minimal (Figure 27 on page 97). For households in the lowest net worth decile, the average levy is equivalent to 0.03 per cent of their net worth, or just 30 cents for every \$1000 of net worth.

Households in the fourth and fifth net worth deciles would pay the highest percentage share of their household net worth through the levy. There are two reasons why.

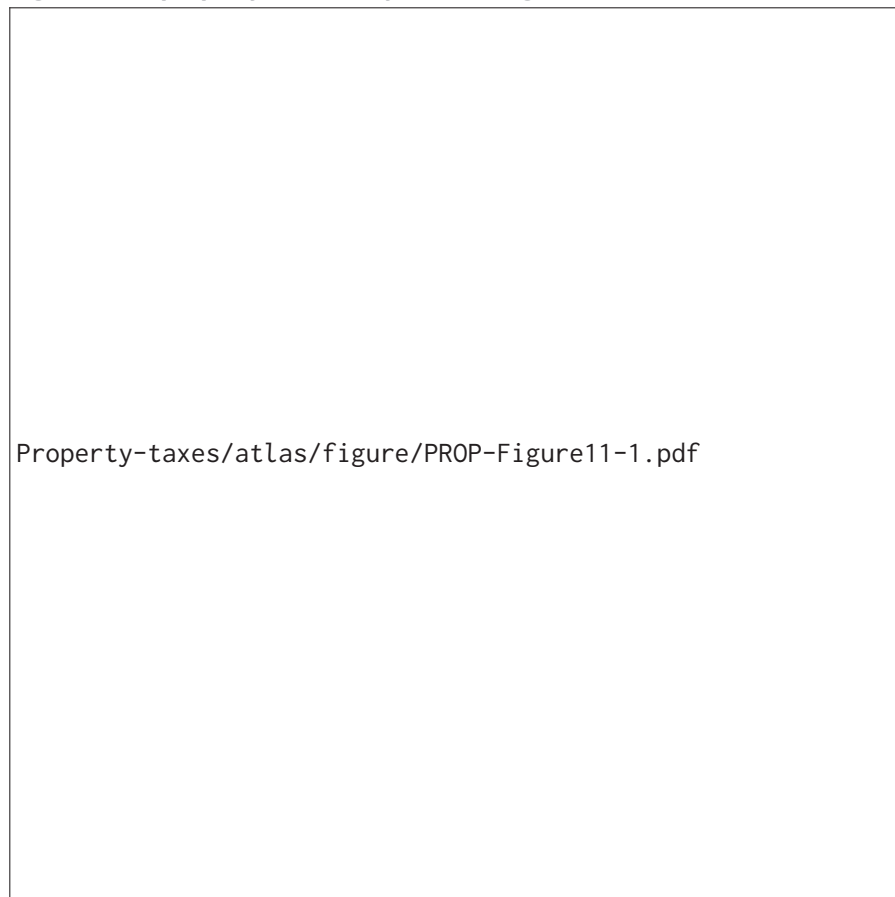
First, many of these middle-wealth households may be young homeowners who have recently purchased residential property. They are likely to have relatively high levels of *gross* property assets, on which the levy is calculated. Since these assets are financed largely by debt, these households would have comparatively low *net* worth, but large levy liabilities.

Second, while property holdings increase with household net worth, property tends to account for a lower share of net worth among the wealthy. Instead wealthier households tend to hold a greater share of their net worth in financial assets, such as equities, bonds and superannuation funds. Since the levy does not apply to these assets,

these wealthy households on average would incur lower levy charges as a share of their net worth.

Nevertheless, high net worth households may pay more than our analysis indicates. Well-off households are more likely to hold their residential property assets in trusts, or other legal entities. These would pay the levy, but cannot be captured by statistical analysis at the household level.

Figure 26: A property-based levy is well-targeted

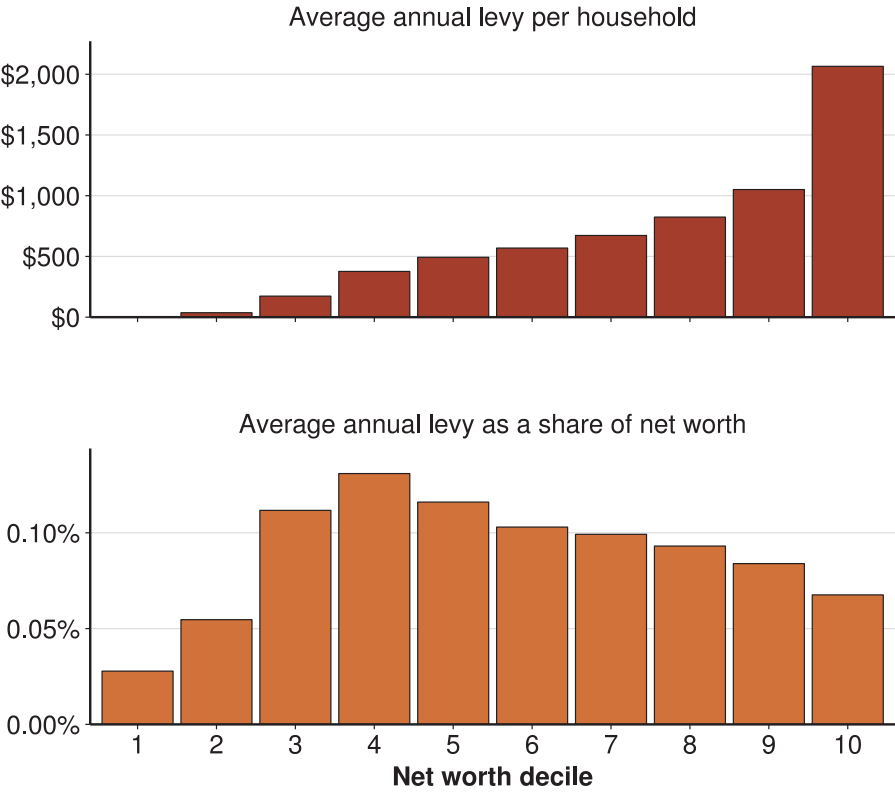


Property-taxes/atlas/figure/PROP-Figure11-1.pdf

Notes: 2011-12 dollars; Simulated impact of applying a 0.2 per cent levy to land values only; Households that have reported negative household disposable income and negative net wealth have been excluded from the analysis; quintiles are grouped by equivalised disposable (i.e. post tax) income and net worth of each household.

Source: ABS (2013b); Grattan analysis.

Figure 27: The burden would be lowest for low wealth households



A

State tax revenue growth and revenue volatility

Section 3.1 analyses trends in growth in revenues from major state taxes, and the volatility of those revenues for the period 1990-91 to 2013-14, for all states combined. The aggregate trends over this 25 year period were:

- State property taxes such as land tax and stamp duty grew faster than other state taxes;
- State property taxes revenues were more volatile than other state taxes;
- Our proposed broad-based property levy would have been less volatile than other property taxes, especially stamp duty.

However, trends in state tax revenues varied across states, and across different time periods. State-specific economic developments affected the growth in state tax bases, and the volatility of state tax revenue streams. Meanwhile explicit tax policy changes by state governments also affected revenues.

This appendix breaks down in more detail the trends in revenue growth and revenue volatility among major state taxes for the five largest states: New South Wales, Victoria, Queensland, Western Australia and South Australia. Trends in revenue growth and revenue volatility for each of these states are presented over three time periods: 1990-91 to 2013-14, 1990-91 to 1999-2000, and 2000-01 to 2013-14. Trends in revenue

growth and volatility for all states combined are also presented for two sub-periods: 1990-91 to 1999-2000; and 2000-2001 to 2013-14.

The trends in revenue growth and revenue volatility in individual states are generally consistent with the national averages. Compared to other property taxes, a broad based property levy would have produced faster growing, more stable revenues for most states, across most time periods.

However, there are some exceptions.

Over the period 2000-01 to 2013-14, stamp duty revenues grew slower than Gross State Product (GSP) in New South Wales, Queensland and Western Australia (Figure 30 on page 104). Weaker than average property markets in this period caused a significant fall in stamp duty revenue for these states over these periods, particularly during the Global Financial Crisis.

In New South Wales, the property market was particularly weak between 2002-03 and 2008-09, with a fall in the number of property transfers leading to lower revenues from stamp duties on conveyances.¹²⁴ The median price of houses transacted in Sydney grew by only 21.4 per cent over this period, while the total number of property transfers fell by more than 30 per cent.¹²⁵

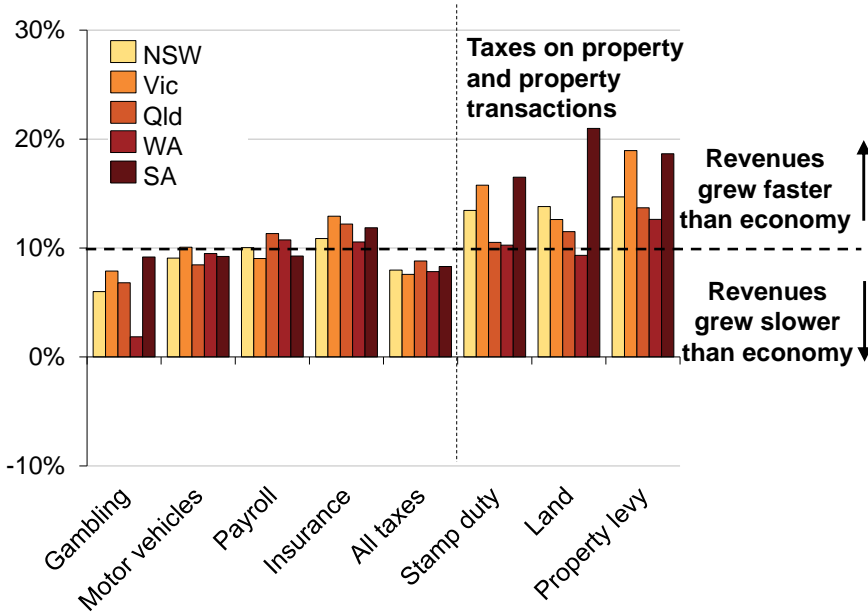
In Queensland, the state government lifted the exemption threshold on stamp duty for first-home buyers from \$320,000 to \$500,000 in 2008-09, eroding the tax base.¹²⁶ The Queensland property market also declined after the GFC. The median price of houses transacted in Brisbane fell by an average of 5 per cent between 2008 and 2012, whereas GSP increased by 23 per cent over the same period.

Queensland revenues from a broad-based property levy would have grown slower than GSP over the period 1990 to 1999. In this period, total land value increased by only 60 per cent, compared to the approximately 300 per cent increase in total land value over the period 2000 to 2013.¹²⁷

In Western Australia, stamp duties fell from 15.4 per cent of state revenues in 2005-06 to 10.6 per cent in 2008-09, due to a similar decline in the property market.¹²⁸ The median price of houses transacted in Perth fell by 10 per cent between 2008 and 2012, whereas GSP rose by 56 per cent over the same period. Moreover, the Western Australian State Government doubled the exemption threshold on stamp duties for first-home buyers in 2007-08, lifting the threshold for residential properties to \$500,000. In 2008-09, stamp duties for residential properties were also lowered, with a 15 per cent cut to stamp duty on a median price house.¹²⁹ This further eroded the tax base, where residential land value accounted for over 75 per cent of total land value in Western Australia.¹³⁰

Figure 28: Revenue from property taxes grew slower than many other taxes between 1990 and 2000

Percentage change in tax revenue for a 10 per cent increase in Gross State Product, 1990-91 to 1999-2000

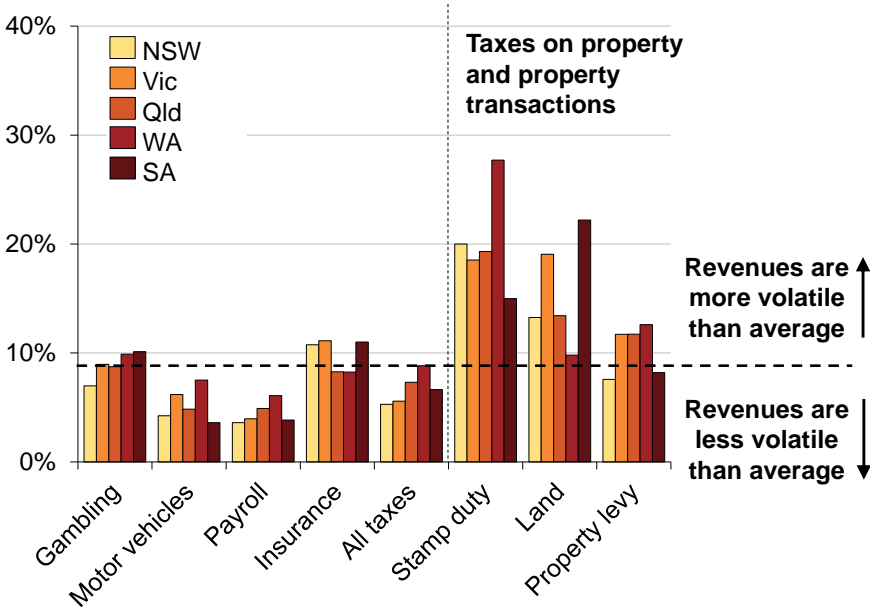


Notes: 'Property levy' shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place over the period.

Source: ABS (Various years[c]) and ABS (2014d); Grattan analysis.

Figure 29: Revenue from property taxes grew faster than many other taxes since 2000

Percentage change in tax revenue for a 10 per cent increase in Gross State Product, 2000-01 to 2013-14



Notes: 'Property levy' shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place over the period.

Figure 30: A broad-based property levy would have been less volatile than other property taxes, and many other taxes between 1990 and 2000

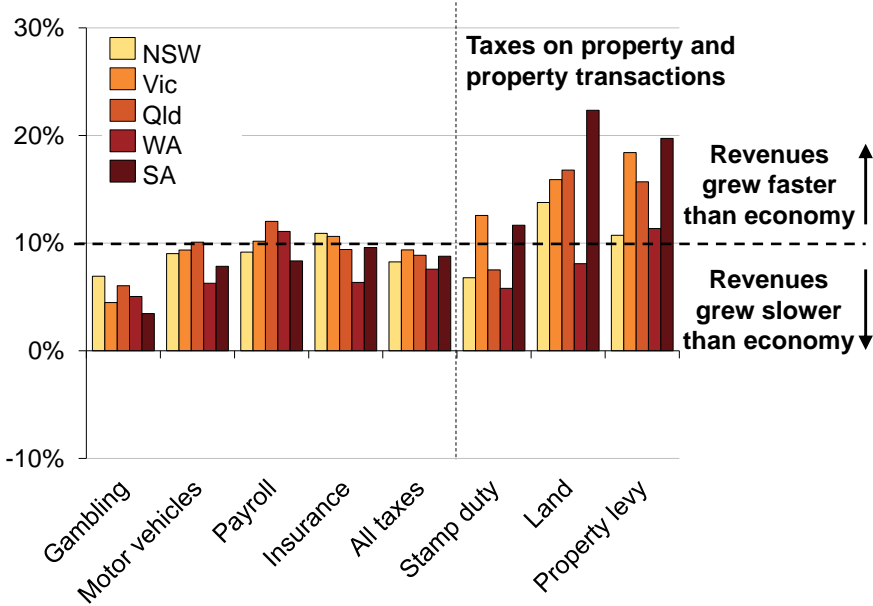
Standard deviation between annual revenue growth and long run average growth, 1990-91 to 1999-2000



Notes: 'Property levy' shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place over the period.

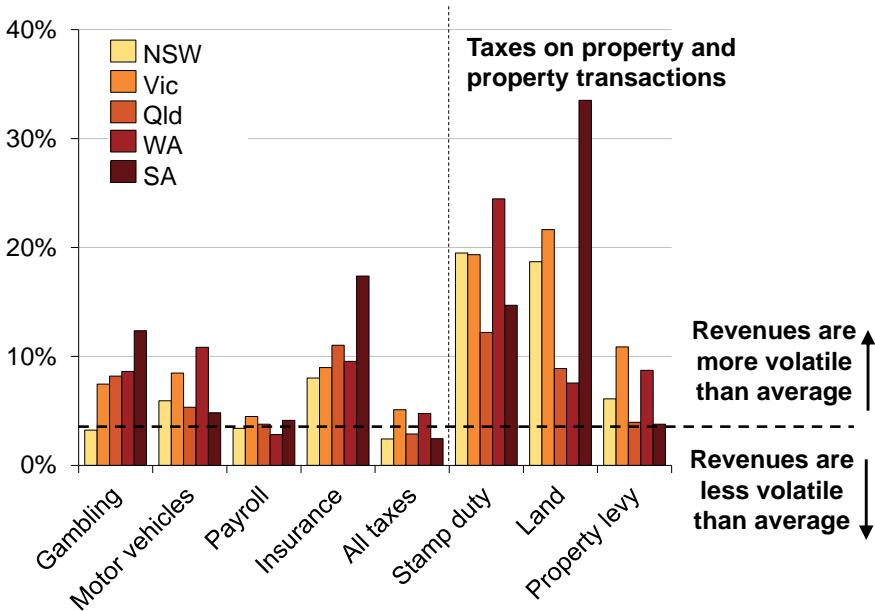
Figure 31: A broad-based property levy would have been less volatile than other property taxes, except in WA, since 2000

Standard deviation between annual revenue growth and long run average growth, 1990-91 to 1999-2000



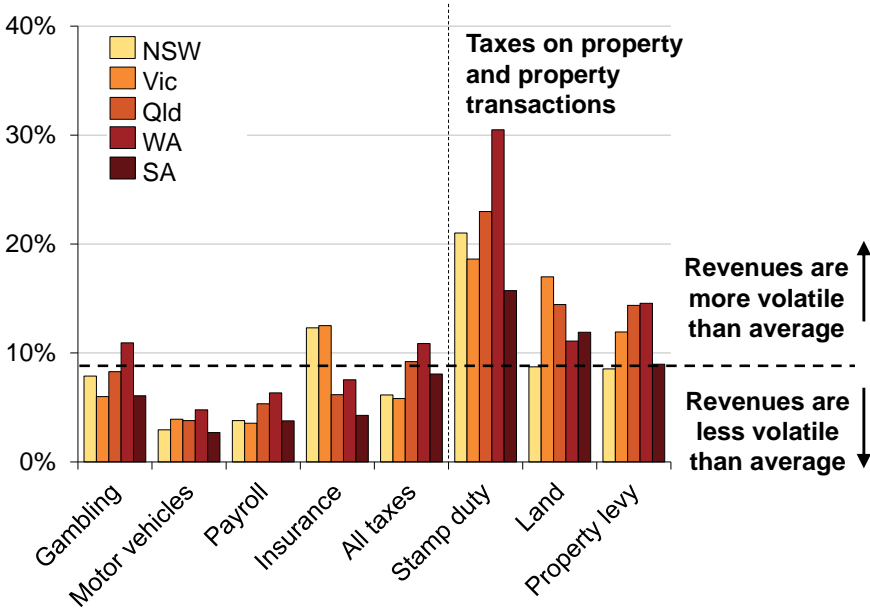
Notes: 'Property levy' shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place over the period.

Figure 32: Unlike most other taxes, a broad-based property levy would have grown faster than GDP between 1990 and 2000, and between 2000 and 2014
 Percentage change in tax revenue for a 10 per cent increase in national GDP, all states



Notes: ‘Property levy’ shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place over the period.

Figure 33: A broad-based property levy would have been less volatile than other property taxes between 1990 and 2000, and between 2000 and 2014
 Standard deviation between annual revenue growth and long run average growth, all states



Notes: 'Property levy' shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place over the period.

III

Super tax
targeting

Overview

Tax breaks for superannuation contributions and earnings should be targeted more tightly at their policy purpose. The current system is expensive and unfair.

Superannuation tax breaks mean that less tax is paid on super savings than is paid on other forms of income. These tax breaks should only be available when they serve a policy aim. Although the \$2 trillion superannuation system does not have legislated aims, most believe it should encourage savings to supplement or replace the Age Pension.

Yet superannuation tax breaks often go well beyond this purpose and their costs are unsustainable. The tax breaks reduce income tax collections by more than \$25 billion a year. More than half the benefits flow to the wealthiest 20 per cent of households who already have enough resources to fund their own retirement, and whose savings choices aren't affected much by tax rates.

Three reforms are needed to target superannuation better.

'Concessional contributions' made from pre-tax income should be limited to \$11,000 per year. Eighty per cent of contributions above this level come from the 20 per cent of taxpayers with the highest incomes, people likely to retire with enough assets to be ineligible for an Age Pension. This change would improve budget balances by \$3.5 billion a year. Other options, such as levying higher taxes on contributions made by higher income earners, would be less well targeted and more complex to administer. Replacing the annual cap with a lifetime cap

sounds attractive because it appears to allow people with broken work histories to catch up, but it would mainly turbocharge tax planning for wealthy older workers.

‘Non-concessional contributions’ made from post-tax income should be limited to \$250,000 over a lifetime. Of the \$33 billion in post-tax contributions each year, around half are made by just 200,000 people who already have at least \$500,000 in super.

Earnings in retirement – currently untaxed – should be taxed at 15 per cent, the same as superannuation earnings before retirement. More than half of the benefit of tax-free earnings in retirement goes to the wealthiest 20 per cent of retirees. For the top 10 per cent of over 60s drawing on super, the tax benefits are extremely generous – they pay no tax on their average super earnings of \$85,000 a year. A 15 per cent tax on all super earnings would improve budget balances by \$2.7 billion a year today, and much more in future.

The proposed reforms are fair. Low-income earners and younger people would pay less in other taxes if super tax breaks for the wealthy were wound back. Those already retired would pay some tax on their superannuation savings, but they would pay much less tax than wage earners on similar incomes. For a small proportion of women with higher incomes later in life, the changes would reduce their catch-up contributions. Yet the changes would reduce the tax breaks far more for a lot of rich old men.

The changes to contributions taxes would be prospective. The changes to earnings tax rates, like changes to income tax rates, would apply to future earnings of assets already acquired.

1

Introduction

1.1 We have a budget problem

Grattan Institute's 2013 report, *Budget Pressures on Australian Governments*, concluded that without structural reforms Australian governments could face a decade of deficits. Part I showed that this may have been optimistic.

The Commonwealth Government has run deficits for six years, largely due to a rapid increase in net spending on older households. The costs of repaying these deficits will fall primarily on younger households.

The next ten years are likely to be even more difficult. Falling terms of trade and lower nominal economic growth will drag on revenues at the same time the Commonwealth Government intends to fund substantial new policy initiatives.

The Commonwealth Government is yet to respond to the scale of its budget challenges. In office, both major political parties have hoped that bracket creep and favourable economic conditions would deliver a surplus. Hope is the key word: over the last six years, outcomes have consistently been worse than these projections. The latest short- and medium-term projections rely on optimistic assumptions about organic revenue growth and spending restraint. If any of them fail to materialise, the burden on younger generations will increase.

1.2 Previous Grattan work has identified pensions and superannuation policy as priorities for budget repair

Balancing budgets identified better targeting of pension and superannuation policies as being among the best opportunities to achieve budget repair.¹³¹

The key choices identified were increasing the age of access for the Age Pension and superannuation, limiting tax concessions for superannuation, and including owner-occupied housing in the Age Pension assets test. Although a government is unlikely to make all these choices simultaneously, we estimated in *Balancing budgets: Tough choices we need* that they could collectively improve the budget bottom line by an estimated \$27 billion a year.

Obviously these choices primarily affect older Australians in the short term. They emerged as high priorities because tax and welfare policies for older Australians are less well-targeted to those most in need than are other policies. Consequently it is easier to identify changes that deliver substantial improvements to the budget with relatively few side-effects. These choices will affect all Australians as they age, not just the current older generation.

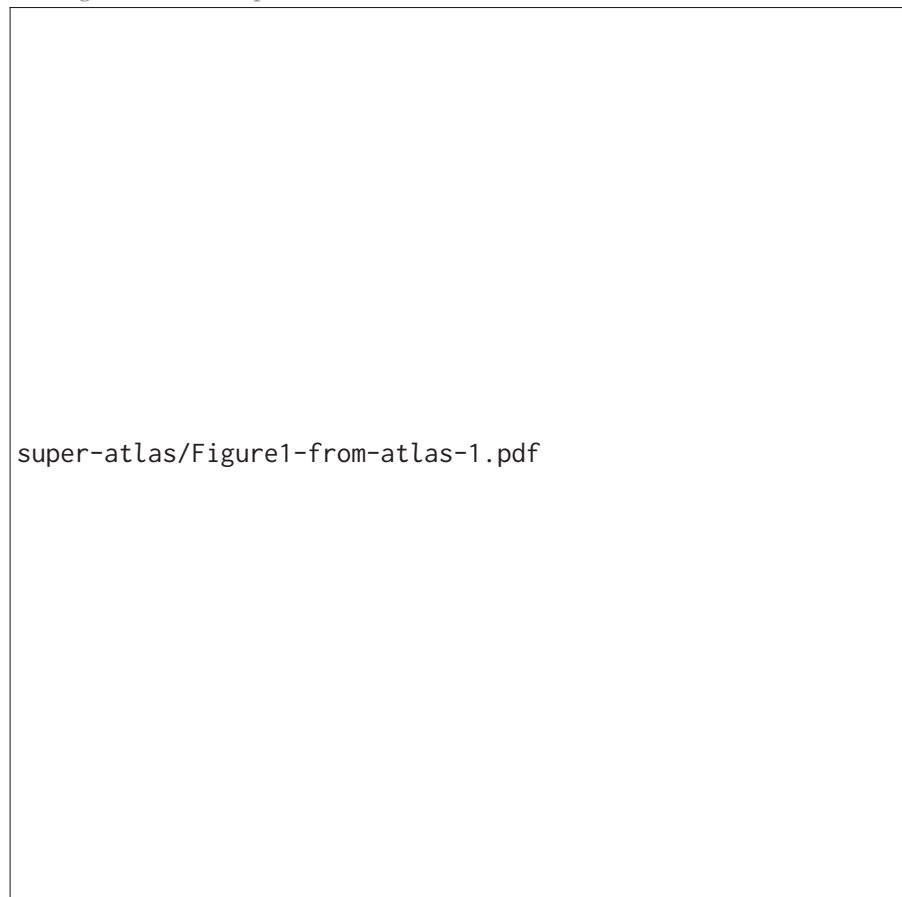
1.3 Older households are putting the most pressure on Australian budgets

Budget measures that affect older Australians may also be appropriate because older Australians are putting most pressure on government budgets. Grattan's 2014 report, *Budget Pressures on Australian Governments 2014*, showed how the largest spending increases over the last decade have been increased spending in health (where governments spend twice as much on each 60 year old as a 30 year old¹³²) and on the Age Pension. Both of these spending categories grew substantially faster than GDP, not because of the ageing population, but because of explicit and implicit choices to spend more per person of a given age.

Grattan Institute's report, *The wealth of generations*, argued that Australia's intergenerational fiscal bargain was coming under threat as

Figure 34: The generational bargain transfers substantial resources from younger to older households

Average net benefits per household, 1988-89 to 2009-10 (2010 dollars)



Notes: Based on the HES surveys of 1988-89, 1993-94, 1998-99, 2003-04 and 2009-10. Net benefits are social assistance benefits in cash, plus support in kind, minus income and sales taxes. Age is by age of household reference person.

Source: Figure 3.1 in The wealth of generations.

younger generations were being asked to do more than their fair share. Figure 34 on the previous page shows how Commonwealth and state governments combined spent \$9,400 more per household aged over 65 in 2010 than they did six years earlier, reflecting increases in the Age Pension and rising health spending per person.¹³³ At the same time, average income taxes paid by those aged 65 and over fell in real dollar terms, despite higher incomes, reflecting the decision by the former Howard Government to abolish taxes on superannuation withdrawals for over 60s and to increase the effective tax-free threshold to \$30,000 for retirees' earnings outside of superannuation. These budgetary decisions have been funded by deficits. The accumulating debt burden will disproportionately fall on younger households.¹³⁴

Transitioning to a fairer set of policies requires careful thought. Younger generations, on the wrong side of the drawbridge after the policies change, lose out when they pay for benefits for older generations that they do not receive themselves. If government reduces spending on health, pensions and superannuation tax breaks, then younger generations will be disadvantaged. Exempting older households from the costs of policy changes – such as by grandfathering existing benefits and tax breaks – simply magnifies the costs shifted onto younger generations.

1.4 Re-targeting superannuation tax breaks would help fix the budget, and restore the intergenerational bargain

This report shows how tax breaks for superannuation contributions and earnings should be targeted more tightly at their policy purpose. The current system is expensive and unfair. They are the largest and fastest growing leaks from our income tax system, reducing income tax collections by over \$25 billion a year.

Better targeting of tax breaks on superannuation contributions could save \$3.5 billion a year. Restoring taxes on superannuation fund earnings for those in retirement – as already applies for workers – could raise another \$2.7 billion a year today, and much more as more people retire.

Better targeting superannuation tax breaks would also reduce the transfers between today's younger taxpayers and older retirees. Taxes on super earnings in retirement, for example, would most affect those who have benefited from windfalls, government largesse and paying lower taxes while deficits accumulated.

Over the last decade, older households captured most of the growth in Australia's wealth. Despite the global financial crisis, households aged between 65 and 74 years today are \$400,000 (or 27 per cent) wealthier in real terms than households of that age were ten years ago. Meanwhile, the wealth of households aged 25 to 34 years fell by \$2,000 (or 4 per cent).¹³⁵

1.5 What this report does not do

This report focuses on what changes are needed to better align the tax treatment of superannuation with the overall objectives of our superannuation system, and to support budget repair.

This report does not advocate **wholesale restructuring of the tax treatment of retirement savings**.

Private retirement savings can be taxed at three points: on contributions; investment earnings; and withdrawals. Each stage in the life of an asset can be described as being either: fully taxed at marginal rates of personal income tax (τ); taxed more lightly than marginal rates (t); or exempt from tax (ϵ). Australia currently has a $t\epsilon\epsilon$ approach to taxing most super savings.

A number of commentators have highlighted the benefits of moving to an expenditure tax treatment of retirement savings. The two most common expenditure tax approaches, detailed in Appendix C, are:

1. **a post-paid expenditure tax (EET)** where contributions and earnings are tax-exempt, but withdrawals are taxed at a person's marginal tax rate; and

2. a **pre-paid expenditure tax (TEE)** where contributions are taxed at marginal rates of personal income tax, but earnings and benefits are tax-exempt.

While there are theoretical reasons to prefer an EET system over a TEE system – for example an EET system makes it simpler to tax retirement savings progressively – the costs of transitioning from a system such as Australia’s are prohibitive.¹³⁶ Either there would be large windfall losses for the generation affected by the transition, or government would need to put in place and maintain complex transitional arrangements (which impose dead-weight administrative costs) for decades. Shifting to an EET system would also lead to substantial short-term revenue shortfalls for Commonwealth governments.¹³⁷

The alternative, moving to a TEE system,¹³⁸ would impose the greatest costs on younger generations that would pay much higher taxes on their super contributions. A TEE system would also provide a windfall to older generations that contributed most of their superannuation savings at concessional rates under the current EET system. It would further undermine the intergenerational fiscal bargain already threatened by sharply reduced taxes and higher public spending for older Australians that has occurred over the past decade.¹³⁹

A common feature of expenditure tax approaches is that, unlike Australia’s superannuation system, they do not tax the earnings on savings. Taxing the earnings on savings reduces the incentives to save. This might be justified if it discourages economic activity less than alternative taxes. Taxes on savings may also be a means to a greater degree of redistribution of income and wealth. Obviously the degree of progressivity in the tax system is a value choice that is contested.¹⁴⁰

This report does not deal with **harmonising the tax treatment of different savings vehicles** in Australia. The different tax treatments lead to distortions in the allocation of savings. Aligning the tax treatment of savings income across different savings vehicles, as highlighted in the Henry Tax Review, is an important avenue for future reform. However, current budget pressures make it unlikely that the Commonwealth

Government will be prepared to collect less from more highly taxed savings vehicles in the near term.

Although investigating the variety of tax treatments for savings is beyond the scope of this report, on any view, superannuation is an outlier, treated much more generously and much less progressively than other savings vehicles (Figure 37 on page 133).

This report also does not advocate reforms to **other components of Australia's retirement income system**. Responding to the challenges and opportunities of an ageing population and longer life expectancy requires a holistic review of Australia's retirement incomes system. A comprehensive review of retirement incomes policy is beyond the scope of this report. As already noted, previous Grattan reports have identified other potential reforms to better target pensions and superannuation policy, such as better targeting access to the Age Pension, and aligning the preservation ages for super and the Age Pension. Future Grattan Institute reports will explore these reforms in greater detail.

1.6 The report shows how superannuation currently works, and how it should work

The following chapters describe in more detail how superannuation works and what its objectives should be. Later chapters consider how existing superannuation tax breaks do (and don't) serve the purposes of superannuation and assess options for reform.

Chapter 2 examines the **role and cost of superannuation tax breaks**. It considers how the overall objectives of the superannuation system have evolved and what the objectives should now be.

Chapter 3 examines the **distribution of superannuation tax breaks overall** and assesses how much superannuation people need to sustain a comfortable retirement.

Chapter 4 examines the tax breaks for **pre-tax contributions** to superannuation. These allow people to save into superannuation from their pre-tax income.

Chapter 5 examines **how much in total people can contribute** to superannuation, including from their post-tax income. The more that a person saves through superannuation, the less tax they pay on the earnings on savings.

Chapter 6 examines **how much tax is paid on superannuation earnings**. It focuses on provisions that result in no tax on super fund earnings in retirement.

2

The role and cost of superannuation tax breaks

Superannuation provides a number of tax breaks. Relative to saving outside of superannuation, less tax is paid on money saved into superannuation, and less tax is paid on the earnings.

The purposes of these tax breaks are contested because the broader purposes of superannuation are poorly defined. The best analysis is that the tax breaks aim to encourage savings that will supplement or replace the Age Pension.

Superannuation tax breaks provide additional incentives to save. They also recognise that superannuation compels people to save, and locks up voluntary contributions until retirement.

Some analyses suggest that superannuation tax breaks are needed because high-income earners paying income tax on the earnings of their savings would not have enough incentives to save. However, even taxpayers on the top marginal rate of income tax have reasonable incentives to save for more consumption tomorrow rather than to consume more today.

In any case, many people, particularly high-income earners, save in order to smooth lifetime incomes or to provide a legacy. Evidence from around the world, confirmed by our analysis of the Australian system, suggests that these taxpayers will tend to save about the same amount, irrespective of the taxes on earnings.

Whatever the benefits of superannuation tax breaks, they must be balanced against the costs – not least the budgetary costs, and the costs of other taxes being higher. Superannuation tax breaks cost a lot – over 10 per cent of income tax collections – and the cost is growing fast.

2.1 Superannuation savings are the least important pillar of Australia's retirement income system

Superannuation savings form part of Australia four-pillar retirement income system, which is made up of:¹⁴¹

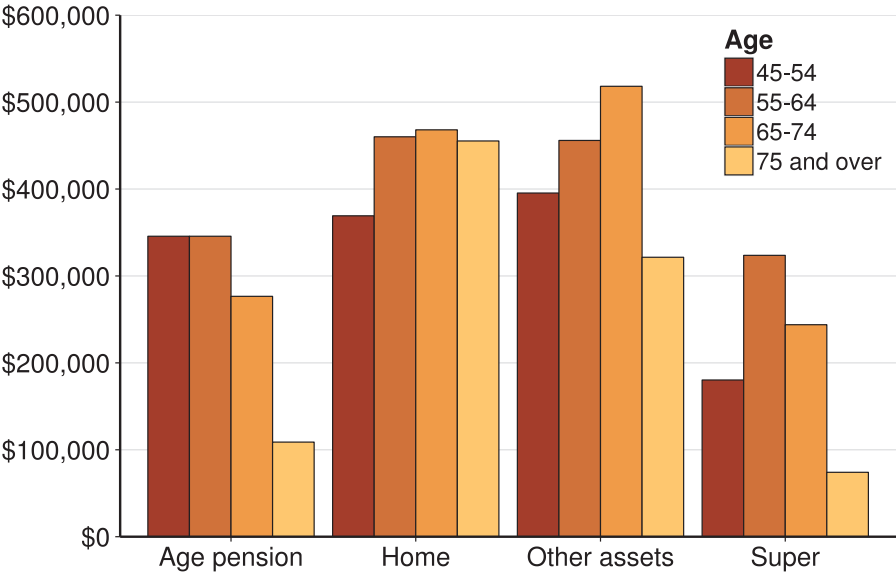
1. The **means-tested Age Pension**, provided by government, which guarantees a minimum 'safety net' level of income in retirement.
2. **Compulsory saving through the *Superannuation Guarantee***, currently set at 9.5 per cent of wages.
3. **Voluntary superannuation savings**, including voluntary pre-tax and post-tax super contributions.
4. **Other voluntary savings** that can contribute towards living standards in retirement, such as other financial assets, and especially housing and other property.

Australia's four-pillar retirement system is well regarded internationally. It spreads the responsibility and risk of providing retirement incomes in a fiscally sustainable way, and has helped Australia deal with the challenges of an ageing population.¹⁴²

Many commentators equate retirement savings with superannuation. But superannuation savings (pillars 2 and 3) are the least important part of Australia's retirement incomes system. While Australians save in a variety of ways, super is only 15 per cent of the wealth of most households (Figure 35 on the next page). And while homes are a large part of accumulated wealth, households of all ages, incomes and wealth typically have other investments that are greater than their superannuation assets.¹⁴³ For older households, assets other than super are often even larger than the value of homes.

Figure 35: Superannuation is the least important ‘pillar’ in Australia’s retirement incomes system

Mean wealth per household by type and age, (2013-14 dollars)



Notes: See page 394.

Source: Grattan analysis of ABS (2013b) and ABS (2015c).

These patterns partly reflect the immaturity of the superannuation system.¹⁴⁴ It will be another two decades before typical retirees have been contributing at least 9 per cent of their wages to super for their entire working lives. But even younger generations that have been paying the 9 per cent Superannuation Guarantee since they started work tend to save more outside superannuation.¹⁴⁵

As discussed in Section 3.2, the fact that Australians save for their retirement through vehicles outside of superannuation has important implications for the amount of superannuation people need for a comfortable retirement. In particular, it is unreasonable to expect superannuation savings alone to fund a comfortable living standard in retirement. Rather, most retired Australians draw on a range of assets to support their retirement – including housing and other investments outside of superannuation.

Nor will superannuation replace the Age Pension as the most important component of retirement incomes for the vast majority of retirees. The capital annuity value of the average Age Pension payments that households aged 65 years and over can expect to receive over their remaining lives is larger than the average superannuation savings of these households (Figure 35).¹⁴⁶ The present value of Age Pension payments that will be received by those aged 55 to 64 years and set to retire in the next few years is also larger than the average superannuation savings of these households.

2.2 Superannuation provides several tax breaks

There are two distinct phases in the tax treatment of superannuation with varying tax treatments for contributions, earnings and payouts, as shown in Figure 36 on the facing page.

Contributions to an individual's retirement savings are made to a nominated superannuation fund. Under the Superannuation Guarantee (SG), employers are required to contribute to the retirement savings of their employees by depositing a proportion of their wage (currently 9.5 per cent) into a nominated superannuation fund.¹⁴⁷ Employers

Figure 36: Tax settings differ across each phase on superannuation

	Accumulation	Benefits
Contributions	Under the Super Guarantee, employers must contribute 9.5% of a person's earnings to their super	Employers and employees can continue to contribute on same basis as in accumulation phase
Earnings	Individuals can make additional voluntary contributions	Individuals can only make voluntary contributions beyond age 64 if still in paid work
Withdrawals	Contributions (up to cap of \$30k or \$35k p.a.) are from pre-tax income and taxed at concessional rate of 15% in the fund	Funds continue to earn returns
	Further contributions can be made from post-tax income (up to cap of \$180k p.a.), and are not taxed again in the fund	Earnings are not taxed
	Superannuation funds are invested, earning returns	The super fund pays out from accumulated funds
	These earnings are taxed at 15% in the fund (10% for capital gains)	Payouts are not taxed from age 60
	Ordinarily, funds cannot be drawn until reaching preservation age (55 years)	
	Most payouts become tax-free from age 60	

are only required to make SG contributions on the first \$200,000 of employees' wages.¹⁴⁸ Some workers also receive a higher proportion of their wages in employer superannuation contributions, where this has been negotiated under a collective agreement.

These 'pre-tax' compulsory contributions are taxed at a flat rate of 15 per cent rather than a person's marginal income tax rate. Individuals can also make voluntary contributions by salary sacrificing some of their income, again taxed at 15 per cent. Individuals can also make voluntary contributions by salary sacrificing some of their income, again taxed at 15 per cent.¹⁴⁹

Individuals can also make 'post-tax' voluntary contributions to their superannuation fund, financed from post-tax income, up to the annual post-tax contributions cap of \$180,000. People aged over 65 can only make post-tax contributions if they are still working.¹⁵⁰ Low-income earners also benefit from a matching 50 per cent government co-contribution on the first \$1,000 of post-tax contributions they make each year.¹⁵¹ Since people have already paid tax on the income that finances these post-tax contributions, no further taxes are levied when they enter the super fund.

Earnings come from contributions, along with compounded earnings from previous years, which are invested by the superannuation fund. In the accumulation phase, earnings are taxed at a flat rate of 15 per cent (10 per cent for capital gains). The effective tax rate on superannuation fund earnings in the investment phase is typically lower – ranging from 7 to 10 per cent depending on the mix of fund investments – after taking into account dividend imputation credits for investments in Australian equities.¹⁵²

Once in the benefits phase and aged 60, any earnings on funds in a superannuation account are tax-free. The effective tax rate on superannuation fund earnings in the benefits phase is negative since funds pay no tax on earnings but receive full refunds on any unused dividend imputation credits.¹⁵³ The tax-free status of earnings for retirees dates back to the era when superannuation benefits withdrawn were taxable.

Exempting earnings for account-based pensions avoided the double taxation of benefits.¹⁵⁴ However, since tax on benefits was removed in 2007, this rationale for exempting earnings for retirees no longer applies.¹⁵⁵

Payouts from the accumulated savings in the superannuation fund begin in the benefits phase. Retirees can only start to withdraw their superannuation 'benefits' after reaching the preservation age, currently 55 years of age.¹⁵⁶ Benefits can be paid as either an income stream or as a lump sum. Either way, payouts from the account are tax-free from age 60.¹⁵⁷

2.3 The purposes of superannuation are becoming clearer

Despite assets of \$2 trillion,¹⁵⁸ annual administrative and management costs of \$21 billion,¹⁵⁹ and tax breaks on contributions and earnings costing \$25 billion in lost tax revenue each year, (see Section 2.8) the superannuation system does not have legislated aims.

It is widely agreed, however, that the system should promote retirement savings so that people enjoy a higher standard of living in retirement, while reducing government's future Age Pension liabilities, subject to the budgetary costs of doing so. The recent Financial System Inquiry recommended that the contemporary purpose of superannuation should be 'to provide income in retirement to substitute or supplement the Age Pension.'¹⁶⁰

Originally, the superannuation system was set up to achieve at least four objectives:¹⁶¹

1. increasing local savings so that Australia was less dependent on foreign capital for economic stability
2. increasing local savings that could be invested in infrastructure
3. encouraging people to save more while they are working so they more to spend in retirement
4. reducing future government liabilities for the Age Pension

The first of these aims – creating a pool of Australian capital for investment in Australia – is less relevant today. It was conceived in an era that was focused on the ‘twin deficits’ – current account and budget deficits – and the concern that Australia was over-reliant on overseas capital to fund its growth. With the increasing mobility of international capital, it is less clear that this is a real economic problem today. While Australian superannuation funds played a significant role in financing the de-leveraging of corporate Australia during the global financial crisis,¹⁶² the Financial System Inquiry argued that ‘funding economic activity is a consequence of a well-designed long-term savings vehicle that invests in the interests of its members, rather than an objective in itself’.¹⁶³

Similarly, it is not clear that greater superannuation balances are required to fund infrastructure. Only a small portion of the existing pool is invested in infrastructure.¹⁶⁴ There is no shortage of funds, from both local and overseas investors, for Australian infrastructure assets with proven cash flow.¹⁶⁵ Investors are relatively reluctant to support new infrastructure with uncertain returns.¹⁶⁶ However, this reflects the poor risk and return of these investments, illustrated by a number of high profile failures,¹⁶⁷ rather than any shortage of capital.

Instead the superannuation system today is primarily about *consumption smoothing* – maintaining a more consistent standard of living across people’s lives.¹⁶⁸ Superannuation encourages people to save while they are working so they have more to spend in retirement.¹⁶⁹ It is well established that people tend to focus disproportionately on the short term, leading many to save less for their retirement than is required to maintain relatively consistent consumption levels across a lifetime.¹⁷⁰ Although superannuation leads people to save less outside of superannuation than they would otherwise, it leads to higher *total* savings at retirement (including superannuation).¹⁷¹

Superannuation also requires governments to give up tax revenue today so that governments do not have to spend so much on the Age Pension in future. This encourages intergenerational equity since each generation

pays more of the costs of its own retirement, rather than imposing this burden on the next generation.

So overall, the superannuation system is designed to promote retirement savings so that people enjoy a higher standard of living in retirement, but with less support from government through the Age Pension, reducing the burden on future taxpayers.

However, superannuation does not and should not aim to provide limitless support for savings that increase retirement incomes. We would all like to be rich. But the benefits of higher retirement incomes must be balanced against the costs of achieving them.

Similarly, the superannuation system should not seek to replace the Age Pension entirely for all, or even most, retirees. The budgetary cost of doing so would be crippling. The tax breaks would cost the budget much more than the Age Pension. To ensure that a very large number of people didn't need an Age Pension, tax breaks would need to support *everyone* to save enough to support themselves in retirement beyond average life expectancy even if they don't live this long. Given targeting would not be perfect, there would be substantial tax breaks beyond those needed to replace the Age Pension for most people.

For this reason, the Financial System Inquiry recommended focusing superannuation on providing 'income in retirement to substitute or supplement the Age Pension.' Implicitly, superannuation should not aim to support the savings of those who already have such ample resources that they are not going to qualify for even a part Age Pension.¹⁷² And implicitly, superannuation should not provide limitless support to savings regardless of the costs to reduce Age Pension liabilities.

2.4 Superannuation tax breaks play several roles

Within this superannuation system, what are superannuation tax breaks supposed to do?

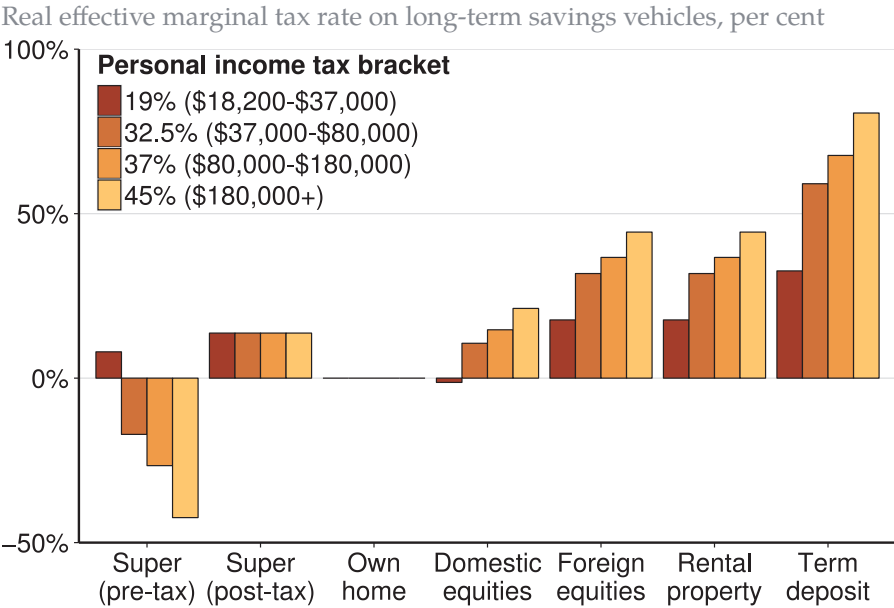
Superannuation tax breaks increase how much people have to spend in retirement from whatever they do save, by reducing the taxes paid on contributions and earnings.¹⁷³

Arguably, superannuation tax breaks also compensate people for being compelled to lock up their savings in superannuation until retirement,¹⁷⁴ although there is no logical way of calculating an appropriate amount of compensation for this or how it might be targeted.

The 'value' of this compensation is very unequally distributed, since high-income earners receive a large tax break (in terms of tax avoided) per dollar of compulsory superannuation contributions, whereas low-income earners receive no compensation. In future low-income earners (below the tax-free threshold) will be penalised for being compelled to save if the Low Income Superannuation Contribution – which refunds the tax paid on compulsory super contributions to those earning less than \$37,000 – is abolished from 2017-18 as currently legislated. Ironically the current system provides the least benefits through tax breaks for compulsory savings to low income earners, even though this group tends to have the greatest preference for immediate consumption rather than saving.¹⁷⁵

Superannuation tax breaks are also supposed to encourage additional savings, over and above compulsory contributions. The income used to finance superannuation contributions is taxed less, and the earnings on superannuation fund balances are taxed less than other forms of savings, so that the real after-tax returns are better, for a given pre-tax return, than can be achieved through other forms of savings, as shown in Figure 37.¹⁷⁶ Most taxpayers who contribute to superannuation from their earnings before tax have more to spend in retirement than if they had saved their wages after tax, but paid no tax on the returns to their savings. Those that put money into super from pre-tax income just before retirement receive an even larger benefit since they avoid income tax on the money saved, and then benefit from tax-free super earnings and withdrawals once they retire.

Figure 37: Tax rates on earnings from savings through superannuation are lower than other savings vehicles



Notes: See page 394.
Source: Treasury (2010) and Wakefield (2009, p. 9) and Grattan analysis.

2.5 Taxes reduce the incentives to save; super tax breaks dampen this effect

So what is the rationale for tax incentives to save more through superannuation?

When individuals earn income they face a choice between spending it right away, or saving to fund spending, or 'consumption', in the future. In theory, rational taxpayers look at how much real earnings on savings will increase their future power to consume. They discount the value of future consumption by applying what economists call a 'discount rate', which is a measure of how much they prefer consuming something today rather than tomorrow.

Taxes on the income from savings reduce the incentives to save.¹⁷⁷ By taxing the returns to saving, income taxes make future consumption more 'expensive', since people will have less than otherwise to consume in the future if they save a dollar today. By definition, taxes on savings lead to consumption choices that differ from the choices people would prefer to make in the absence of taxation.¹⁷⁸ Taxes on savings also reduce the incentives to work today in part to save for the future.¹⁷⁹

Some commentators have argued that broad superannuation tax breaks are a worthwhile step towards lower taxes on earnings on savings in general.¹⁸⁰ They argue that all savings income should be tax-exempt to avoid any bias against savings.¹⁸¹ This argument is sometimes buttressed by claims about tax rates on savings that sound extremely high. While these grab headlines, they calculate tax rates on savings in artificial ways that are very different from the way that effective tax rates are typically calculated.

Australia's personal income tax system already taxes most returns from long-term savings at a lower rate than other income, or exempts them, consistent with an expenditure tax approach (Appendix C).¹⁸² Around 60 per cent of household savings is concentrated in owner-occupied housing and superannuation, where the returns to savings are taxed lightly, or not at all.

However, it is not obvious that it is bad to tax the earnings from savings. The UK's Mirrlees tax review concluded that to avoid bias against savings, only the risk free component of investment returns – the 'return to waiting' – should be untaxed.¹⁸³ Other recent analyses have concluded that even the risk-free return to savings should be taxed, albeit at a lower tax rate than other income.¹⁸⁴ Alternatively, it can be argued that all earnings from savings should be taxed at marginal rates of income tax because savings tend to lead to concentrations of wealth even more unequal than the distribution of income.¹⁸⁵

Even if income taxes on savings were unreasonably high, tax breaks specific to superannuation would be a poor solution to the problem. As the progressivity of the tax system is a basic value choice, changes to the level of progressivity should be made as transparent as possible. The complexity of superannuation tax breaks conceals how they effectively reduce tax rates for a limited set of taxpayers. Such complexity increases the opportunity for well-resourced vested interests to benefit at the cost of the public interest.¹⁸⁶

2.6 Savings outcomes are not affected much by tax rates or incentives

There is a more fundamental problem with claims that taxes on earnings discourage savings and drag on economic growth. Taxes on savings have limited influence on how much people actually choose to save, particularly people with high incomes. Savings behaviour isn't just determined by the rate of return to savings after tax. Actual savings are influenced by many factors including:

1. how much *earnings* on savings increase the amount they have to spend (which is influenced by taxes on earnings)
2. their life circumstances
3. the desire to smooth spending over the life span
4. the desire to leave a legacy

Tax incentives for saving – such as the superannuation tax breaks – only affect the first of these drivers. In practice, life circumstances and lifetime consumption smoothing often play a much larger role in savings decisions. High-income earners often want to maintain a lifestyle in retirement similar to that enjoyed while working. Typically this requires much more income than the Age Pension would provide. They are prepared to pay whatever tax is imposed to ensure a high standard of living in retirement. By contrast, those on lower incomes tend to value immediate consumption more than those on higher incomes.¹⁸⁷

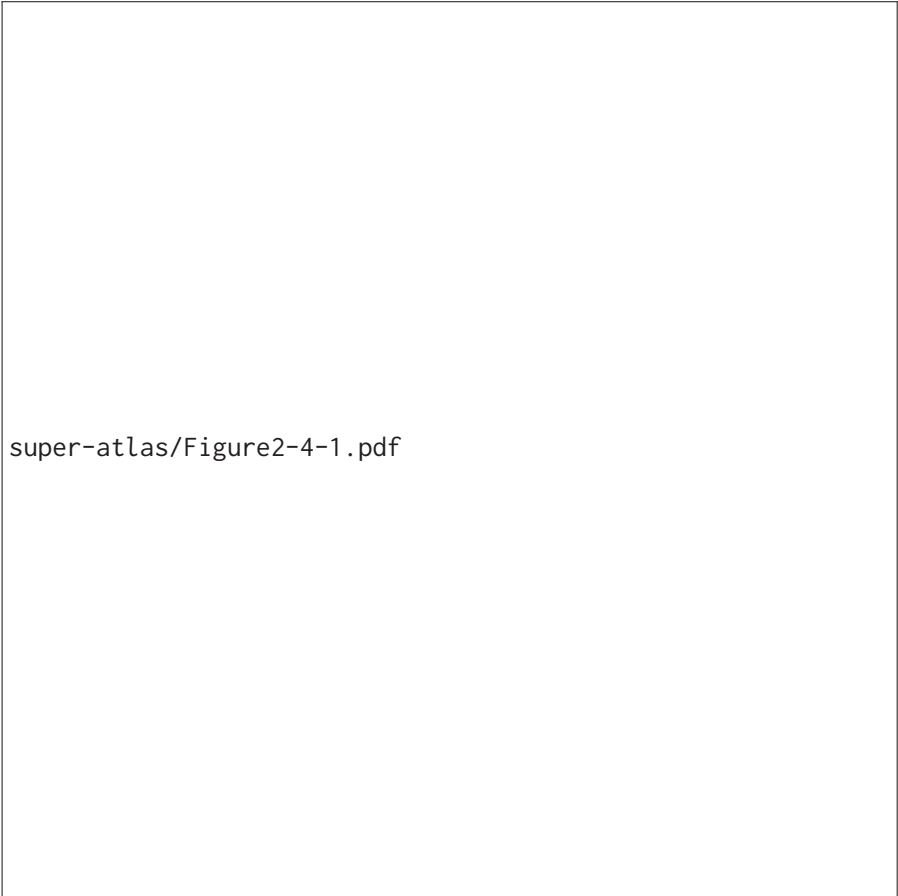
The empirical evidence from around the world confirms that those on higher incomes are more likely to save, and they tend to save about the same amount irrespective of tax rates. Most studies have found that tax incentives for retirement savings have little effect on the total amount saved, as summarised in Figure 38 on the next page.

However, those with higher incomes, and older savers, tend to switch their savings into whichever investment vehicle pays the least tax. Engen and Gale (2000), Attanasio et al. (2004), and Benjamin (2003) all find that tax-advantaged retirement savings accounts have generated limited new savings in the US, with most contributions ‘reshuffled’ from other savings vehicles.¹⁸⁸ Ayuso et al. (2007) find a similar effect for tax-favoured retirement plans in Spain.

Tax breaks for savings are more likely to generate additional savings for those on low and middle incomes.¹⁸⁹ People in those income categories tend to value future consumption less (that is, they apply higher discount rates),¹⁹⁰ the Age Pension is not so much lower than their current consumption, and savings can materially reduce their future entitlements to an Age Pension.¹⁹¹

In contrast, studies suggest that people on higher incomes, and those close to retirement, Ayuso et al. (ibid.) tend to use tax-advantaged savings programs to reduce the tax paid on money they would save anyway. A detailed study from Denmark showed that reduced subsidies for retirement savings for high-income earners led to almost no reduction in their overall savings efforts.¹⁹²

Figure 38: Tax-preferred treatment of voluntary retirement savings encourage relatively little new savings
Percentage of new savings in tax-favoured retirement accounts, by study



Notes: Additional savings is new savings from reduced consumption and/or increased labour effort. Of course, if taxes on savings are lower, the ultimate value of those savings will be higher. For Venti we report the mid-point estimate for new savings across a number of studies. For others, we report the maximum estimate for new savings.
Source: Poterba et al. (1996) for Venti; Engen and Gale (2000), Benjamin (2003), Attanasio et al. (2004), Ayuso et al. (2007) and Chetty et al. (2014)

In Australia, there is only weak evidence that superannuation tax breaks lead to increases in voluntary retirement savings. One recent study concluded that ‘current tax incentives have a limited effect, if any, on the decision to make salary sacrifice arrangements.’¹⁹³ Only about 10 per cent of employees make salary-sacrificed contributions from pre-tax income.¹⁹⁴ Tax breaks on superannuation fund earnings may be a strong motivation for those making voluntary post-tax contributions, but many of these contributions appear to reflect tax minimisation strategies rather than additional retirement savings, as noted in Section 5.1. The voluntary flow of savings into superannuation does not necessarily mean people are saving more; it merely implies that people are choosing to save in the vehicle that pays the least tax.

Superannuation has supported higher savings overall, but mostly thanks to compulsory contributions rather than tax incentives to save.¹⁹⁵ A recent Reserve Bank of Australia study found that each dollar of compulsory superannuation savings added between 70 and 90 cents to total household wealth.¹⁹⁶ At the national level, Gruen and Soding (2011) estimate that compulsory superannuation has already boosted private national saving by around 1.5 per cent of GDP, and is expected to rise as the Super Guarantee rises gradually to 12 per cent. And compulsory superannuation savings – unlike the tax concessions – also prompt some individuals to make further voluntary contributions.¹⁹⁷

These findings suggest that any tax breaks on savings should be targeted towards low- and middle-income earners, where they will have the most impact on voluntary retirement savings relative to the budgetary cost. Unfortunately, Australia’s current system does the opposite, offering tax breaks on savings that provide the most benefit to high-income earners and are little-used by low- and middle-income earners.

2.7 The benefits of super tax breaks must be balanced against the costs

Thus the welfare and efficiency losses from taxes on savings must be balanced against the alternatives. All taxes reduce someone’s welfare – they distort decisions away from what people would otherwise prefer.

Most taxes also reduce efficiency – they reduce the total amount of economic activity. Those seeking to justify super tax breaks need to show that they provide larger benefits in economic efficiency and welfare than the cost of additional taxes elsewhere to make up the shortfall.

Arguably, the fact that people tend to save almost the same amount irrespective of the tax rate on savings means that savings should be taxed more.¹⁹⁸ From an economic perspective, taxes are generally considered to be more efficient if they affect behaviour less in practice than other taxes.

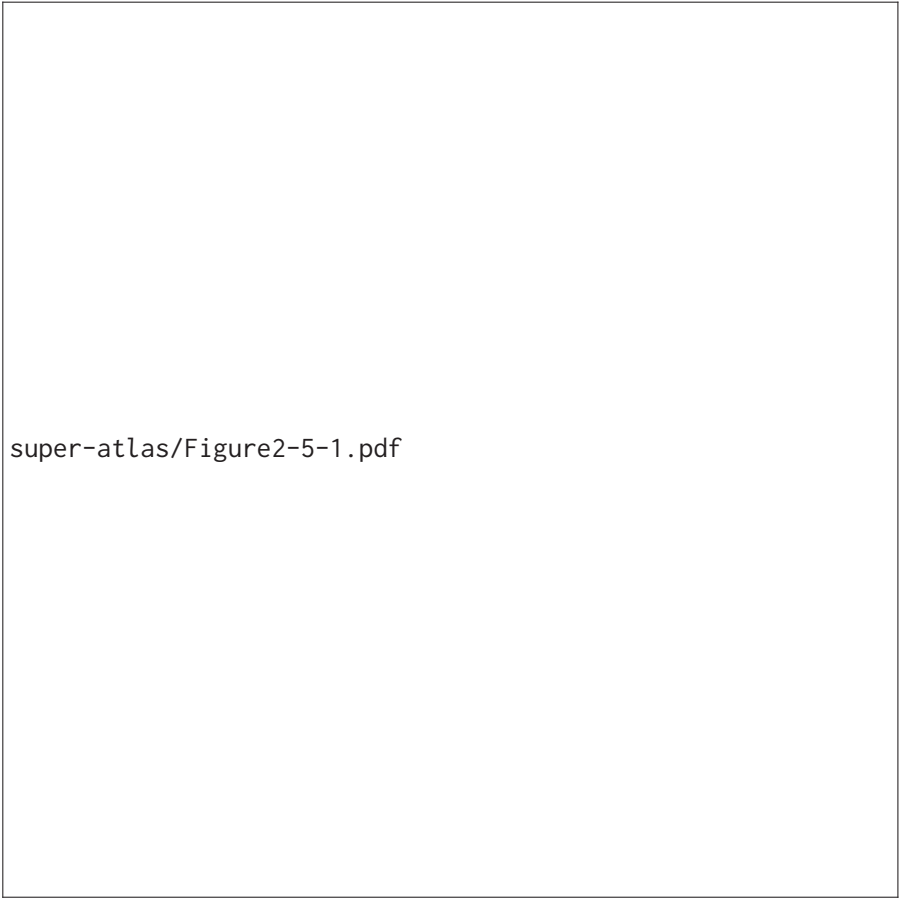
2.8 Current superannuation tax breaks are costly

Superannuation tax breaks are a large and growing cost to the budget bottom line, and other taxes must be higher than otherwise to compensate. The annual revenue lost in superannuation tax breaks – after accounting for potential behaviour change and the interaction between contributions and earnings tax breaks – is over \$25 billion.¹⁹⁹ This is well more than 10 per cent of personal income tax collections, which raised around \$177 billion in 2014-15.²⁰⁰

The leakage from the personal income tax base will increase, because the costs of superannuation tax breaks are growing much faster than the economy and tax collections. In 2015-16 superannuation tax breaks will cost almost \$30 billion in foregone revenue, rising to close to \$40 billion by 2017-18.²⁰¹

The cost of contributions tax breaks is expected to continue to grow a little faster than nominal GDP, at 4 per cent per year, rising to **\$18.1 billion** in 2017-18 (Figure 39 on the following page).²⁰² This reflects both wages growth, population increase, and the fact that 60 to 69 year olds, who tend to make larger voluntary pre-tax contributions to superannuation (Figure 69 on page 227), will make up an increasing share of the population.

Figure 39: Superannuation tax breaks are set to increase rapidly
Revenue cost of superannuation tax breaks (2014-15 dollars)



Notes: See page 395.
Source: Treasury (Various years).

Tax breaks on earnings are expected to grow much faster at 23 per cent per year, rising to **\$22.5 billion** in 2017-18. Inherently earnings (and therefore tax breaks on earnings) tend to grow in line with the pool of superannuation assets – driven by new contributions, earnings on balances, less withdrawals. Total superannuation assets have more than doubled in the last 8 years.²⁰³ In addition, the revenue from taxes and the cost of tax breaks on fund earnings are expected to grow faster than the pool of assets as superannuation funds use up tax losses accumulated during the global financial crisis and carried forward. Tax breaks on earnings are also expected to grow faster than the pool of assets as a greater proportion of the pool comes to be held by those over 60 in pension phase, who pay no tax on superannuation earnings.²⁰⁴

These trends are likely to continue into the future. In addition, the government is planning to raise the Super Guarantee contribution rate to 12 per cent between 2021 and 2026. This will further increase the costs of tax breaks to the budget as the level of funds channelled into the superannuation system rises.²⁰⁵

There has been extensive commentary about how changes to the tax breaks will have less budgetary impact than the tax expenditure estimates suggest.²⁰⁶ However, Treasury's 'revenue gain' tax expenditure estimates cited in this report already account for behavioural change, whereby some people would put less into superannuation and more into other vehicles where they pay less tax than their marginal rate of income tax.

In any case, behavioural change does not make much difference, particularly for contributions tax breaks.²⁰⁷ Alternative savings vehicles are much less generous than superannuation. Unlike other savings vehicles, superannuation allows saving from pre-tax income (less 15 per cent), and imposes much lower tax rates (see Figure 37).

Some commentators argue that an income tax benchmark is not appropriate for measuring savings tax breaks.²⁰⁸ They prefer the 'pre-paid' expenditure tax benchmark, where earnings and benefits are untaxed but contributions are fully taxed at marginal tax rates (Appendix C).

Box 5: Measuring the value and cost of super tax breaks

Superannuation tax breaks mean that less tax is paid on money saved into superannuation, and less tax is paid on the earnings, compared to if that money was saved outside of superannuation. In this report, the value of superannuation tax breaks, and their distribution among taxpayers, are measured against a comprehensive income tax (or 'TTE') benchmark. Treasury estimates the 'tax expenditures' from super tax breaks by comparing the tax paid on contributions and earnings against the tax payable if they were taxed at marginal rates of income tax (Treasury (2015c)).

As noted in Section 1.5, some commentators argue that an expenditure tax approach – where no tax is paid on income from savings – is a desirable structural feature of the tax system, and so the cost of super tax breaks should be measured against such a benchmark. However, arguments about the best policy for taxing savings should not be confused with questions about how to measure their cost (Daley, D. Wood and Coates (2015)). The income tax benchmark remains the best measure of how much tax breaks cost. Absent superannuation, savings would be taxed under this regime. Of course there are tax breaks for other forms of savings, and these should be measured against the same benchmark.

Treasury now also estimates the 'revenue gain' from abolishing super tax breaks, which takes into account behavioural change. If superannuation tax breaks were abolished, some people would move super savings into vehicles that pay less tax than the benchmark marginal income tax rates. However, the revenue loss from contributions tax breaks is largely unaffected by behaviour change: there aren't many ways outside of superannuation for taxpayers to reduce the tax payable on the principal invested.

Unsurprisingly, the superannuation industry prefers this benchmark, which reduces the apparent size of the tax expenditures.

However, this benchmark does not reflect the trade-off faced by most people. Only a small proportion of the assets in super are owned by people legally entitled to pay no tax on the earnings of their savings outside of super.

Under a pre-paid expenditure tax benchmark, Treasury estimated that contributions tax breaks cost \$16 billion in foregone revenue while the earnings regime provides a gain to the budget of \$5.8 billion (Treasury (2014b)). These estimates show that Australia's superannuation tax breaks cost \$10 billion more in foregone tax revenue than if Australia adopted an EET system for taxing superannuation savings, which is widely recognised as an amply generous tax treatment for taxing retirement savings.²⁰⁹

More recently, some have noted that the tax expenditure measures do not account for the additional costs of higher Age Pensions in future if the rules are changed.²¹⁰ However, the changes proposed in this report will have little impact on Age Pensions, as they are targeted at those who are unlikely to qualify for much Age Pension anyway.²¹¹

3

The targeting of superannuation tax breaks overall

Superannuation tax breaks, as currently structured, are an unfair and costly way to promote retirement savings. By value, most of the superannuation tax breaks go to people on higher incomes.

In practice these people are likely to save enough, even without superannuation tax breaks, so that they are unlikely to qualify for a part Age Pension. The top 20 per cent of income earners at age 55 have usually already acquired assets approaching \$2 million. Usually they hold more financial assets outside of superannuation than within it. The wealthiest 20 per cent of households headed by someone over the age of 65 have typically saved enough to generate a substantial retirement income: 70 per cent of them have annual incomes over \$50,000, excluding the Age Pension.

Those consistently earning more than \$115,000 a year are likely to save enough just through compulsory superannuation contributions to enjoy an affluent retirement. Their disposable income in retirement is likely to be higher than that of most Australians during their working life. They are likely to have a superannuation balance large enough to disqualify them for the Age Pension for most, if not all, of their retirement years.

Thus superannuation tax breaks for those consistently earning more than \$115,000 are not required to reduce Age Pension liabilities. Nor can they be justified on the alternative grounds that they compensate for high tax rates on high-income earners.

Incomes tend to be fairly consistent. So those with high incomes in any given year are likely to have high lifetime incomes. Consequently, it is fair enough to target superannuation tax breaks on the basis of annual incomes and contributions.

3.1 Superannuation tax breaks primarily benefit high-income earners

Superannuation provides much larger tax concessions per person to high-income earners. Over half of the value of superannuation tax breaks – for earnings and contributions combined – flow to the top 20 per cent of income earners (Figure 40 on the facing page).

3.2 High-income earners are likely to save without superannuation tax concessions

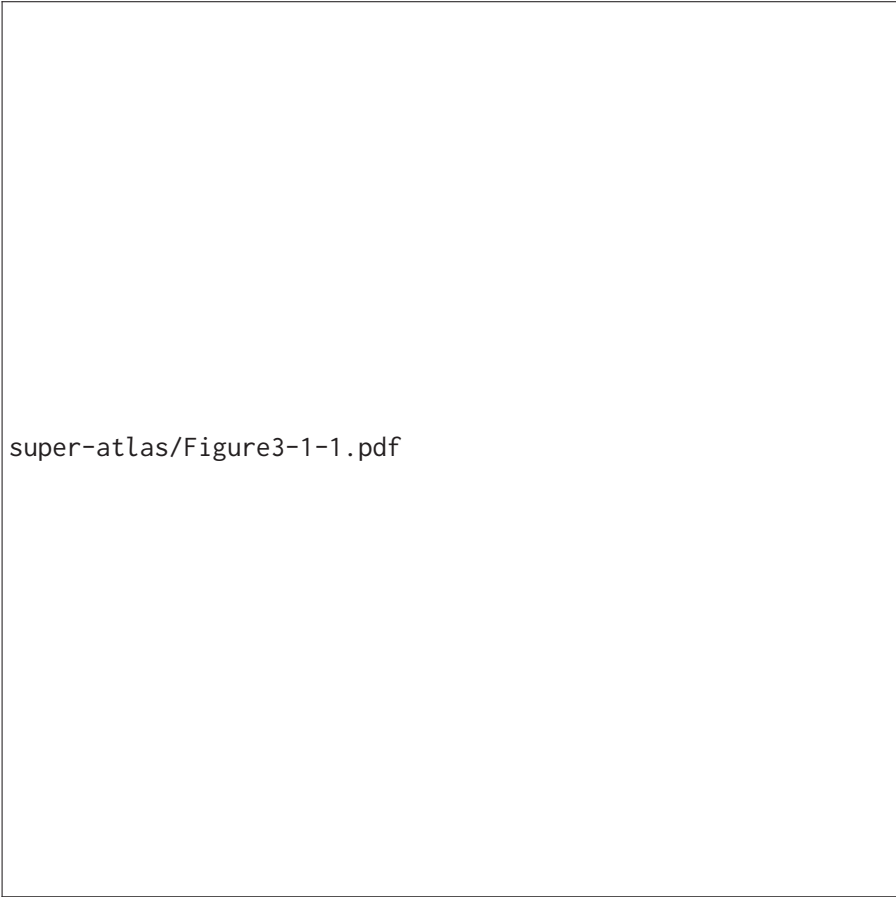
These high-income earners receiving most of the superannuation tax concessions are likely to save and self-fund their retirement even without government incentives to do so. Few households that have been earning over \$100,000 a year plan to retire onto an Age Pension paying at most \$34,000 a year.²¹² As shown by the savings tax literature discussed in Section 2.6, higher income households around the world typically save a substantial portion of their income, irrespective of the tax rates on savings.

The actual behaviour of high-income households in Australia bears this out. They tend to save substantially in the decade or so before retirement. Wealthy retirees usually earn more from investments outside of superannuation than inside.

High-income Australians approaching retirement have typically saved substantial assets (Figure 43 on page 152). Households aged over 50 earning more than \$100,000 a year have amassed average net assets worth more than \$1.7 million. Excluding owner-occupied housing, more than half of these assets are invested outside of superannuation. This suggests that many would save even if there were no superannuation tax concessions. This investment pattern is typical for households of all ages and incomes (Section 2.1).

Figure 40: Superannuation tax breaks primarily benefit high-income earners

Percentage of values of superannuation concessions per income decile



super-atlas/Figure3-1-1.pdf

Notes: The value of tax break is calculated against a comprehensive income tax benchmark, as per Box 5; income deciles sorted by taxable incomes for 2011-12; only includes taxpayers that made a pre-tax contribution in that year.

Source: Financial System Inquiry (2015, p. 138).

The savings of high-income households before retirement is reflected in their sources of income in retirement. The wealthiest retired households typically earn more from superannuation than less wealthy households (Figure 41 on page 150). But they also typically earn even more from other investments, suggesting they would have saved for retirement regardless.

There are not many exceptions. Of the wealthiest 20 per cent of retired households, 70 per cent have annual incomes over \$50,000 (Figure 42 on page 151). Most of this income is from sources other than the Age Pension and superannuation.

These patterns may change a little as the superannuation system matures, so that retired households earn more from superannuation than at present. However, it is likely that households of all ages will continue to invest more outside of superannuation than inside (Figure 35 on page 125). And high-income households are likely to continue to amass wealth to fund their own retirement, irrespective of the superannuation tax incentives.

3.3 Those earning over \$115,000 a year are likely to enjoy a comfortable retirement without an Age Pension

At what level of income are people likely to self-fund their retirement through superannuation and other forms of saving? Our analysis shows that people who consistently have taxable income of \$115,000 per year are likely to largely self-fund their retirement through their compulsory superannuation contributions alone. Such people are earning 1.5 times average full time weekly earnings and are in the top 8 per cent of income earners.²¹³ Their superannuation savings, together with private savings outside of superannuation, would probably give them sufficient assets that they would not qualify for a part-rate Age Pension for much or all of their retirement. The income from their superannuation savings, together with some drawdown, would fund a lifestyle in retirement more affluent than that enjoyed by over half of Australians before retirement, and by more than two thirds of Australians after retirement.

In practice, people with superannuation savings of that size are likely to have even more invested outside of superannuation, and will therefore enjoy even higher incomes in retirement.

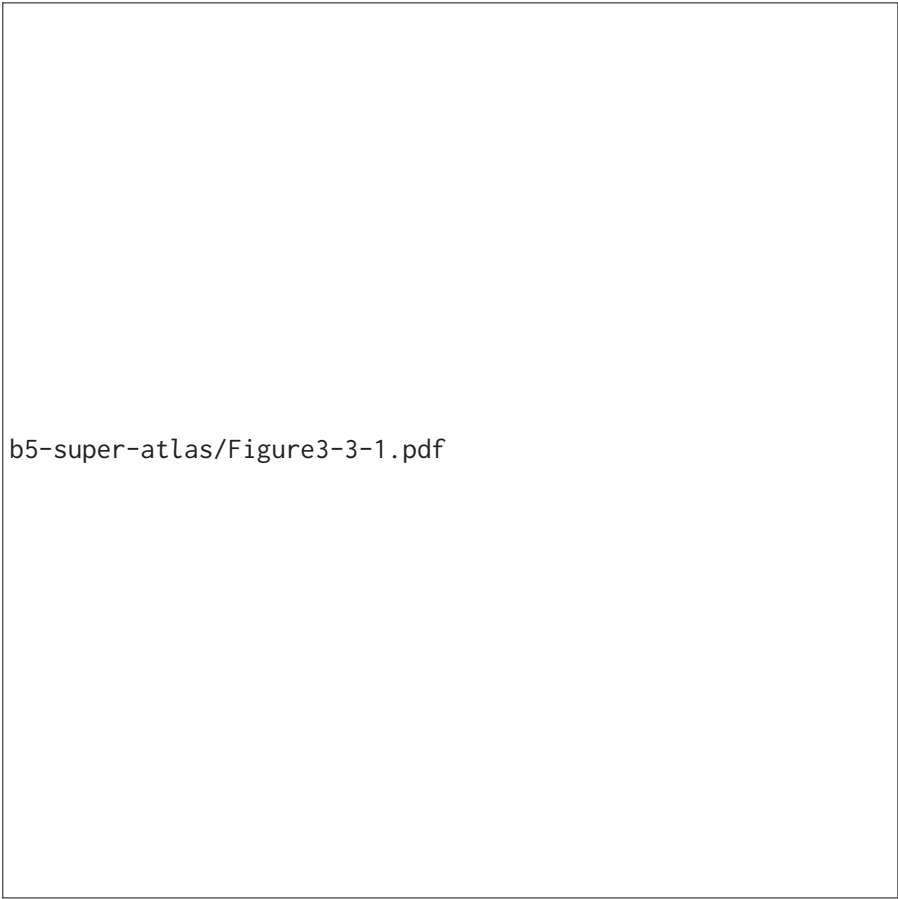
A person earning \$115,000 a year would make compulsory superannuation contributions of \$11,000 each year (indexed for inflation). This should generate a superannuation balance of about \$588,000 (in 2015 terms) after 30 years (Table 4 on page 154). With some superannuation accumulated by a second-income earner, and savings outside super (beyond the family home), a couple would be likely to amass combined assets well over \$805,025. On these assets, retiring homeowner households would not be eligible for a part Age Pension after 2017 (Table 5 on page 154). Whether they ever qualify for a part Age Pension will depend on the earnings on their assets, and how much they choose to consume in retirement.²¹⁴

This level of superannuation assets would fund a 'comfortable' lifestyle in retirement as defined by the Association of Superannuation Funds of Australia (ASFA).²¹⁵ However, calling this a 'comfortable' lifestyle may be misleading: a pool of savings of that size would fund an 'affluent' lifestyle more luxurious than that enjoyed by the majority of Australians even while they are working, let alone when retired (Figure 44 on page 155). ASFA's definition of a 'comfortable' retirement is based on a bottom-up calculation of spending that most Australians could never afford. It would fund one Australian holiday a year, and an international holiday every five years. It implies (post-tax) expenditure in retirement of \$58,444 for a couple. Although this may sound low relative to average full-time pre-tax earnings, retirees tend to have lower expenditure as they are no longer saving, and typically are no longer paying off a mortgage.

A couple without assets that earned this much would only just qualify for a small part-rate Age Pension (Table 6 on page 154). It may seem surprising that a household with a disposable income sufficient for an affluent lifestyle can qualify for a part Age Pension. This results from the 'taper rate' for the Age Pension, which is set so that those beyond

Figure 41: Wealthier retirees earn more from superannuation – and even more elsewhere

Average income of retirees in 2009-10, by source

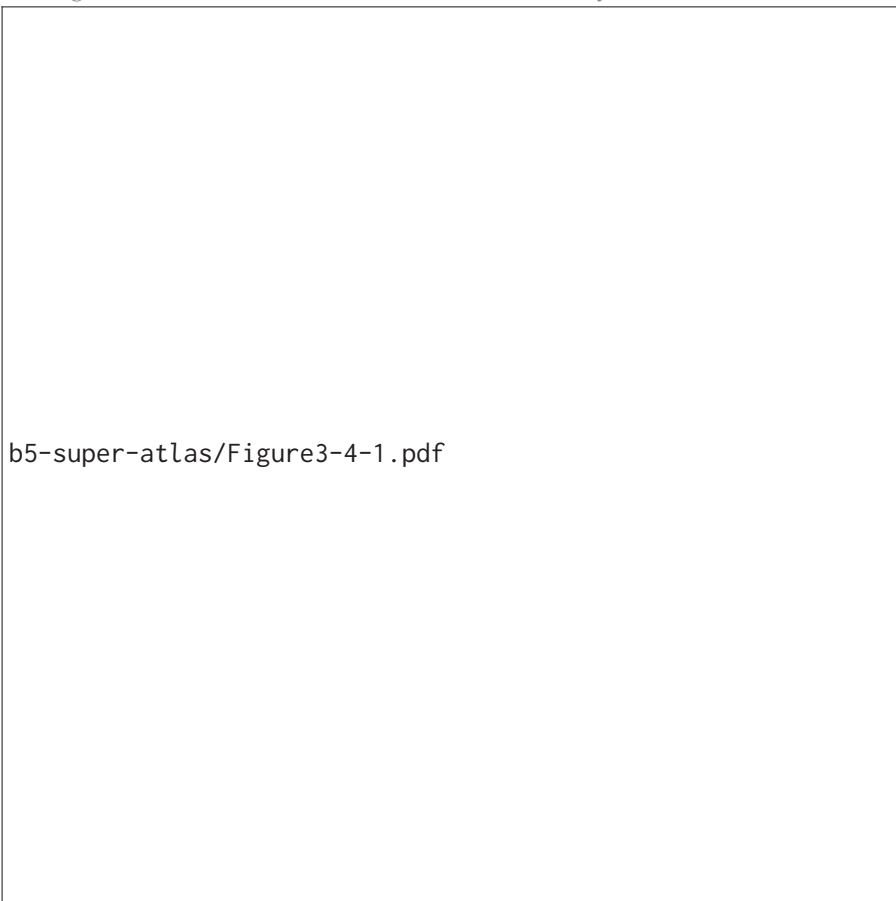


Notes: ‘Superannuation’ includes other private pensions, which account for only a small share of income across all households.

Source: Grattan analysis of HILDA (2015)

Figure 42: Most wealthy retirees have annual incomes above \$50,000, mostly from sources outside superannuation

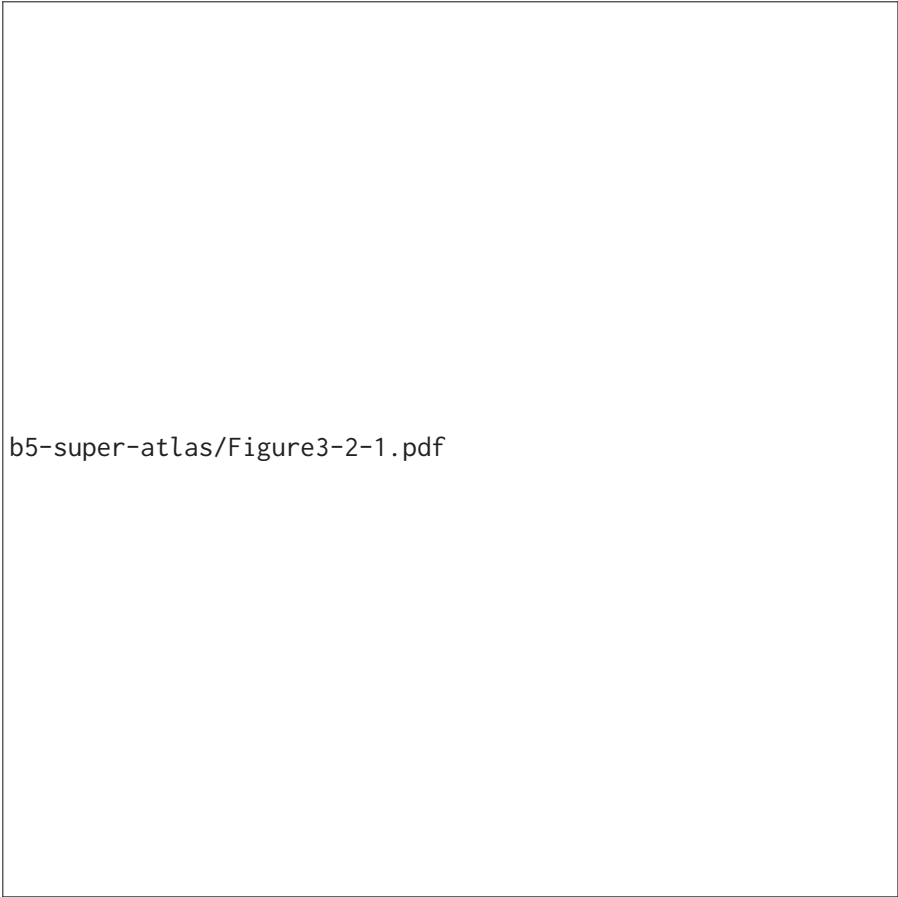
Average income of the wealthiest 20% of retirees, by source



Notes: ‘Superannuation’ includes other private pensions, which account for only a small share of income across all households.

Source: Grattan analysis of HILDA (2015)

Figure 43: Households approaching retirement than earn more than \$100,000 typically build significant wealth outside of superannuation
Average wealth of households earning more than \$100,000 annually, (2011-12 dollars)



b5-super-atlas/Figure3-2-1.pdf

Notes: See page 395.
Source: ABS (2013b); Grattan analysis

pension age still have reasonable incentives to work part-time. Under the taper rate the pension is reduced by 50 cents for each additional dollar of income. The result is a small Age Pension for those with an income just over that sufficient for an affluent lifestyle. In practice, such households are also likely to be excluded from the Age Pension by the assets means test.

Thus, an individual consistently earning \$115,000 a year – on the basis of their superannuation assets alone – is unlikely to be eligible for a pension on retirement. However, some households that do not qualify for an Age Pension on retirement may nonetheless qualify later in life if they consume their savings in retirement – as the ASFA standards assume. Consequently, greater savings may be required to minimise future Age Pension liabilities.

In practice, however, most pensioners don't draw down much of their assets. Australian Government data shows that less than 50 per cent of all pensioners draw down on their assets, and over 40 per cent of pensioners are net savers.²¹⁶ A recent study found that at death the median pensioner still had 90 per cent of their wealth as first observed.²¹⁷ Another study found that many Australian retired households – pensioners or otherwise – do not spend down much of their financial wealth as they age.²¹⁸ This suggests that those who do not qualify for a pension on retirement are unlikely to draw down on their assets to the point that they start to qualify for a material Age Pension.

In any case, the ASFA standard assumes that a household's only income-earning asset in retirement is a superannuation fund built on compulsory contributions. In practice, someone earning \$115,000 annually is likely to save far more for their retirement than just their compulsory superannuation contributions (Section 3.2), and as a result will have a retirement much more prosperous than the 'affluent' benchmark as defined by ASFA.

Some commentators have suggested that retirees need an even higher super balance at retirement than that proposed by ASFA, and that Australians need savings of up to \$1 million in order to generate

Table 4: Account balances (2015-16 dollars) from contributing \$11,000 (indexed) p.a.

Number of years of contributions	Balance accumulated	% of lump sum for a 'comfortable' lifestyle	% of lump sum for a 'modest' lifestyle
5	\$53,218	10	106
10	\$120,113	22	240
20	\$306,618	56	613
30	\$588,765	108	1178
40	\$1,007,861	185	2016

Table 5: Pension asset thresholds and ASFA retirement targets

		ASFA 'comfortable' lifestyle	Assets threshold for part-rate pension	
			2015	2017
Couple	owns home	\$640,000	\$1,163,000	\$805,025
	renting	N/A	\$1,312,000	\$997,753
Single	owns home	\$545,000	\$693,250	\$535,212
	renting	N/A	\$842,250	\$727,940

Table 6: Pension income thresholds

Household type	Age Pension income threshold		ASFA	
	Before tax	After tax	'moderate' lifestyle	'comfortable' lifestyle
Single	\$49,429	\$41,336	\$24,438	\$42,569
Couple	\$75,655	\$66,446	\$33,799	\$58,444

Notes: See page 399.

Source: Social Services Legislation Amendment (Fair and Sustainable Pensions) Bill 2015; ASFA (2015) and DHS (2015); Grattan analysis.

Figure 44: The ASFA ‘comfortable’ standards are more affluent that most singles and about half of couples
Household expenditure, 2015 dollars



Retired
Working



an adequate retirement income.²¹⁹ Their analyses typically assume that retirees are only prepared to invest their retirement savings in government bonds, currently yielding around 2.3 per cent. This is clearly unrealistic. Superannuation fund returns have averaged almost 6 per cent a year since 2000.²²⁰ Such claims also ignore the role of the part Age Pension in boosting the retirement incomes of retirees with post-tax incomes of less than \$41,336 (singles) or \$66,446 (combined couples), and ignore any other financial savings outside of superannuation.

Other commentators have noted that sustained low investment returns may reduce the accumulated value of superannuation savings at retirement, leading to lower retirement incomes. While lower returns are a risk to retirement incomes, it does not follow that more generous superannuation tax breaks should make up the difference. First, if investment returns are permanently lower, then the target living standard in retirement should also be lowered.²²¹ Second, increasing the generosity of superannuation tax breaks is an expensive way to boost the retirement incomes of low and middle-income earners, as this report makes clear. Most of the benefits from increasing superannuation tax breaks – such as from raising the annual cap on pre-tax contributions or lowering tax rates on super fund earnings – flow to high income earners that have larger savings. Instead, concerns about the adequacy of retirement savings in a world of lower investment returns should be addressed through changes to the Age Pension.

3.4 Superannuation tax breaks are poorly targeted at those with variable incomes

What about those with more variable incomes? Concerns are sometimes raised about how annual limits on contributions can disadvantage people whose income varies a lot from year to year.²²² This is a common pattern for women who take time out of the workforce to have children. Overall, annual earnings tend to rise to about age 35, and then stay around that level until just before retirement.²²³

This argument assumes that there are a material number of people who return to the workforce after a substantial break and who have sufficiently high incomes that they can afford to make substantial contributions to superannuation. However, incomes in Australia tend to be persistent. The longitudinal dataset of the HILDA (2015) survey, which commenced in 2000, confirms that those who earn a lot in one year, tend to earn a lot for many years (Figure 45 on the next page).

As the more detailed analysis in Figure 46 on page 160 shows, people of prime working age who are in the top income decile in any single year spent 85 per cent of the 13 years in which data was collected among the top 30 per cent of income earners. Overseas studies confirm the finding that most high-income earners in a given year tend to stay towards the top of the income distribution for most of their working lives.²²⁴

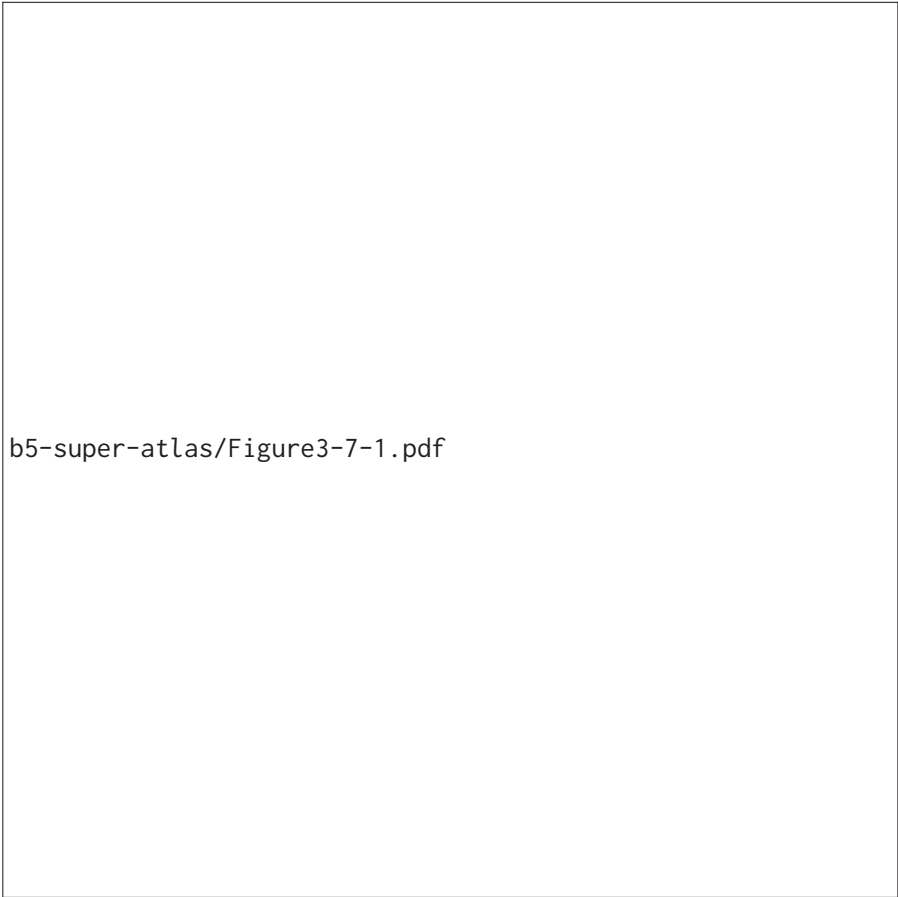
Although volatility over a 35 year period would be greater than over the 13 years of longitudinal data available in HILDA, clearly high incomes tend to persist.²²⁵ Furthermore, high contributions to superannuation tend to be made later in life (Figure 54 on page 177 and Figure 58 on page 195) when incomes tend to be more consistent.²²⁶

Of course, some people, particularly women, do have variable incomes. But they are unlikely to be impacted much by limits that only affect those contributing more than \$11,000 a year. As shown in Figure 53 on page 176, there are relatively few women who contribute more than \$10,000 a year.

Policies to encourage adequate savings for those with irregular earnings need to be far more targeted. In practice, the current rules that allow substantial pre-tax and post-tax voluntary contributions to superannuation are overwhelmingly used by those with high incomes (Figure 64 on page 222 and Figure 71 on page 230) and who already have high savings (Figure 59 on page 196).

The current tax breaks are an expensive way for government to boost retirement incomes for a relatively small group of lower income women making 'catch up' payments. If government wants to increase the

Figure 45: Those who earn a lot in a year tend to earn a lot for many years
Percentage of years in income decile for people of prime working age who are in top income decile at least once



Notes: Primary working age is defined as aged over 30 at the beginning of the survey and less than 60 at the end of the survey. Analysis of the 13 years of the HILDA survey. Income deciles are of population aged 15 and over.
Source: HILDA (2015)

retirement balances of women that have spent time out of the workforce, reinstating the Low Income Superannuation Contribution (LISC) would have far more impact on this group per government dollar than the current superannuation tax breaks.

3.5 Superannuation tax breaks for those on high incomes do not materially reduce Age Pension costs

As high-income earners are likely to save and self-fund their own retirement anyway, superannuation tax concessions that benefit this group do little to reduce future Age Pension liabilities. Treasury projections show that the lifetime value of tax breaks to high-income men is much higher than the value of the Age Pension for low-income earners (Figure 47 on page 161).

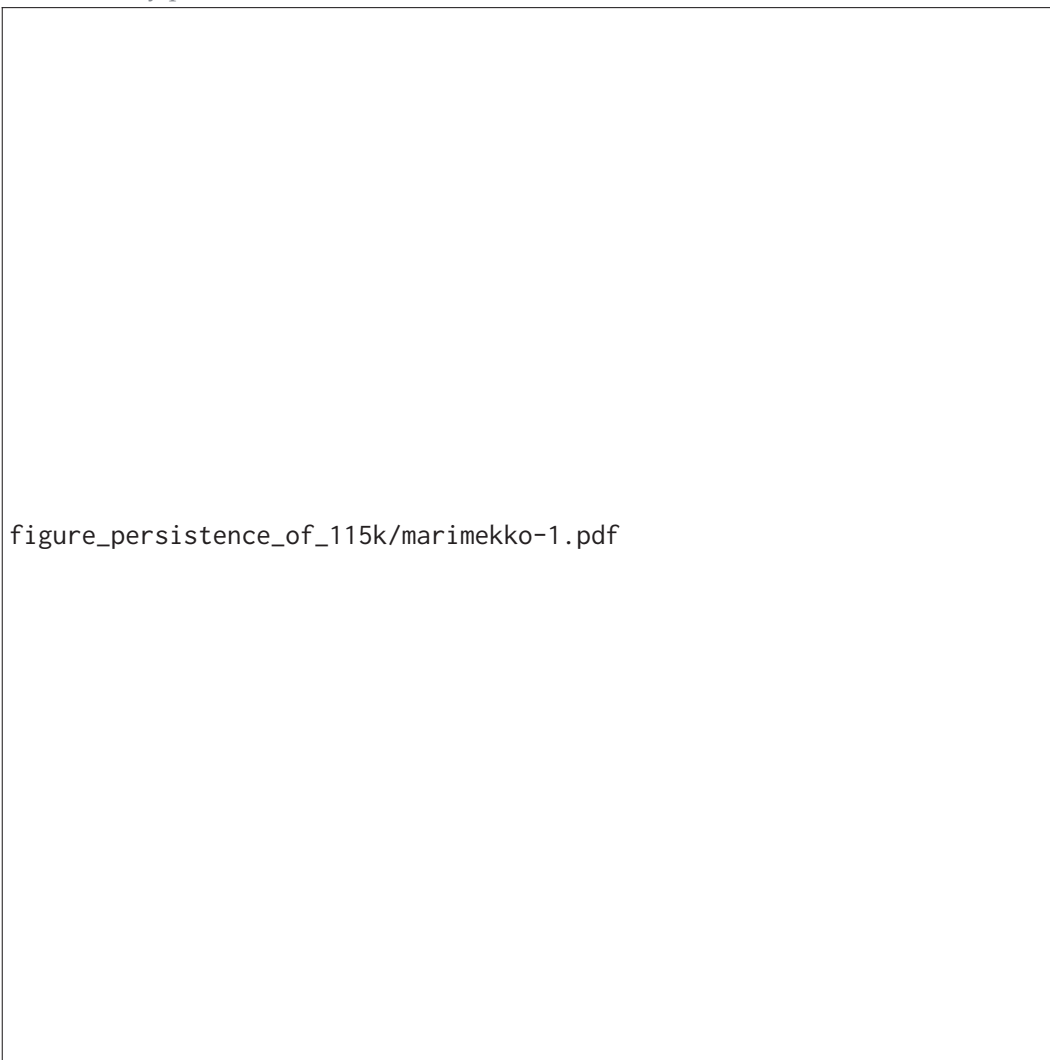
ASFA has criticised this analysis because it assumes that people remain in the same income percentile amongst their age group for their entire working life.²²⁷ As shown by Figure 46, incomes are persistent, but not as persistent as this.

However, the Treasury projections make other assumptions that substantially understate the tax breaks for high-income earners. They do not account for post-tax contributions, which are concentrated amongst high-income earners and provide large breaks on super earnings in retirement.²²⁸ Different assumptions about life expectancy and draw-down rates can also result in much higher estimates of the lifetime benefits for high-income earners. Industry Super calculates that superannuation tax breaks for the top 5 per cent of income earners are worth more than \$2 million for men over their lifetimes.²²⁹

Thus the substantial superannuation tax breaks for high-income earners do little to serve the purposes of superannuation: to encourage savings to replace and supplement the Age Pension. High-income households are very likely to self-fund their retirement, irrespective of superannuation tax breaks, and consequently they are unlikely to qualify for an Age Pension.

Figure 46: About a quarter of the population have just a single year earning a high income

People of working age who were in the top decile at least once during the HILDA (2015) survey period



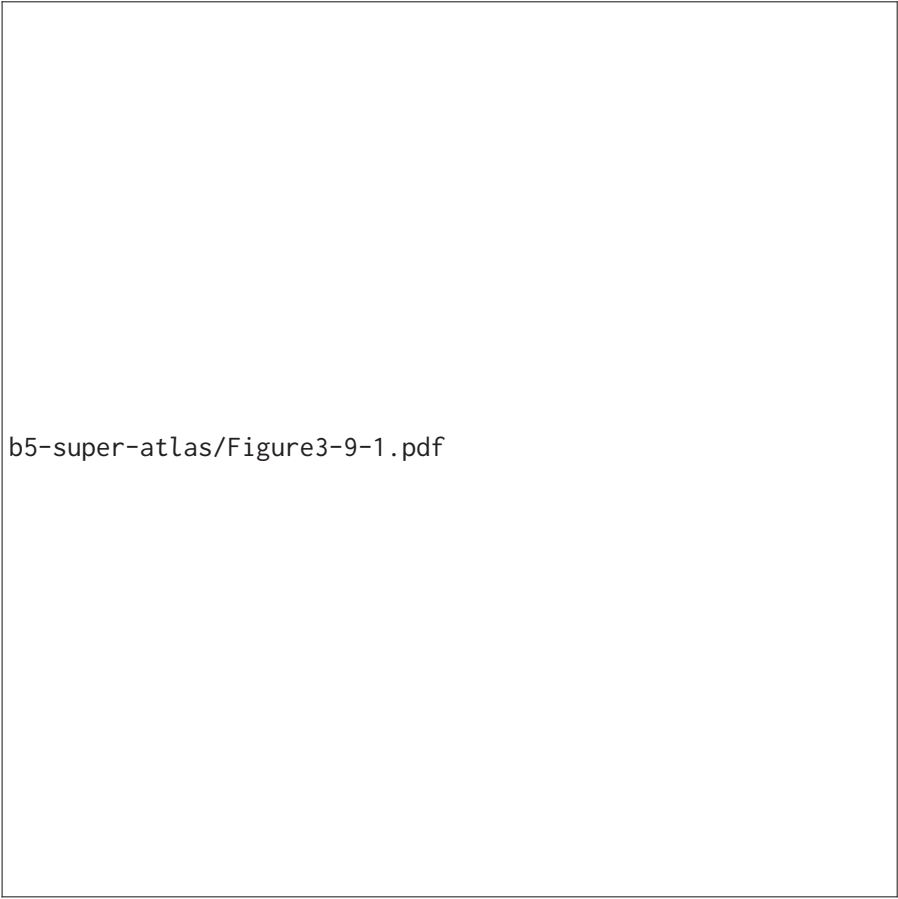
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Notes: See notes for Figure 45.

Source: Grattan analysis of HILDA (2015).

Figure 47: Superannuation tax breaks for high-income earners cost more than Age Pension payments to others

Net present value of the projected lifetime cost of government support for retirement incomes (2010 dollars)



b5-super-atlas/Figure3-9-1.pdf

Notes: See page 395.
Source: Treasury (2012b)

The primary effect of superannuation tax breaks on this group is to make them even richer in retirement, without either affecting their savings behaviour, or reducing government pension liabilities.

3.6 Superannuation tax breaks cannot be justified as compensation for not receiving the Age Pension

Some have suggested that superannuation tax concessions to high-income earners are nevertheless fair because they provide government support equivalent to that provided through the Age Pension to the less well off (see Figure 47 on the preceding page).²³⁰

However, this muddles a tax break with a welfare payment. To use an analogy, wage earners don't expect tax breaks equivalent to Newstart payments. That is because, by definition, welfare payments are made to those who otherwise lack resources. The purpose of the Age Pension is to provide all Australians with a safety net in retirement so that they have enough money for a reasonable minimum standard of living when many are no longer able to work. As with other welfare payments, the Age Pension is targeted – via the income and assets means tests – to those in need.

3.7 Superannuation tax breaks need to be targeted to meet their policy aims

The targeting of superannuation tax breaks will never be perfect. Superannuation will be far too generous for most households if the limits are set so that a sole breadwinner can save enough assets solely in super to support a couple in retirement without recourse to an Age Pension. In practice, each member of couple households will have their own superannuation, and will typically have other assets outside of superannuation and their home.

If we consider the way tax breaks currently operate in Australia's superannuation system overall, it is clear that they are very poorly targeted at promoting additional retirement savings that reduce Age Pension liabilities.

1. **Compulsory contributions from pre-tax income** do increase retirement savings for middle-income earners (Section 2.6), and the associated tax concessions are arguably reasonable compensation for the compulsion to lock up earnings in superannuation (Section 2.4). But they still most benefit those on higher incomes who make larger compulsory contributions (Figure 63).
2. **Voluntary contributions from pre-tax income** are mostly made by those aged over 50 – and therefore relatively close to the age of 60 at which they can start to withdraw these contributions. Those in the top fifth of income earners make over half of all voluntary pre-tax contributions (Figure 51).
3. **Voluntary contributions from post-tax income** are dominated by those already over 60. These contributions rarely increase retirement savings – they are primarily funded from funds already saved by those entitled to retire (Figure 58).

Better targeting superannuation tax breaks does not imply removing all contributions tax breaks for those earning more than \$115,000 a year. However, the proposals set out later in this report would reduce them so that in absolute terms the tax breaks for high-income earners are not much bigger than the tax breaks for those earning less.

3.8 Previous reforms to superannuation tax breaks were piecemeal

Governments have repeatedly tweaked the tax breaks on superannuation contributions, but none of these changes have made much difference compared to the total size of the tax breaks. Given the escalating cost of superannuation tax breaks, more substantial reforms are needed to ensure budget sustainability.

Governments have changed the amounts that can be contributed to superannuation from pre-tax earnings many times, as shown in Table 6. Collectively these changes over the last eight years have improved the budget bottom line by around \$1 billion per year.²³¹

Table 7: Annual caps on pre-tax contributions to superannuation

Year	General cap		Age-based higher cap	
	Age	Cap	Age	Cap
2007-08	under 50	↑ \$50,000	over 50	↓ \$100,000
2009-10	under 50	↑ \$25,000	over 50	↓ \$50,000
2012-13	(all)	\$25,000	↓ n/a	
2013-14	under 59	\$25,000	over 59	↑ \$35,000
2014-15	under 49	↑ \$30,000	↑ over 49	\$35,000

↑

↓

tax concession more generous

tax concession less generous

Notes: See page 399.
Source: ATO (2015d), Tax Laws Amendment (Simplified Superannuation) Act 2007 (Cth) and Swan and Shorten (2013)

The value of superannuation contribution concessions for high-income earners were also reduced in 2012 when the Labor Government increased the tax rates on concessional superannuation contributions for individuals with income greater than \$300,000, from 15 per cent to 30 per cent. Treasury estimated that this reform, known as **Division 293** tax, would boost revenue by \$475 million in 2015-16.²³²

The incoming Abbott Government announced the abolition of the LISC from 2017-18, at a saving of around \$1 billion in 2017-18.²³³ The LISC refunds contributions tax for low-income earners, who would pay little or no income tax on the income they are forced to contribute to super. Once the LISC is abolished, those earning less than \$18,001 will pay higher tax on their superannuation contributions than on their take-home pay.²³⁴

Other government programs to support the superannuation balances of low-income earners have also been reduced in the search for budget savings. The former Labor government temporarily reduced the matching rate for government co-contribution available to low-income taxpayers who made a post-tax superannuation contribution from 150

per cent to 100 per cent in the 2009-10 Budget.²³⁵ This reduction was made permanent in the 2010-11 Budget.²³⁶ The matching rate for the government co-contribution was reduced again to 50 per cent in the Government's 2011-12 mid year fiscal update.²³⁷

Thus superannuation tax breaks need more substantial reform. They are an unfair and costly way to promote retirement savings. Most of the value goes to people on higher incomes who are likely to save anyway, unlikely to qualify for an Age Pension, and not in need of government support. And by definition, other taxpayers (often younger and less well off) pay more in tax to make up for superannuation tax breaks. The frequent but minor changes over the last decade have left a large gap between the purposes of superannuation and its outcomes. Further changes to the rules, which undermine stability and confidence in the system, will continue until super tax breaks are targeted at the purpose of the system.

3.9 Superannuation tax breaks should be reformed in a principled way

The remainder of this report investigates how the superannuation tax breaks should be reformed so that they are more tightly targeted at their purposes.

A number of principles should apply to any reforms to superannuation tax breaks:

1. Tax breaks that **don't serve the policy purpose** of replacing or supplementing the Age Pension should be minimised.
2. Tax breaks that **do encourage savings to replace or supplement the Age Pension** should be preserved.
3. Where possible, **equity** should be maximised. This implies that superannuation should aim to provide more benefits to those on low incomes than those on high incomes. But this is not the primary focus of the superannuation system. Progressivity should primarily be achieved through the welfare and income tax system. On the other hand, superannuation tax breaks should not

be designed for the primary purpose of reducing the progressivity of the income tax system.

4. The **budgetary costs** of superannuation tax breaks should be minimised unless they are justified by the social benefits of those tax breaks.
5. The system must be **administratively workable**. This needs to take into account both the starting point of systems in place, as well as the transitional issues of reform.

Of course these principles do not always work in lockstep. Some arrangements may marginally increase savings that serve the purposes of superannuation, but result in very large tax breaks for people who were going to save for their own retirement anyway. In assessing any reform, it is important to look at the balance of likely impacts.

4

Contributions tax breaks

While about two thirds of contributions to superannuation are compulsory, the remaining third are ‘voluntary’ contributions. All compulsory contributions are ‘concessional’ – that is, they are made from pre-tax income. Of the voluntary contributions, about a quarter are pre-tax; the remainder are made from post-tax income.

The tax breaks on contributions disproportionately benefit high-income earners: they save more tax per dollar contributed, and they contribute more dollars. Voluntary pre-tax contributions over \$10,000 in a year are mostly about tax planning rather than adding to net savings. Those contributing more than \$10,000 a year are predominantly high-income men aged over 50.

As a result, the tax breaks for contributions of more than \$10,000 a year primarily benefit those who would have self-funded their retirement anyway. Indeed, around 24 per cent of voluntary pre-tax contributions are made by those aged over 60, entitled to withdraw their contributions immediately.²³⁸

The best way to reform these tax breaks would be to limit concessional contributions to a maximum of \$11,000 per year. This change would target superannuation tax breaks to those who need them to reduce and replace their Age Pension. It would be relatively easy to implement, and would improve the budget bottom line by around \$3.9 billion a year.

4.1 Superannuation contributions are made and taxed in a variety of ways

Australians contributed around \$115 billion to superannuation in 2012-13 (Figure 48 on the next page).

Pre-tax contributions make up 70 per cent of the total. A flat rate of 15 per cent tax is usually paid on these contributions once they enter the super fund, which is normally much less than the contributor's marginal income tax rate. If the contributor earns more than \$300,000, a flat rate of 30 per cent tax is paid on these contributions.

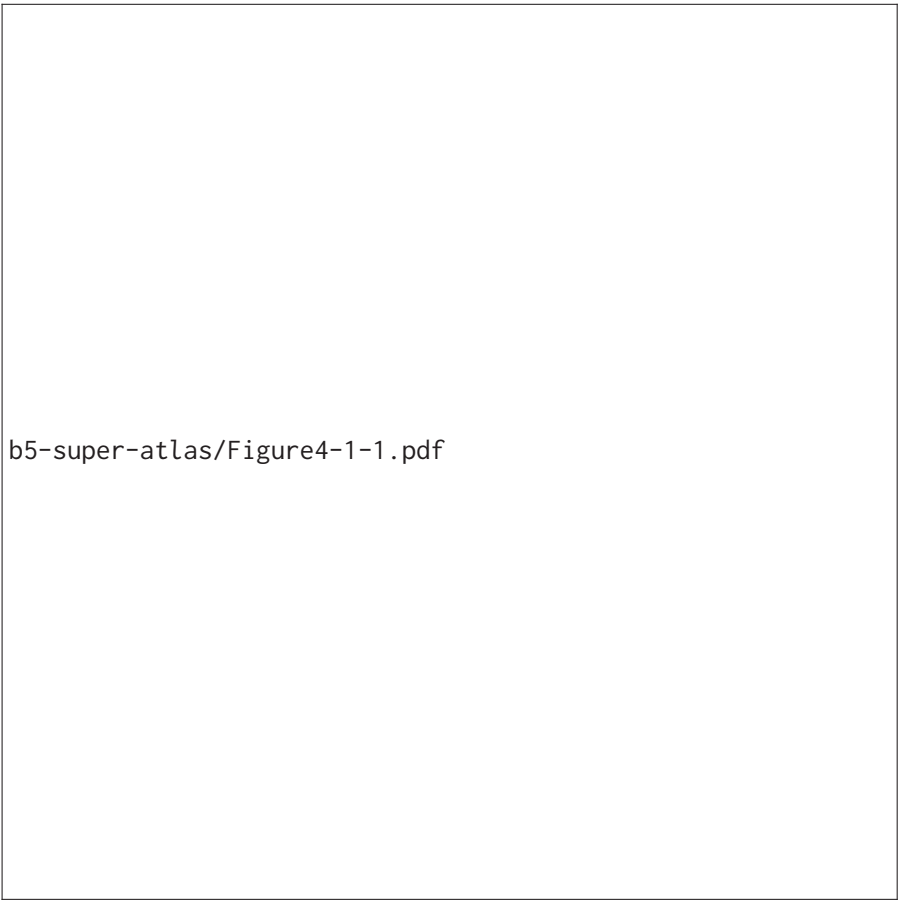
Most pre-tax contributions – 60 per cent of all contributions – are **compulsory contributions**, which employers are required to make, at the super guarantee rate of 9.5 per cent on the first \$200,000 of an employee's earnings.²³⁹

Voluntary pre-tax contributions – 10 per cent of all contributions – are made when a worker salary sacrifices some of their earnings into superannuation, or claims a tax deduction on superannuation contributions (if self-employed).²⁴⁰ Pre-tax contributions are now capped – at a total of \$30,000 for compulsory and voluntary pre-tax contributions combined if the contributor is aged under 50, and \$35,000 if the contributor is over 50.

Annual contribution flows into superannuation funds can be volatile. The recent decline in superannuation contributions in 2012-13, particularly for voluntary concessional contributions, likely reflects the reduction in the cap on pre-tax contributions for those aged 50 years and over from \$50,000 to \$25,000, as well as the introduction of higher taxes on concessional contributions for high-income earners (Division 293 tax). The recent plateau in compulsory pre-tax contributions may also reflect weak wages growth, and a decline in the proportion of employees receiving employer contributions beyond the SG contribution rate.²⁴¹

Figure 48: About 40 per cent of superannuation contributions are voluntary, mostly from post-tax income

Total contributions to all superannuation funds, \$ billions



Notes: See page 396.

Source: APRA (2014) and ATO (2015h). Grattan analysis.

4.2 Generous tax breaks for pre-tax contributions disproportionately benefit high-income earners

People who earn more get the biggest benefits from superannuation contribution tax breaks, both as a percentage of their income and in absolute amount.

Those earning between \$180,000 and \$300,000 per year save 30 cents of tax for each dollar contributed (Figure 49 on the facing page). The majority of taxpayers – earning less than \$80,000 a year – save 17.5 cents or less for each dollar contributed. By contrast, those earning between \$18,200 and \$37,000 only save 4 cents of tax for each dollar contributed. For those earning less than \$18,200 per year, the 15 per cent tax on superannuation contributions increases their tax, since their income is otherwise tax-free. The Low Income Super Contribution currently refunds this tax paid by low-income earners, but is due to be abolished from 2017-18 onwards (See Section 3.8 at page 164).

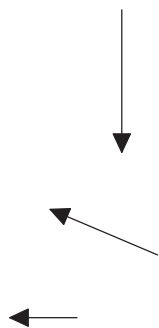
High-income earners not only save more tax per dollar contributed, they contribute many more dollars to superannuation. (Figure 50 on page 172, and see also Figure 63). Their compulsory contributions are larger (because their wages are higher), and they make higher voluntary contributions (presumably because with higher incomes it is easier for them to save more).

In the over-50s age bracket pre-tax contributions from the top 10 per cent of income earners exceed those of the bottom 60 per cent combined (Figure 51 on page 173, and see also Figure 65 on page 223). Indeed, this understates the skew: many low-income earners do not file a tax return and therefore would not be included in the ATO data analysed.

Figure 51 also highlights the generosity of the current cap on pre-tax contributions. Even the top 10 per cent of income earners over the age of 50 usually contribute only around half of the \$30,000/\$35,000 pre-tax contributions cap.

Figure 49: Contributions tax concessions provide the biggest discount to those on high incomes

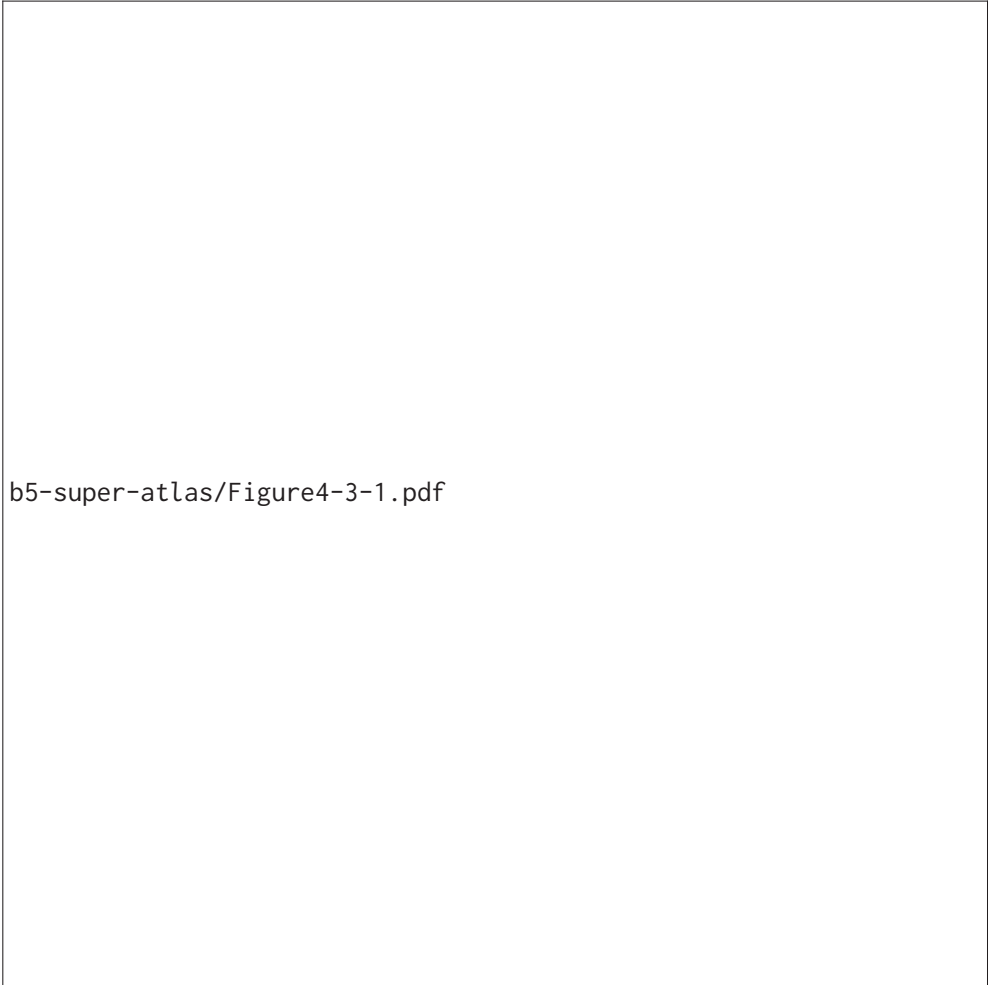
Tax rate



*Notes: See page 396.
Source: ATO (2015e); Grattan analysis.*

Figure 50: Those on high incomes make larger voluntary contributions, increasing the value of contributions tax breaks

Average superannuation contributions for 2012-13 (in 2012-13 dollars)



*Notes: See page 396.
Source: ATO (2015a) and ATO (2015i); Grattan analysis.*

Figure 51: Contributions among over 50s are heavily skewed towards high-income earners

Average concessional contributions in 2012-13 for people over 50



Notes: 2012-13 dollars. Excludes compulsory employer contributions beyond the Super Guarantee rate. Does not include post-tax super contributions. Taxable income deciles are for taxpayers aged 50 and over. Source: ATO (2015i); Grattan analysis.

4.3 Most voluntary contributions are made later in life and are unlikely to increase *net* savings much

Over half of all pre-tax voluntary contributions are made by those in the top 20 per cent of income earners, and over half are made by those over 55 (Figure 52).

Figure 52: Voluntary pre-tax contributions are mostly made by those who are older and on high incomes

Total voluntary pre-tax contributions 2012-13, by income decile and age



Notes: Includes reportable salary sacrifice contributions and contributions from post-tax income for which the taxpayer has claimed a tax deduction for 2012-13.

Source: Grattan analysis of ATO (2015h).

Around 24 per cent of voluntary pre-tax contributions are made by those aged over 60 entitled to withdraw their contributions immediately, as shown in the more detailed analysis by age and income decile in Figure 64.

These super contributions do less to boost retirement incomes since they compound for a shorter period before retirement. Very few people

under the age of 50 make material voluntary concessional contributions, even when they are in the top 10 per cent of income earners (Figure 69).

4.4 People making large pre-tax contributions are unlikely to qualify for an Age Pension

Only 12 per cent of taxpayers – about 1.6 million people make pre-tax contributions of more than \$10,000 in a year. Almost 1 million of these are in the top 10 per cent of income earners (Figure 53). Less than 5 per cent of median-income earners make pre-tax contributions of more than \$10,000. By contrast, 79 per cent of men (and 61 per cent of women) in the top income decile contribute over \$10,000 (Figure 69).

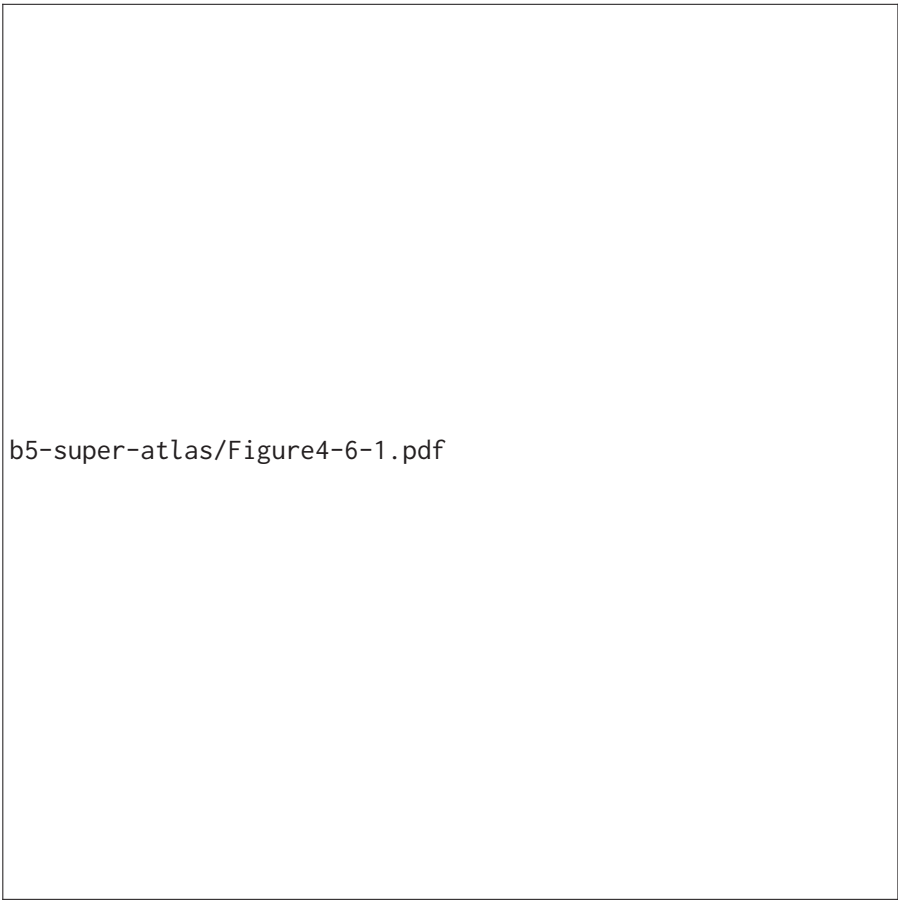
There are 163,000 women earning less than \$77,000 making pre-tax contributions of more than \$10,000. In contrast, there are more than 900,000 men earning more than \$77,000 that contribute more than \$10,000 a year from pre-tax income.

Most of these high-income earners need little help to provide for their own retirement. Often they are just making compulsory 9.5 per cent contributions, which will be more than \$10,000 if they earn more than \$105,000.

Most *voluntary* pre-tax contributions over \$10,000 are probably tax-planning measures rather than additional savings. High-income earners over 55 are much more likely to make voluntary pre-tax contributions, and to sacrifice a large part of their income when they do (Figures 67 to 68). As shown in Figure 54 on page 177, one third of all voluntary pre-tax contributions to superannuation over \$10,000 are made by people aged over 60.

Generally they can contribute from their pre-tax income, and then withdraw their superannuation immediately. By recycling wage income through their super fund in this way, middle- and high-income earners can continue to consume their income immediately while substantially reducing their tax liability. For workers aged between 60 and 64 years earning between \$65,000 and \$150,000, this strategy reduces the amount

Figure 53: Few people other than high-income earners contribute over \$10,000 a year
Number of individuals whose pre-tax contributions exceeded \$10,000, 2012-13

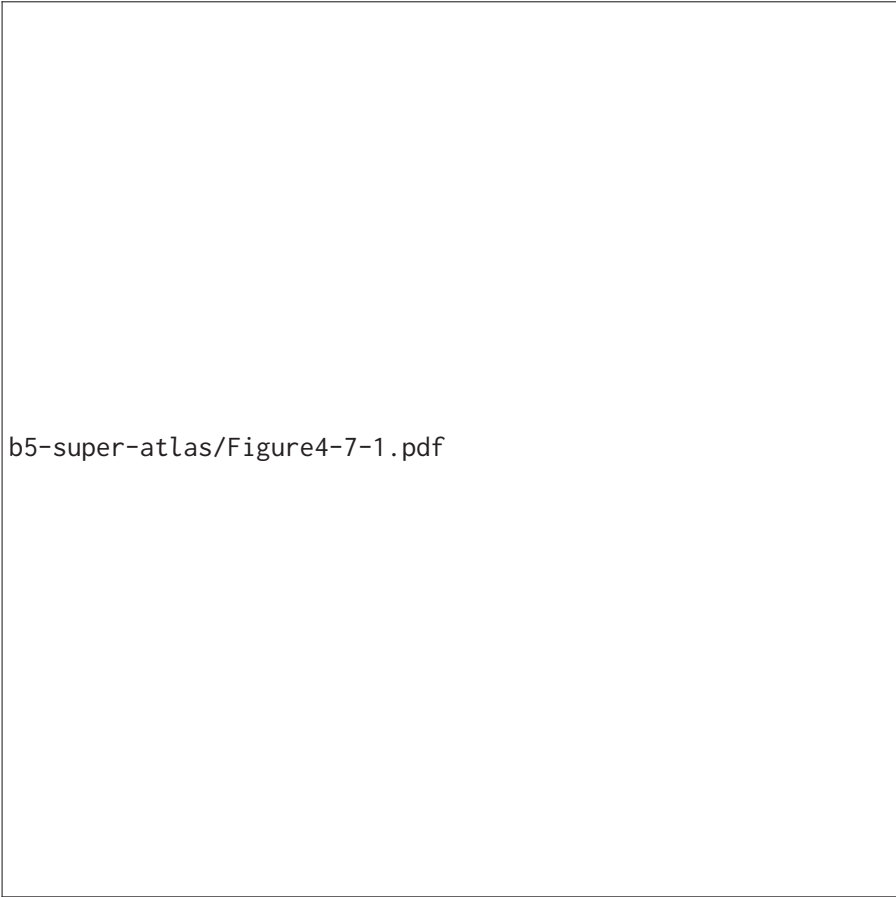


b5-super-atlas/Figure4-6-1.pdf

Notes: See page 396.
Source: ATO (2015i); Grattan analysis.

Figure 54: The bulk of voluntary concessional contributions over \$10,000 are made by those who are retired or close to retirement

Value of pre-tax voluntary contributions to superannuation in excess of \$10,000 in a year, 2012-13, \$2015-16 (by age)



Source: ATO (2015i); Grattan analysis.

of tax paid by over \$5,000 (see Appendix B). The tax benefits for workers aged 65 years and over are even larger.²⁴²

The ‘transition to retirement’ rules that allow workers between the age of 60 and 65 to access their super were originally designed to allow individuals to move from full-time to part-time work without reducing their incomes. Superannuation withdrawals would compensate for lower wages.²⁴³ However, recent evidence suggests that these rules are mainly used by high-wealth individuals to reduce their tax bills while they continue to work full-time.²⁴⁴

Of course, some voluntary contributions made by over 60 year olds are not immediately withdrawn and consumed in this way. However, these voluntary contributions do not serve the purposes of superannuation if the person would have saved anyway, or if they would not in any case qualify for an Age Pension. More detailed analysis of annual contributions by age and taxable income is provided in Appendix A.

4.5 Superannuation contributions tax breaks could be reformed in a number of ways

Various proposals have been made to target contribution tax breaks better. We focus on three of these.

1. Reduce the concessional contributions cap to \$11,000

This would reduce the maximum amount that can be contributed annually to super from pre-tax income (the ‘concessional’ contributions cap) from \$30,000 (or \$35,000 for those over 50) to \$11,000. This could improve budget balances by around **\$3.9 billion** annually. This cap would still allow taxpayers earning 1.5 times average earnings to benefit from tax concessions for the full amount of super guarantee contributions made by their employer.²⁴⁵ The cap should be indexed to growth in wages (probably in \$1,000 increments) to prevent it eroding in real terms. The maximum superannuation contributions base would need to be reduced to \$115,000 so that workers are not compelled to make super

contributions upon which they receive no tax concession.²⁴⁶ This policy is based on a proposal made in the Grattan Institute report *Balancing budgets: Tough choices we need*.²⁴⁷

2. Increase the tax rate on contributions to 30 per cent for those earning more than \$115,000

Those earning over \$300,000 already pay 30 per cent tax on contributions.²⁴⁸ This higher tax rate could apply to those on a lower income level, say \$115,000. This would improve budget balances by around **\$3.8 billion** annually.* The income threshold from which a 30 per cent tax rate applies would be indexed annually to average weekly earnings so that the value of the super tax breaks is not eroded over time. This design takes further proposals from the Australian Labor Party to apply a 30 per cent tax on contributions for those earning more than \$250,000.²⁴⁹

3. Tax contributions at marginal rates, less a 20 per cent discount

Taxpayers could contribute to superannuation at their current marginal tax rate, less a uniform 20 per cent rebate. We assume that the current cap of \$30,000/\$35,000 on concessional contributions remains in place.²⁵⁰ This policy would remove the penalty for those on low marginal tax rates making super contributions by providing a top-up payment to their super account. This could improve budget balances by around **\$1.1 billion**, while also improving the super balances of those on low incomes.²⁵¹ This reform extends a proposal in the Henry Tax Review,²⁵² recently taken up by Deloitte Access Economics,²⁵³ to tax contributions at the taxpayer's marginal rate, less 15 per cent.

To mirror the benefit to low-income earners of the third proposal, the first two reforms could be supplemented by the retention of the Low Income Super Contribution beyond 2016-17 so that low-income earners are not disadvantaged when contributing to super. This would cost around **\$1 billion**.²⁵⁴

*This figure has been updated since first publication.

A further option for reform would be to impose a lifetime cap on concessional contributions. However, this would further entrench the tax advantages for wealthy older workers, and encourage more tax planning rather than genuine increases in savings. The budgetary impact is also difficult to ascertain from publicly available data.

Older workers who have already benefited from particularly generous superannuation tax breaks that are now closed would be even further advantaged by a lifetime cap relative to younger workers. Data on contributions may not be as reliable before 2003-04, and so contributions before then – mostly made by older workers – would not be included.²⁵⁵ Furthermore, because records are limited, it would be a long time before many people reached the recorded lifetime cap on contributions, and so a lifetime cap would have little budgetary impact for many years.

A lifetime cap creates significant tax-planning opportunities. To maximise their superannuation tax breaks, taxpayers who have not used up their lifetime cap could sacrifice the entirety of their earnings. Such tax-planning is likely given how post-tax contributions are used already (Section 5.1).²⁵⁶ The existing tax breaks, limited by annual caps, are more difficult to game, since to maximise contributions taxpayers must make contributions consistently every year over decades.

Limiting annual contributions, or taxing them at a higher rate, would be fairer between generations, and would raise more revenue. An annual contributions cap would be a reasonable proxy for a lifetime cap since someone who has the capacity to make a substantial contribution over \$11,000 in any one year is likely to have a higher income over their lifetime (Section 3.4).

Views differ on an appropriate cap. Deloitte has suggested a lifetime cap of \$580,000.²⁵⁷ The Association of Superannuation Funds of Australia (ASFA) has suggested \$1 million, which amounts to \$850,000 after contributions tax.²⁵⁸ Both these proposals fail to target superannuation at its purposes. A superannuation account the size of ASFA's lifetime cap would be well above ASFA's own benchmark of the amount a couple needs for an affluent retirement even after the Age Pension assets test

takes effect in 2017 (Table 5 on page 154). The ultimate value of an account of this size would be much higher than the sum of lifetime contributions, once investment returns on the account are added. A couple would be even better off if they both have superannuation accounts (as many do), or if they have savings outside owner-occupied housing and superannuation – as almost all do when they have superannuation savings of this size (Figures 43 to 41 on pages 152–150).

Other policy variations include an annual cap on pre-tax contributions, with an ability to roll over some portion of any unused cap for use in future years. This would create more tax planning opportunities than an annual cap, and fewer than a lifetime cap.²⁵⁹ However, such an approach would add further complexity to the superannuation system, particularly when there is little evidence that an annual cap on pre-tax contributions would in fact restrict many low and middle income earners from making ‘catch up’ super contributions (Section 4.3).

4.6 Reducing the maximum concessional contribution would be the best reform overall

As discussed above at Section 3.9, reform should aim to minimise tax breaks that don’t serve the policy purposes of superannuation, maximise tax breaks that do, minimise the budgetary cost, and be administratively workable.

The first option for reform – reducing the concessional cap to \$11,000 – provides the best balance amongst these considerations, as summarised in Table 8 on the following page, and elaborated below.

4.6.1 Targeting tax breaks at those need them

All three proposals would reduce the super contribution tax breaks for high-income earners, as shown in Figure 55 on page 183.

Capping pre-tax contributions at \$11,000 would reduce the tax breaks for very high-income earners more than the other proposals. This option would also have smaller impact on the contributions of those in

Table 8: Assessment of concessional contribution reform options

<i>Principles</i>	Reduce concessional contributions cap to \$11,000	Increase tax on contributions to 30% for those earning > \$115,000	Tax contributions at marginal tax rate less 20%
<i>Minimise tax breaks that don't serve policy purpose</i>	Substantial reductions in tax breaks above 90th percentile	Minimal tax break for 95th percentile; large tax break for 99th percentile	Reduce tax break for 95th percentile, large tax break for 99th percentile
<i>Maximise tax breaks that do serve policy purpose</i>	Maintain incentives for 90th percentile	Little incentive for 90th percentile	Slightly reduced incentives for 80th and 90th percentile
<i>Equity</i>	Reduce tax breaks for top 10%; only helps lower income if reintroduce LISC	Reduce tax breaks for top 10%; only helps lower income if reintroduce LISC	Increases progressivity of entire super system
<i>Budgetary impact</i>	\$3.5 billion	\$3.8 billion	\$1.1 billion
<i>Administrative issues</i>	Builds on existing procedures	Builds on existing procedures	Requires significant systems changes

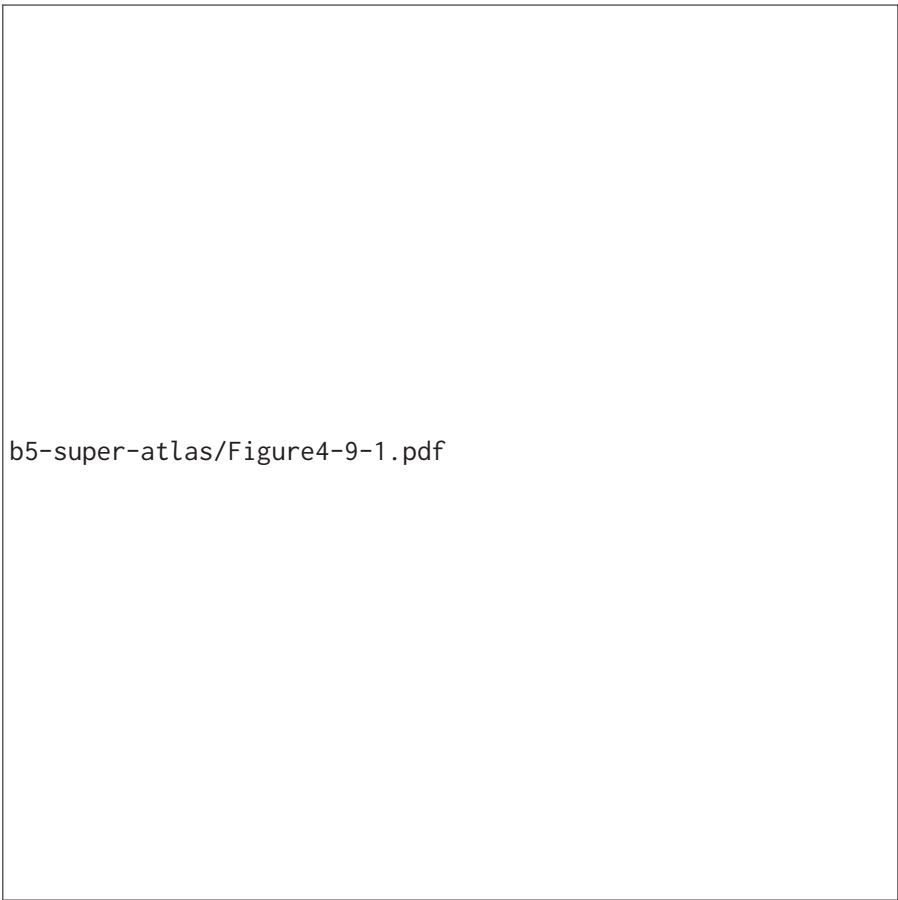
Figure 55: Lowering the concessional threshold would mainly affect the highest income earners
Contributions tax concession per taxpayer in 2012-13 (2015-16 dollars)

— Current

Notes: See page 396.
Source: ATO (2015h); Grattan analysis.

Figure 56: All income levels would have ample incentives to save in superannuation under the reforms proposed

Real effective tax rate on long-term earnings from superannuation savings



Notes: Assumptions as for Figure 55, except that the proposed concessional contributions cap of \$11,000 assumes a LISC of up to \$530 for those earning up to \$37,000, so that a contribution is made to all wage earners equivalent to the 9.5 per cent Superannuation Guarantee rate. Calculations of the post-tax baseline include the Medicare Levy only for taxpayers with incomes over \$37,000. Real effective tax rates are defined as per the note to Figure 37 and set out in Appendix C.

the 8th and 9th deciles of taxpayers – those who are likely to be on the threshold of qualifying for a part Age Pension.²⁶⁰

The Henry Review proposal to tax contributions at marginal tax rates, less a 20 per cent discount, would deliver increases in super to the bottom 70 per cent, but would also deliver more super to the very highest income earners. The alternative version of the Henry Review proposal put forward by Deloitte, with a 15 per cent discount, would help the bottom 30 per cent, but would leave middle-income earners worse off than they are today.

Even if the proposals made later in this paper were adopted, there would still be substantial incentives for high income earners to save via superannuation, even if they do so from post-tax rather than pre-tax income. As Figure 56 on the facing page shows, the effective tax rate on earnings would still be low. Compared to the alternatives, superannuation would remain a highly attractive vehicle for the long-term savings of high-income earners (Figure 37).

4.6.2 Increasing equity

All of the proposals would reduce the superannuation tax breaks for the top 10 per cent of taxpayers. The Henry proposal – or a variant on it – is the only proposal examined that would improve the value of superannuation tax breaks to low-income earners: it proposed to reduce the tax rate on their contributions to under 15 per cent. In this respect it is similar to the Low Income Superannuation Contribution Scheme. In addition, the Henry proposal would also top up a low-income earner's super account if the rebate were higher than their marginal personal income tax rate.²⁶¹

However, it is unclear that topping up superannuation accounts is the best way to improve retirement incomes for the poor. Those on low incomes accumulate relatively less superannuation, and casual employment with multiple employers often leads to multiple small superannuation accounts. Administration fees can eat up most or all of the balances. Although beyond the scope of this report, it is possible that

government funds would have more impact if they simply contributed to increasing the full Age Pension or Rental Assistance for pensioners.

Some argue that the Henry proposal is fairer because it provides an equal tax break to all taxpayers. However, that this argument is used only demonstrates how far superannuation has drifted from its purposes. Superannuation should not simply deliver an equivalent tax break to all taxpayers. It should deliver a tax break that serves the purposes of encouraging savings that will supplement or replace the Age Pension. Tax breaks for high-income earners, equivalent or otherwise, don't serve this purpose.

4.6.3 Budgetary impacts

The three proposals would each have similar budgetary impacts, as shown in Figure 57 on page 188.

These estimates of budgetary savings are not affected much by behavioural change.²⁶² All of the proposals effectively limit the ability to save (or spend) from pre-tax income. There are no obvious alternatives that would allow income earners to save from pre-tax income, and so pay less income tax up front on savings. Even in the long-term, behavioural change will have little impact on budget outcomes. High-income earners affected by the proposals are unlikely to reduce savings rates much (Section 3.2). And high-income earners are unlikely to find other investment vehicles for savings on which they pay less tax than superannuation (Figure 37).

At the margins, these changes might lead to some increase in high-income earners investing more in owner-occupied housing or geared investor housing rather than financial assets. Rather than detracting from the case for superannuation reform, this reinforces the importance of reforming property taxes,²⁶³ negative gearing, and capital gains tax rules.²⁶⁴

Nor would these budgetary savings be offset by large future increases in Age Pension spending. All of the proposals would primarily reduce the superannuation tax breaks for the top 10 per cent of taxpayers. As

noted in Section 3.5, the top 10 per cent of income earners can expect to receive little or no Age Pension payments over their lifetimes, but benefit the most from tax breaks on superannuation contributions. Therefore reducing the value of superannuation tax breaks to this group will have little impact on future Age Pension expenditure. The Henry proposal – with a 15 per cent offset to marginal tax rates – would result in modestly larger increases in future Age Pension spending since it reduces the value of contributions tax breaks to middle-income earners.

The budgetary impacts illustrate the advantages of targeting super tax concessions at their policy purpose.

The original Henry proposal, advocated by many industry group submissions to the Commonwealth Government's tax reform process, would tax contributions at marginal tax rates less a 20 per cent discount. We estimate that this would do relatively little for the budget bottom line, saving just \$1.1 billion in 2015-16. It would do little for equity – indeed it marginally increases the tax break for those earning more than \$300,000 a year, whose contributions are currently taxed at 30 per cent under Division 293 tax.²⁶⁵ The modified Henry proposal of taxing contributions at marginal tax rates less a 15 per cent discount adds much more to the budget bottom line, but at a cost to the super balances of middle-income earners.

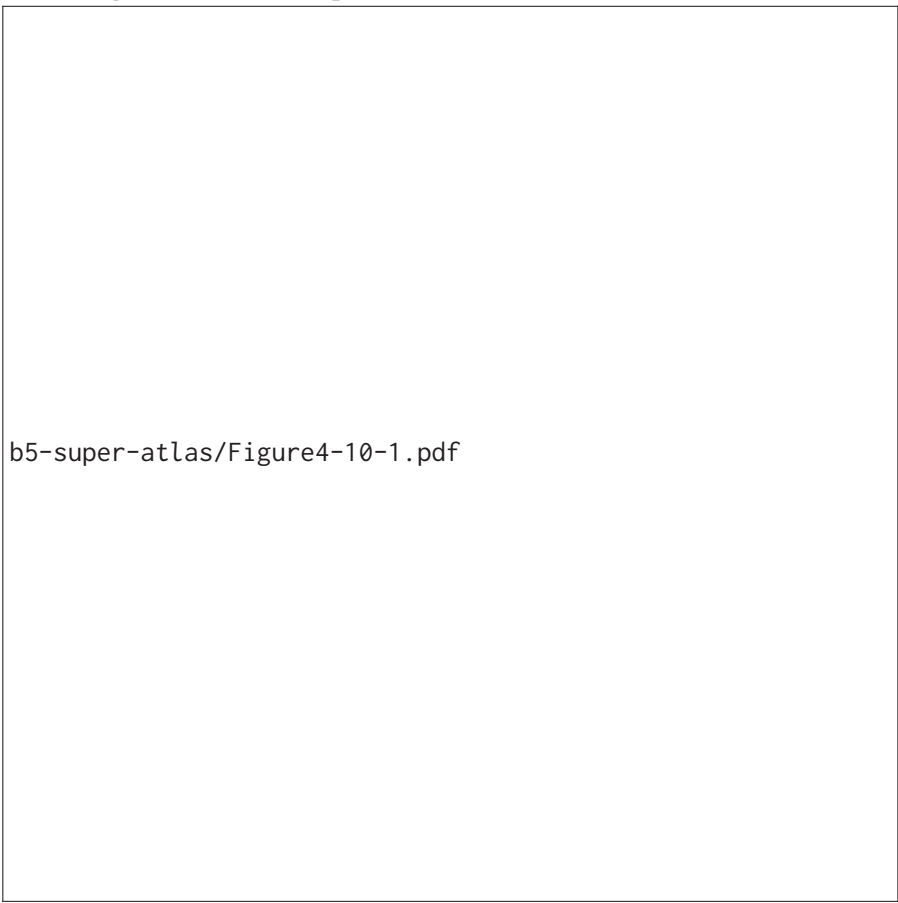
By contrast, capping pre-tax contributions at \$11,000 provides large budgetary savings, with little impact on the super balances of middle-income earners.

4.6.4 Administrative issues

The first two proposals do not raise substantial administrative issues. Reducing the cap for pre-tax contributions, or reducing the income from which higher tax is paid on contribution, both build on existing features of the superannuation system. More taxpayers would be affected by these rules, but administrative arrangements would not change, including for defined benefit schemes.²⁶⁶ The Henry proposal, however, would require substantial new arrangements.

Figure 57: Reforms to tax concessions on super contributions could significantly help the budget bottom line

Revenue gain from reform options, (2015-16 billions)



*Notes: As per Figure 55. Deloitte (2015) estimate a slightly higher budgetary gain of \$6 billion per year from taxing contributions at a 15 percentage point discount to marginal rates of tax.
Source: ATO (2015i); Grattan analysis.*

Reducing the cap for pre-tax contributions would affect about 1.6 million taxpayers, assuming no change in behaviour (Figure 53). In reality, the number affected would be less than this: some people will respond to the changes in tax rates by dropping their contributions to the cap and redirecting their savings elsewhere. It is unlikely that this would 'overwhelm the ATO',²⁶⁷ which already routinely collects information from super funds on all super contributions by all taxpayers, and requires those who have contributed more than the existing caps to pay more tax either from their post-tax income, or from their superannuation fund.

Levying a higher tax rate on the super contributions of those earning more than \$115,000 would affect about 1.45 million taxpayers. Again the ATO would require these people to pay more tax either from their post-tax income, or from their superannuation fund.

The Henry model would raise significant new administrative issues.

The best mechanism we have identified for implementing the Henry model would shift responsibility for paying contributions taxes. Instead of super funds paying tax of 15 per cent on all pre-tax contributions received,²⁶⁸ employers would withhold tax on contributions paid at the marginal rates applicable for that employee,²⁶⁹ less the rebate, through the PAYG tax system. Discrepancies between an employee's presumed income and their actual taxable income would be reconciled through tax returns. Employees would have an option to deduct unpaid tax from their super fund balance (as they do with Division 293 tax and extra tax on contributions in excess of the concessional cap). Legislation would clarify that contributions to super specified in awards or employment agreements would be deemed to include the tax paid by employers.

However, this would require significant systems reform. Many employers operate one system for regular earnings and PAYG tax payments, and another system for superannuation payments. The earnings PAYG system does not necessarily have information about the amount of superannuation contributed (which can vary depending on awards, individual employment agreements, and salary sacrifice arrangements).²⁷⁰

Even where salary and superannuation contributions systems are linked, there would be transition costs. For each employee, the employer would need to change the amount contributed to the superannuation fund (depending on the employee's tax rate), and increase the amount forwarded to the ATO.

While the Henry reforms were originally designed to deliver a net increase in super contributions, they could instead be designed (as we have assumed) to deliver no change to take-home pay, no change to super contributions before tax, but with changes (depending on the employee's total earnings) to the amount of contributions tax paid. The positive budget impact we have calculated implies that net super contributions (after tax) would be lower. Superannuation funds might advocate that the increased tax be paid from take-home pay rather than super contributions. However, this would require substantial changes to a wide range of awards and individual contracts that specify how much should be contributed to superannuation before contributions tax, and add to the administrative complexity of the transition.

The Henry model would have some benefits for superannuation funds. Currently, funds must know whether contributions are taxable or non-taxable as they are received. Under the recommendation, funds would treat all contributions in the same way, making the system easier for them to administer.

4.7 Transitional issues are straightforward

Changing the taxation of contributions inherently raises few transition issues. By definition it only affects contributions that have not yet been made.

The proposals discussed in this chapter affect people who are yet to retire. High-income earners aged 50 and over will be affected most because they would otherwise receive large tax concessions in the medium term. In the long term, the changes would apply equally to future generations when they approach the end of their working lives. Delaying reform increases the implicit cost to younger households that

pick up the tab for tax breaks that are likely to be changed before they benefit from them.²⁷¹

5

Total super contributions

Post-tax super contributions are designed to allow individuals (such as those with broken work histories) to make top-up payments to a superannuation fund. Australians made \$33.6 billion in post-tax super contributions in 2012-13, about three quarters of all voluntary contributions (Figure 48). Clearly superannuation is an attractive destination for earnings even when contributions are made from post-tax income.

In practice, many post-tax super contributions are motivated by tax-planning objectives rather than a need to build a reasonable balance after a broken work history. About 60 per cent of post-tax contributions are made by those aged over 60. Most of these contributions must be the movement of existing savings from other vehicles into superannuation, rather than additional savings for retirement.²⁷² As the Financial System Inquiry noted, many high-income earners can make large post-tax super contributions so that they pay less tax on the earnings on these savings, with no loss of flexibility once they begin to draw a retirement income stream. They are also able to avoid inheritance taxes that are potentially payable on superannuation balances.

Consequently, the existing cap on annual post-tax contributions of \$180,000 – or \$540,000 over three years²⁷³ – is far too high. It should be reduced to a lifetime limit on post-tax contributions of no more than \$250,000 to provide a better balance between allowing for broken work histories and limiting tax planning.

5.1 Non-concessional contributions are mostly made by those who provide for their own retirement anyway

Unsurprisingly, high-income earners and those who are older are more likely to make non-concessional contributions, and make very large contributions when they do (Figure 72 on page 231). Over three quarters of post-tax contributions are made by people aged over 55 (Figure 58 on the next page).

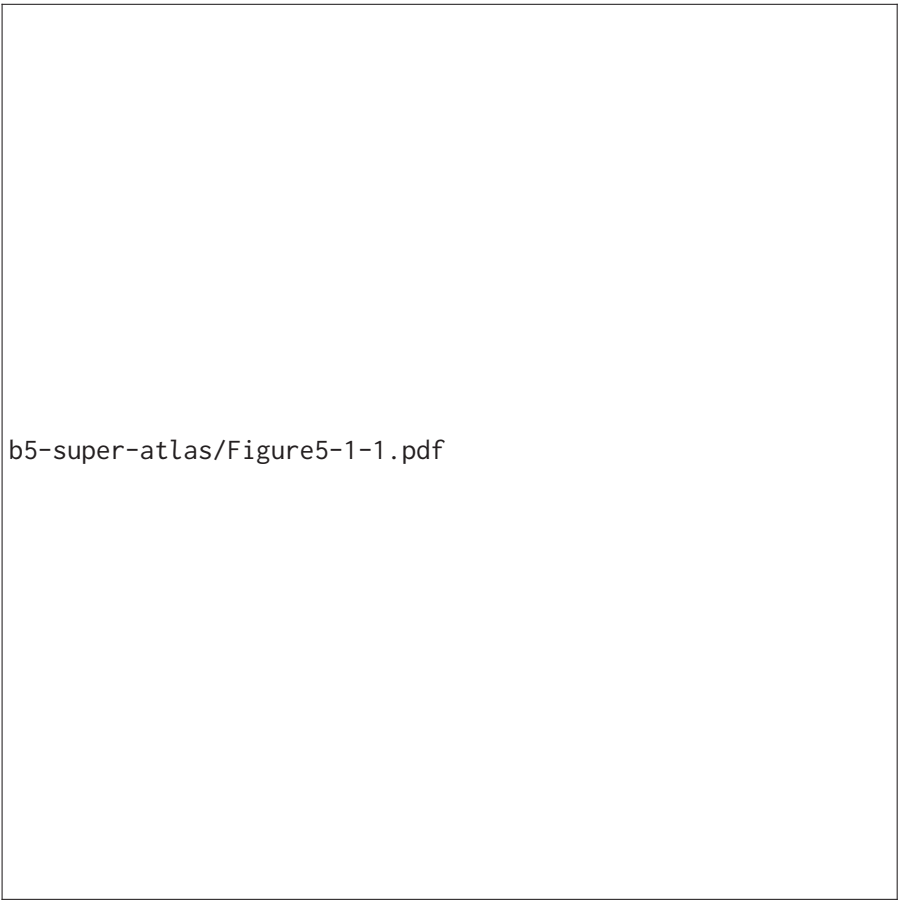
Most of these post-tax contributions are made by those who already have large super balances, rather than by those who are ‘catching up’ (Figure 59 on page 196, and for more detail see Figure 71 on page 230). Only 1.2 per cent of taxpayers have total super account balances of more than \$1 million, yet they account for 26 per cent of all post-tax contributions. The 70 per cent of taxpayers with super balances of less than \$100,000 account for just 9 per cent of post-tax contributions.

As well as enabling people to reduce future income tax on the earnings on their wealth, large post-tax contributions enable people to reduce the inheritance taxes on their superannuation. So-called ‘re-contribution strategies’ minimise the tax paid on superannuation fund balances passed on as inheritances.²⁷⁴ When inherited, super fund balances originally funded by pre-tax contributions can be taxed at a 17 per cent rate (including the Medicare Levy), depending on the age of the deceased and the beneficiary.²⁷⁵ To avoid this tax on their estate, individuals over the age of 60 can withdraw superannuation funds tax-free and contribute them back as a post-tax contribution, up to the annual post-tax contributions cap of \$180,000 each year. Funds re-contributed in this way are classified as post-tax contributions and are therefore tax-free when passed on as inheritances. While these inheritance taxes can be avoided by withdrawals and gifts while still alive, re-contribution strategies will often be preferred because they maintain control over the funds until death.

Perhaps for these reasons, comparable countries limit post-tax super contributions much more tightly than Australia.²⁷⁶

Figure 58: Voluntary post-tax contributions are mostly made by those who are older and on high incomes

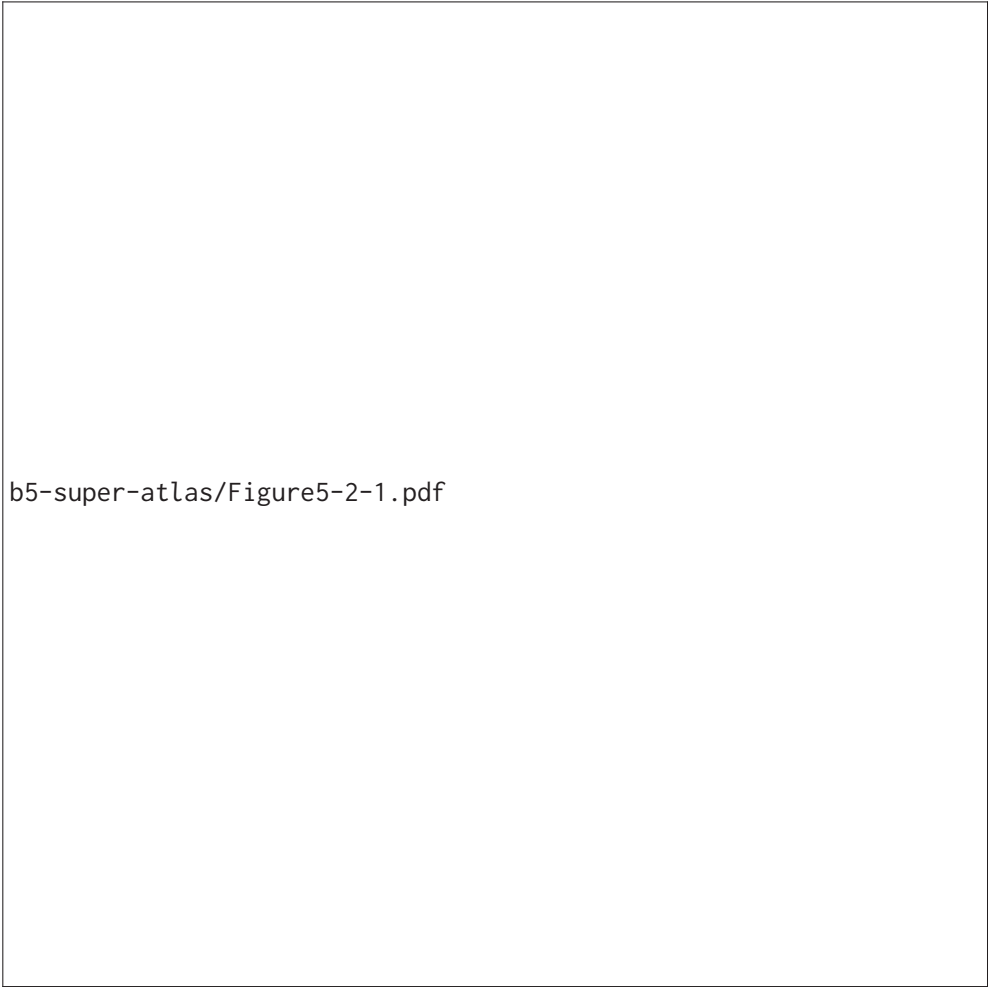
Percentage of voluntary post-tax contributions, 2012-13



*Notes: See page 396.
Source: ATO (2015b)*

Figure 59: Voluntary post-tax contributions are mostly made by those who already have high superannuation balances

Share of taxpayers and post-tax contributions, by existing superannuation balance, 2012-13, per cent



b5-super-atlas/Figure5-2-1.pdf

Source: ATO (2015a)

5.2 The total amount that can be contributed to super should be more tightly restricted

The current annual cap on post-tax contributions should be replaced with a lifetime cap on all post-tax contributions of \$250,000.²⁷⁷

Changes to the post-tax contributions regime need to strike a better balance between allowing those with broken work histories to contribute towards a reasonable superannuation balance, and restricting the opportunities for tax minimisation by those unlikely to qualify for an Age Pension.

That means being realistic about the level of post-tax contributions that are likely from those who are genuinely making up for broken work histories. Very few people stay out of the workforce for an extended period and then have such high earnings that they can make large post-tax contributions to superannuation on top of their pre-tax contributions.

A number of groups have suggested a lifetime cap on post-tax contributions. However, the levels proposed seem designed for the very rare case of a person with a broken work history, but a much-increased income, who is able to save so much in superannuation that it can entirely replace the Age Pension.²⁷⁸ The benefit to the small number of people in this category needs to be balanced against the tax leakage from a much larger number of well-off taxpayers who would use these provisions to minimise their tax.²⁷⁹

People returning to work after an extended absence are unlikely to contribute more than \$25,000 in a year to superannuation in addition to their pre-tax contributions of \$35,000 per year.²⁸⁰ Consequently, a lifetime limit of \$250,000 (in addition to pre-tax contributions) is likely to be more than most people with broken work histories can afford contribute to superannuation. Beyond this point, post-tax contributions are much more likely to be tax-planning than catch-up.

Post-tax contributions may also be made by those who have been self-employed, and have made minimal contributions, but want to

capture the capital value of their business in their superannuation fund. However, there are already separate provisions in place that allow small business owners to transfer assets from their business into their superannuation fund. Small business owners can make additional post-tax contributions, outside of the annual post-tax contributions cap of \$180,000, up to the *lifetime CGT cap*, which is currently set at \$1.395 million for 2015-16.²⁸¹ If a small business owner transfers assets from their business into their superannuation fund then, within limits, they do not pay tax on capital gains that have accrued over the life of the asset and these gains do not count towards their non-concessional contributions cap.²⁸²

The budgetary savings from a lifetime cap on post-tax contributions are difficult to determine given publicly available data. They are likely to start small and become large over the long-term.²⁸³ Their primary impact would be to increase the tax rate on savings over time. In effect they would redirect savings from superannuation to other investment vehicles where more tax is paid on earnings. The budget impact would cumulate as an increasing pool of savings is held outside rather than inside superannuation. By limiting re-contribution strategies, they would also increase the inheritance taxes paid on superannuation. This would be a reform for the long-term: most of those re-contributing are aged between 60 and 69 – at an age when most people can expect to live another 20 years, to about age 85.²⁸⁴

5.2.1 Transitioning to a lifetime cap

For people approaching retirement who had planned to make voluntary contributions, the transition to a lifetime cap would be much less disruptive than a tighter annual cap. The lifetime cap would not apply retrospectively, so those who have made large post-tax contributions in the past would not be required to pay additional tax on those contributions. However, those who have already made more than \$250,000 in post-tax contributions – before the cap was introduced – would be prevented from making additional post-tax contributions. Given the size of the superannuation savings they have already accumulated,

these people are unlikely to qualify for an Age Pension even if they make no additional contributions.

5.2.2 Administering the lifetime cap

Introducing a post-tax contributions cap should be administratively straightforward. The ATO already administers a lifetime cap on some post-tax superannuation contributions by small business owners, called the lifetime CGT cap. This would provide a template for administering a lifetime cap on post-tax contributions for all individuals.

The ATO already collects data from super funds on all contributions that individuals make in order to administer the annual concessional and post-tax contributions caps.²⁸⁵ The ATO could send an annual notice to each taxpayer, updating them on their entitlements to make post-tax contributions up to the new lifetime cap.

6

Superannuation earnings tax breaks

Earnings on superannuation balances are taxed less than earnings on savings held outside of superannuation (Figure 37). Superannuation accounts held by under-60s pay 15 per cent tax on investment income, and 10 per cent on capital gains.²⁸⁶ Superannuation accounts held by over-60s do not pay *any* tax on the earnings of their super fund, such as dividends, interest and capital gains, so long as the account-holder is making some withdrawals.

By reducing the tax rate on the future earnings of savings, the lower tax rate on super earnings encourages individuals to save for their own retirement. But the impact of this lower rate on the those with high superannuation balances does little to meet the objectives of the superannuation system. It boosts their retirement incomes by increasing the tax burden on other taxpayers. The majority of this transfer benefits those on high incomes. Tax breaks on super earnings also open-up planning opportunities that are usually used more by high-income earners.

Taxing superannuation earnings for those over 60 at 15 per cent would align with the tax treatment for younger account holders. It would improve the fairness of the system and the budget's bottom line by up to **\$2.7 billion** per year.²⁸⁷ It would also simplify the administration of the current system as all accounts would be taxed in the same way.²⁸⁸

6.1 Earnings tax concessions are large and growing rapidly

The total cost of a tax rate of 0 per cent – rather than 15 per cent – for those over 60 in draw-down phase is around \$2.7 billion each year.²⁸⁹ The cost of providing this tax break will increase as super balances rise, and as a greater proportion of the population enters the retirement phase where no tax is paid on earnings.

6.2 Earnings tax concessions disproportionately benefit retirees with high incomes

Two thirds of superannuation earnings tax concessions for those aged over 60 go to the 20 per cent whose annual incomes are above \$87,000. Figure 60 on the facing page shows the superannuation earnings, and the value of the tax break – because these earnings are untaxed – for those aged over 60. Those over 60 with low incomes receive less than \$100 a year on average from this superannuation earnings tax break, while those in the highest income category receive over \$4,000 per year.

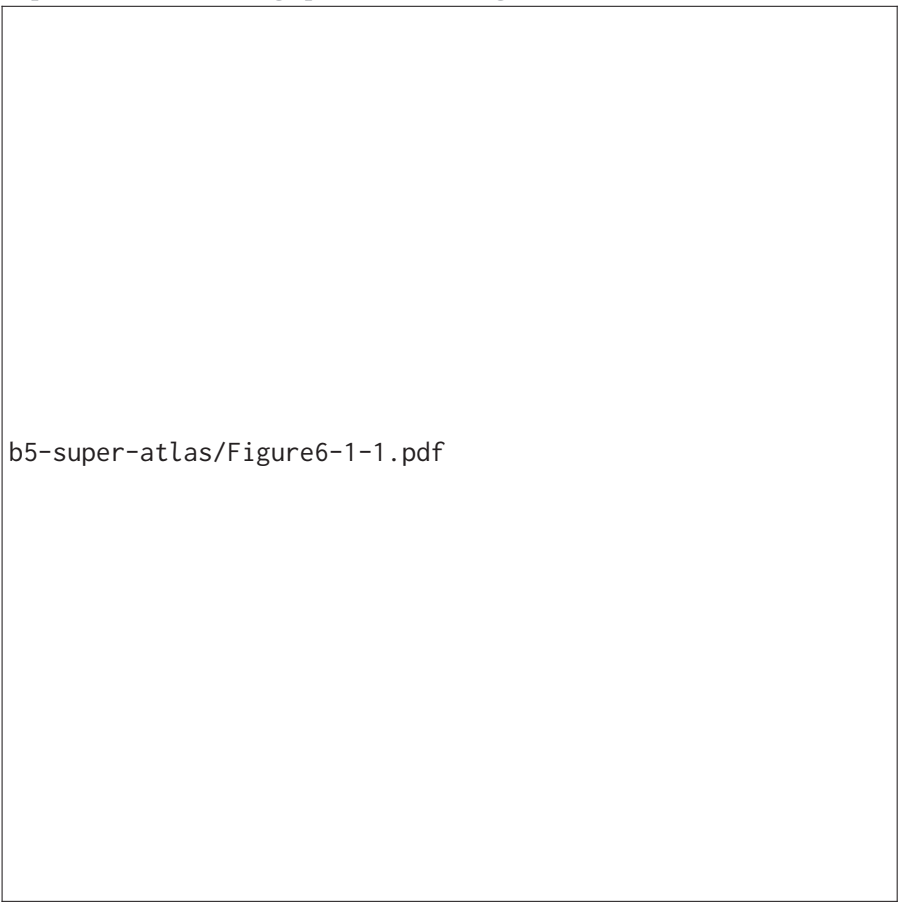
A recent ASFA report shows that at the extreme upper end there are 475 retirees with super account balances greater than \$10 million, receiving average income streams of \$1.5 million a year, almost tax-free.²⁹⁰

Super earnings tax concessions also open up tax planning opportunities that are used more by high-income earners. For example, if an asset is not sold until a person has turned 60, then no tax is payable on any of the capital gain on the asset since it was purchased – potentially many years earlier.²⁹¹

This is particularly valuable for SMSFs where the account holder can directly control the timing of asset sales.²⁹² It also provides big benefits to small business owners who can move their business into superannuation, and then sell it, without paying any capital gains tax.²⁹³

Figure 60: Those on high incomes benefit most from superannuation earnings tax concessions

Superannuation earnings per individual aged over 60, (2015-16 dollars)



Notes: See page 396.

Source: ABS (2013b); Grattan analysis.

6.3 Earnings tax breaks could be targeted in a number of ways

We focus here on three possible ways to target earnings tax breaks in pension phase, based on proposals from a variety of sources.

1. Tax all super earnings in the pension phase at 15 per cent*

This would improve budget balances by up to **\$2.7 billion** in 2015-16. These savings would grow rapidly in future years as the super system matures and the number of retirees increases. The costs would fall primarily on wealthier retirees paying very little tax. This proposal would also simplify the administration of superannuation.²⁹⁴ We proposed this policy in *Balancing budgets: Tough choices we need*.

2. Tax super earnings exceeding \$20,000 in the pension phase at 15 per cent

The proposed threshold of \$20,000 would roughly mirror that for wage-earners.²⁹⁵ The tax offset for earnings under the \$20,000 threshold would be worth up to \$3,000.²⁹⁶ This would improve budget balances by **\$1.6 billion**. It would target the benefits to less wealthy retirees. However, this policy would increase costs to administer the rebate. It would provide retirees a higher tax-free threshold than other taxpayers because they could use separate tax-free thresholds both inside and outside of the super system. In April 2015, the ALP proposed a variant of this policy that would tax super earnings in excess of \$75,000 at 15 per cent, raising \$0.5 billion in 2015-16, and more over time.²⁹⁷

3. Tax super earnings in the pension phase from balances of more than \$400,000 at 15 per cent

The costs would fall on more wealthy retirees, and have similar financial impacts to a tax of 15 per cent on earnings above a threshold of \$20,000, while raising similarly complex administrative issues. This policy would also save around **\$1.6 billion** per year.

*Capital gains would be taxed at 10 per cent, as they are before retirement.

In 2015 the Association of Superannuation Funds of Australia (ASFA) proposed a similar mechanism but a much higher cap of \$2.5 million.²⁹⁸ Such a cap, three times the threshold of the assets test for the Age Pension for a couple, is manifestly far too high.²⁹⁹

A variant on the first option would **tax all super earnings for all ages at 7.5 per cent**. This would *reduce* budget balances by around \$5 billion per year.³⁰⁰ There would be some costs for wealthier retirees. Those not yet retired would benefit, with the primary beneficiaries being those who have already accumulated significant super balances. This scheme was proposed in the Henry Review.³⁰¹ It has not been explored further in this report since proposals to *increase* the cost of the superannuation system are unlikely to be viable given budgetary pressures.

6.4 Taxing all super earnings for over 60s at 15% would be the best reform overall

As discussed above at Section 3.9, reform should aim to minimise tax breaks that don't serve the policy purposes of superannuation, maximise tax breaks that do, equity, minimise the budgetary cost, and be administratively workable.

The first option for reform – taxing all super earnings for over 60s at 15 per cent – provides the best balance among these considerations as summarised in Table 9 on the next page, and elaborated on below.

6.4.1 Targeting tax breaks and increasing equity

All proposals would reduce the super earnings tax breaks for wealthy retirees. A flat tax of 15 per cent on all earnings in the benefits phase would have the greatest impact (Figure 61 on page 207).

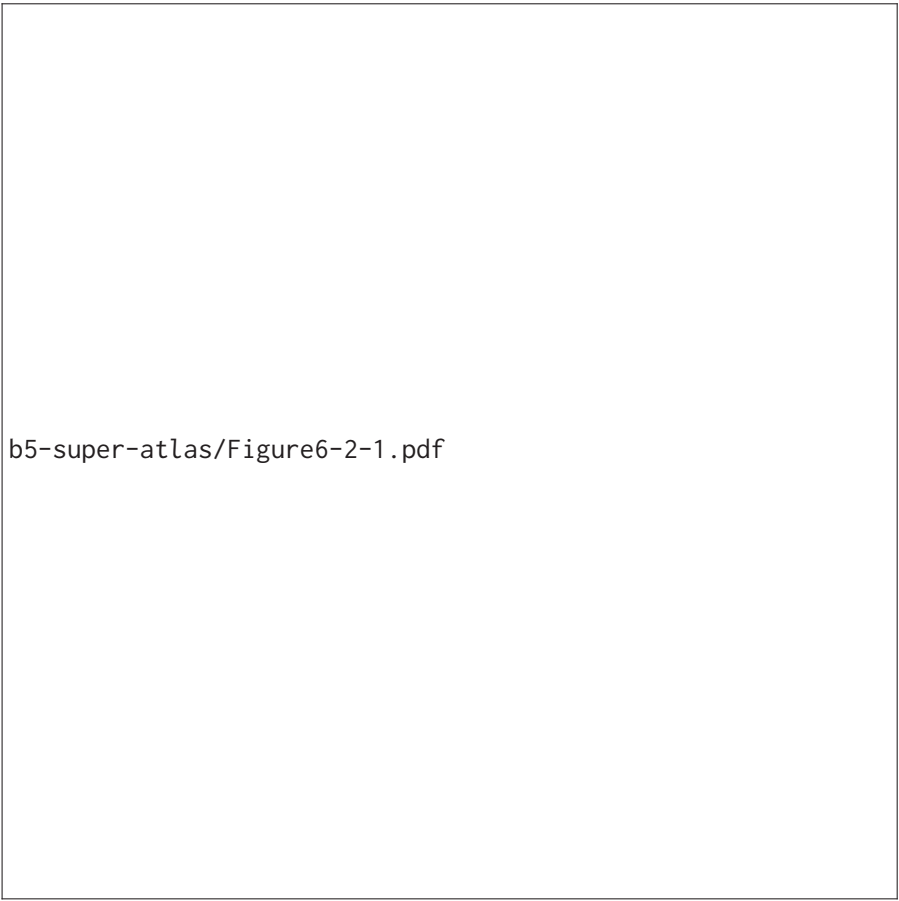
Assuming no behaviour change, those drawing on their super and in the highest income decile for over 60s would start to pay an average of \$11,000 in tax on their super earnings. Many of those in lower income deciles would pay around \$1,000 in tax.

Table 9: Assessment of earnings tax concession options

<i>Principles</i>	Tax all earnings for over 60s at 15%	Tax earnings for over 60s in excess of \$20,000 at 15%	Tax earnings for over 60s with balances over \$400,000 at 15%
<i>Maximise tax breaks that do serve policy purpose</i>	Some effect on retirees with low super balances, although able to rearrange affairs	Minimal impact on bottom 90%	Minimal impact on bottom 90%
<i>Equity</i>	Reduces tax breaks for top 30%;	Reduces tax breaks for top 20%;	Reduces tax breaks for top 20%
<i>Budgetary impact</i>	\$2.7 billion	\$1.6 billion	\$1.6 billion
<i>Administrative issues</i>	Simplifies fund administration	Simplifies fund administration but requires new system for ATO to rebate funds in pension phase	Complex to administer unless a much higher threshold, applying to a small number of accounts, is used

Figure 61: A tax on earnings in retirement would mostly affect those with higher incomes

Average additional tax paid by 60+ year olds under reform proposals, by total income decile (including super earnings), 2015-16 dollars



b5-super-atlas/Figure6-2-1.pdf

Notes: See page 397.
Source: ABS (2013b); Grattan analysis

However, behaviour change would result in much tighter targeting in practice. Those with super but on low and middle incomes could maintain a zero tax rate on earnings by moving savings out of super. Their total taxable earnings would be below the tax-free threshold, which is effectively around \$30,000 for those aged over 65 who qualify for the Senior Australian and Pensioner Tax Offset (SAPTO).³⁰²

The biggest concern would be for those in the 8th income decile who would pay around \$1,700 in tax on their superannuation earnings, relative to their taxable income between \$33,000 and \$47,500. Of course, this is still less than the tax that would be paid by a wage-earner with this income. And a typical household in this decile would expect to draw down some of their average superannuation balances of \$456,000.

Compared to a tax of 15 per cent on *all* earnings, a tax-free threshold of \$20,000 in retirement would collect about \$1,000 less from most people aged over 60 – assuming no behaviour change. A person in the top income decile would pay an average of over \$9,000 more in tax than they do today. Those in the middle-income tax brackets – with taxable incomes less than \$33,000 – would on average pay very little tax on their super earnings. Those in the 8th income decile – earning between \$33,000 and \$47,500 – would pay about \$850 more in tax than they do today, and almost nothing if they maximise the tax-free thresholds both inside and outside of superannuation. The tax-free threshold of \$20,000 would save this 8th decile about \$300 million a year in tax (after behaviour change), but overall tax collections would fall by over \$2 billion. A targeted change to the Age Pension income test threshold could probably provide compensation to this 8th decile at much lower budgetary cost.

With a tax-free threshold for superannuation earnings, retirees would continue to pay much lower rates of tax compared to younger people paying taxes on wages. Retirees would be able to use a tax-free threshold both inside and outside of super. A retiree over the age of 65 could earn up to \$20,000 tax-free from super, and a further \$32,280 tax-free outside of super, for a total tax-free income of \$52,280.³⁰³ In comparison,

a younger worker earning \$52,000 in wages would pay tax of around \$9,000, at an average tax rate of 18 per cent.

Taxing balances over \$400,000 would have similar impacts to taxing earnings over \$20,000. There would be small differences in that taxing earnings above a threshold would dampen the volatility in returns between years, while taxing balances above a threshold would have a larger impact on retirees with more conservative investment strategies. It would induce similar behaviour change as taxpayers transferred some balances over \$400,000 out of super to utilise the income tax-free earnings threshold.

ASFA proposed an alternative cap of \$2.5 million. It would only affect a small number in the highest income decile. In 2012-13, there were around 7,125 retirees (just under 1 per cent of retirees) in the drawdown phase with balances greater than \$2.5 million.³⁰⁴ A larger number – about 63,000 people – have super balances of more than \$2.5 million, but are still in the accumulation phase.

However, a threshold of \$2.5 million is difficult to justify. It simply does not go far enough in targeting superannuation tax concessions at those who would otherwise qualify for a part-pension. Many of those under the \$2.5 million threshold would be very well-off. Their funds could generate earnings of up to \$100,000, even on a 4 per cent return. And in practice most people with superannuation balances of this level also have substantial other assets and income streams (Figure 41 on page 150). ASFA's own calculations indicate that that a single person needs a lump sum of \$535,000 at retirement in order to support an affluent lifestyle, or \$640,000 in the case of couples (Section 3.3), so it is difficult to understand the rationale for continuing to provide tax breaks to those with balances between \$640,000 and \$2.5 million, except to maximise the Funds Under Management, and therefore the profits, of the super industry.

There may be concerns that the tax free threshold outside of super may encourage people to move funds out of super, and into investments that are less prudentially supervised. In practice, however, this horse has

already bolted. Most households already invest more financial assets outside of super than inside (Section 2.1).

There may also be concerns that taxes on super earnings for retirees would reduce the living standards of middle-income retirees who do not move savings out of super to use the existing tax-free thresholds. But this is not sufficient reason to exempt the first \$20,000 of superannuation earnings in retirement – whether by exempting the first \$20,000 in earnings or by taxing balances above \$400,000. Firstly the tax should be seen in context: it would be less than 1 per cent of super balances, would be paid by households of an age that are receiving substantially greater health benefits from government than a decade ago, and these households would still be paying less tax than households of working age on similar incomes.

If it is seen as imperative to maintain the exact living standards of middle-income retirees who do not optimise their investments, there are far better ways to achieve this outcome. For example, a \$500 boost to the Age Pension for Australia's 2.4 million pensioners would cost \$1.2 billion a year³⁰⁵ – roughly the same as the revenue foregone from taxing fund earnings in retirement with a tax-free threshold of \$20,000. Boosting the Age Pension would do far more than a tax-free threshold to maintain the living standards of low and middle income retirees right up to those in the 8th income decile, without providing more support to the top 20 per cent of retirees, and without imposing additional dead-weight administrative costs on the super system.

6.4.2 Budgetary impacts

The three proposals would have different budgetary impacts, as shown in Figure 62 on the facing page.

A flat 15 per cent tax on earnings would raise about **\$2.7 billion** in 2015-16, and substantially more as the super system matures.³⁰⁶

This estimate accounts for behaviour change as low- and middle-income earners move their savings out of superannuation where their earnings

Figure 62: Reintroducing taxes on super earnings for over 60s could raise almost \$2.7 billion in 2015-16, and would grow quickly
Revenue gain from reform options (2015-16 dollars, billions)



Notes: See page 397.
Source: ABS (2013b); Grattan analysis

would be beneath the income tax-free threshold for older Australians.³⁰⁷ It assumes that high-income earners will largely leave their funds in super and pay tax on the earnings levied at a 15 per cent tax rate. Those with larger super balances typically also have substantial income outside of superannuation (Figure 41). Consequently, they gain little advantage from moving funds out of superannuation. There are very few alternative investments where the tax on earnings is less than the 15 per cent tax rate on superannuation earnings.³⁰⁸ There may be some switching of investments into family homes and negatively geared property, the major forms of investment with tax rates approaching 15 per cent for high-income earners. However, this is unlikely to be a large effect. Owner-occupied housing and negatively geared investment property only provide returns when they are sold, so they are much less useful for providing retirement income. And the tax rate on the equity in negatively geared property is not materially less than 15 per cent, but the leverage makes the investment substantially more risky.

This analysis may understate the long-term impact on the budget. The current system imposes no tax on capital gains on superannuation assets provided the sale is deferred until pension phase. If earnings in pension phase are taxed at the same rate as earnings while working, substantial additional capital gains tax may be raised as this arbitrage is removed.³⁰⁹

Introducing a tax on earnings will have some impact on the super balances of retirees over time. For some, it will mean receiving the Age Pension earlier, with an associated increase in government spending on benefits. But since most concessions flow to high-income earners who are least likely to receive a pension, the budgetary impacts would be small.³¹⁰

A flat 15 per cent tax with a tax-free threshold of \$20,000 would raise about **\$1.6 billion**. A higher tax-free threshold of \$75,000, as proposed by the ALP, would raise much less, around \$0.6 billion. There would be relatively little movement of funds out of superannuation if there were a tax free threshold. Most households that earn more than \$20,000

from superannuation also have income from other sources of more than \$20,000 (Figures 41 to 42 on pages 150–151).

A tax on balances over \$400,000 could raise **\$1.6 billion**. A tax on balances over \$2.5 million would only raise about \$0.2 billion, although this would increase over time if the cap remained fixed. Because it only targets retirees with very high balances, the ASFA proposal does not contribute much to budget repair. As discussed above, this proposed cap is far too high, and preserves earnings tax breaks for high-income earners that bear no relation to the plausible purposes of super.

6.4.3 Administrative issues

Taxing all super earnings for over 60s at 15 per cent would simplify superannuation administration, since both pre-pension and pension funds would be taxed at the same rate. Currently, superannuation funds must maintain two separate pools of funds, with different tax treatments for those in pre-pension and drawdown phases of superannuation.³¹¹ This proposal would also remove the requirement for retirees to set up a separate pension account with their superannuation fund in order to benefit from tax-free super earnings in retirement, which increases the number of accounts and adds to administration costs.³¹² The Financial System Inquiry found that aligning the tax rates in this way would encourage pension product innovation.³¹³

Taxing super earnings in excess of \$20,000 for over 60s at 15 per cent would have mixed administrative impacts. There would be substantial practical issues in administering the tax-free threshold within funds. The most workable mechanism we have encountered would tax all funds at 15 per cent, which would remove at least one complexity from the system. The Financial System Inquiry suggested that the ATO could calculate superannuation earnings net of taxes and fees using existing account balance and contributions data, without the need for additional reporting.³¹⁴ It could apply a presumed tax rate, and credit the rebate to the person's nominated superannuation account. Although there would be some mismatch between the precise amount of tax paid

by funds, and the amount of tax refunded through the rebate,³¹⁵ the variance would not be material, given that the maximum rebate payable would be \$3,000.

Taxing earnings on superannuation balances over \$400,000 would create substantial complexities. ASFA suggested that any balance in excess of the cap at the time a person moved into pension phase would be left in the accumulation phase, and continue to pay tax on earnings at a 15 per cent rate.³¹⁶ Presumably people already in pension phase would have to roll back into a taxed account their balances in excess of the cap. This would affect an estimated 580,000 retirees today. Beyond the significant administrative costs of this approach, the further proliferation of super accounts would add greatly to the costs of the superannuation system.³¹⁷ Substantial issues would arise for taxpayers with accounts with multiple providers, who failed to transfer excess balances in advance. If earnings were only taxed for balances over \$2.5 million, the reform would only affect about 12,500 people, and the administration might be more manageable, although it is unclear it would be worth the trouble given the small budgetary savings it would yield.³¹⁸

All proposals to tax earnings in pension phase create issues for defined benefits funds that pay an annuity or a defined percentage of working-life salary. However, the problems are not insurmountable. Defined benefit schemes are now a minority of superannuation accounts. Taxes on fund earnings could be based on notional earnings based on actuarial calculations, as proposed by Swan and Shorten (2013). Alternatively, fund earnings could remain exempt and benefits paid out each year could be taxable.³¹⁹

6.4.4 Transitional provisions can manage the appearance of retrospectivity

Moving to a system of taxing earnings for those in the benefits phase may raise concerns about the government retrospectively 'changing the rules'.

However, the proposed changes in earnings tax breaks are comparable to a change in income tax rates that affects investments. An investor who buys shares pays taxes on future dividends at whatever tax rate is applicable at the time. The investor does not expect to grandfather the tax rate applicable at the date that the shares were bought.

Nor would these proposals impose new taxes on funds that are 'locked in'. They would only affect people in draw-down phase, who by definition are entitled to withdraw all their money from super and reinvest it elsewhere. In practice, few are likely to do so, since few investment vehicles have a tax rate on earnings of less than 15 per cent (Figure 37).

It might be argued that the change would be unfair to people who changed their savings arrangements in response to the superannuation rules. The claim would be that they tied up their savings, and sacrificed flexibility, in the expectation of paying no tax in retirement. However, it is difficult to believe that such people would have made different investment choices if they had known there would be a tax rate of 15 per cent on superannuation in retirement. This is still almost certain to be a lower tax rate on investment earnings than applies to other investments. The investor would also usually have benefited from contributions tax breaks, and a relatively low tax rate of 15 per cent on earnings before retirement.

Finally, it might be argued that retirees have less scope to adjust their behaviour in response to the removal of these tax breaks. But the proposed changes need to be seen in context. For the top three income deciles, the changes would impose additional taxes of much less than 1 per cent of their superannuation balance (Figure 61). They would still be paying much less tax than a working household that has a much lower income, and only minimal savings, and so little hope of accumulating large superannuation balances.

Thus, while grandfathering the tax-free status of accounts for existing retirees might be the most politically expedient option, it is neither prudent nor fair. Grandfathering would mean that the reform would

contribute little to the budget for many years. It would also exacerbate intergenerational transfers from existing concessions: younger generations would continue to fund generous tax benefits they will never be able to access.³²⁰

An alternative mechanism to soften the impact on retirees – and give them time to adjust their spending habits – is to phase in the 15 per cent tax rate over 5 years. Each year, the tax rate applied to earnings would increase by 3 percentage points.

Conclusion

Australia's superannuation system has acquired dizzying complexity. Ironically, this has not led to precise targeting. Rather, it has concealed the growth of a system where the outcomes diverge a long way from any plausible social policy purpose or notions of fairness.

Australia's superannuation system has become a textbook example of 'kludgeocracy'. Complexity originally driven by the search for fair outcomes has ultimately provided large benefits to vested interests with the time and resources to push for technical changes that serve their interests.³²¹

This report has proposed specific reforms that would start to drive the superannuation system towards simpler, fairer outcomes. Our proposals would target the outcomes better to the system's purpose, reduce administrative complexity, and improve budget balances.

Many other features of Australia's retirement incomes system also need reform. Areas beyond the scope of this report include:

- Increasing the age at which tax free withdrawals can be made from super to match the age of access to the pension;³²²
- Better targeting the Age Pension by including owner-occupied housing in the Age Pension assets test;³²³
- Reducing the value of superannuation tax breaks for small business owners, such as the lifetime CGT cap;

- Restricting the Senior Australian and Pensioners Tax Offset (SAPTO), which provides a much higher tax-free threshold for pensioners and other retirees.³²⁴

Clearly more comprehensive reforms are needed. However, the reforms proposed in this report do not need to wait. They would be no-regrets steps in the right direction.

A

Superannuation contributions by age, income and super account balance

This appendix provides a more detailed analysis of the super contributions made by taxpayers of different ages, taxable income, and by contribution type. Overall, the results reinforce the findings from the main report. These aggregate trends are:

- Total amount contributed voluntarily is dominated by post-tax contributions;
- Voluntary pre-tax contributions increase with income and age, and peak amongst those aged 55-59;
- Voluntary post-tax contributions increase with income and age and are dominated by those aged over 60, especially those with already large super account balances.

For pre-tax, and then post-tax contributions, this appendix analyses:

- Total amount contributed
- The amount contributed on average per taxpayer
- The distribution of contributions

A.1 Pre-tax contributions

Pre-tax contributions are generally dominated by compulsory rather than voluntary contributions. Voluntary pre-tax contributions are generally only material for high-income households, and for households aged 55 and over (Figure 63).

The bulk of pre-tax voluntary superannuation contributions are made by older high-income individuals. (Figure 64 on page 222). The total amount contributed is dominated by the top quintile of income earners, and peaks amongst those aged 55-59.

These patterns are magnified at the household level. Even more of the contributions are made by the top quintile of income earners, and by older households (Figure 65 on page 223).

Around 70 per cent of voluntary pre-tax contributions are made by the 20 per cent of households with the most wealth. Of these, 80 per cent are aged 50 or over (Figure 66 on page 224).

Salary sacrifice contributions are much more common among older households (Figure 67 on page 225). Those aged over 60 can recycle salary through superannuation to reduce their tax (Appendix B).

Super recycling is reflected in the amount sacrificed, with older households that do sacrifice their salary more likely to give up a large part of their income (Figure 68 on page 226).

Large contributions per household are generally only made by those who are older and have high incomes. Contributions of over \$10,000 are only material for households aged over 60, or for those in the top 30 per cent of income earners (Figure 69).

A.2 Post-tax voluntary contributions

Post-tax contributions account for the bulk of contributions made by taxpayers aged 60 years and over (Figure 70 on page 228).

Figure 63: High-income earners are the dominant source of concessional contributions
Average concessional contribution by tax bracket and type of contribution in 2012-13. (2012-13 dollars)

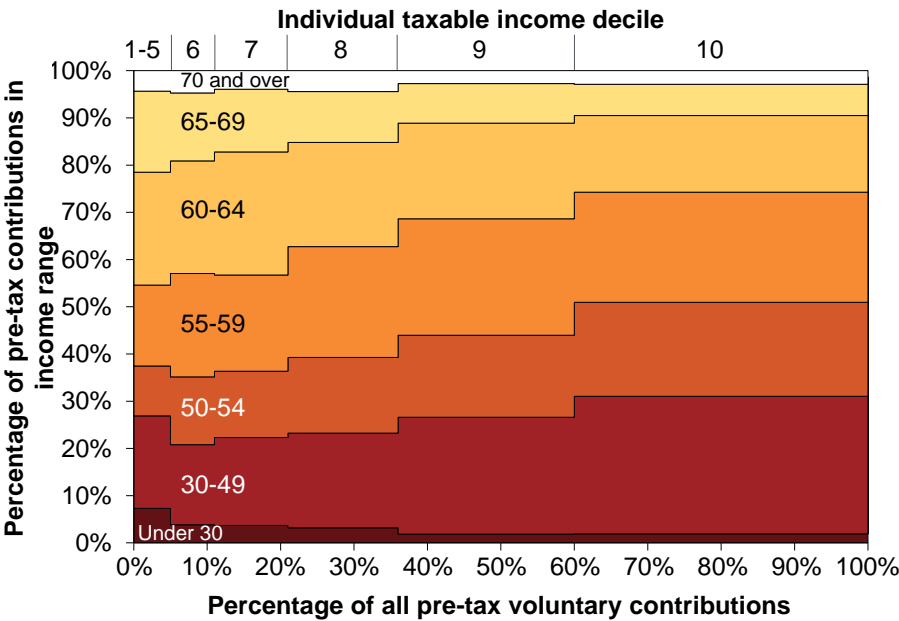


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Notes: See page 397.
Source: ATO (2015i) and ATO (2015b).

Figure 64: Voluntary pre-tax contributions are mostly made by those who are older and on high incomes

Percentage of voluntary pre-tax contributions, 2012-13

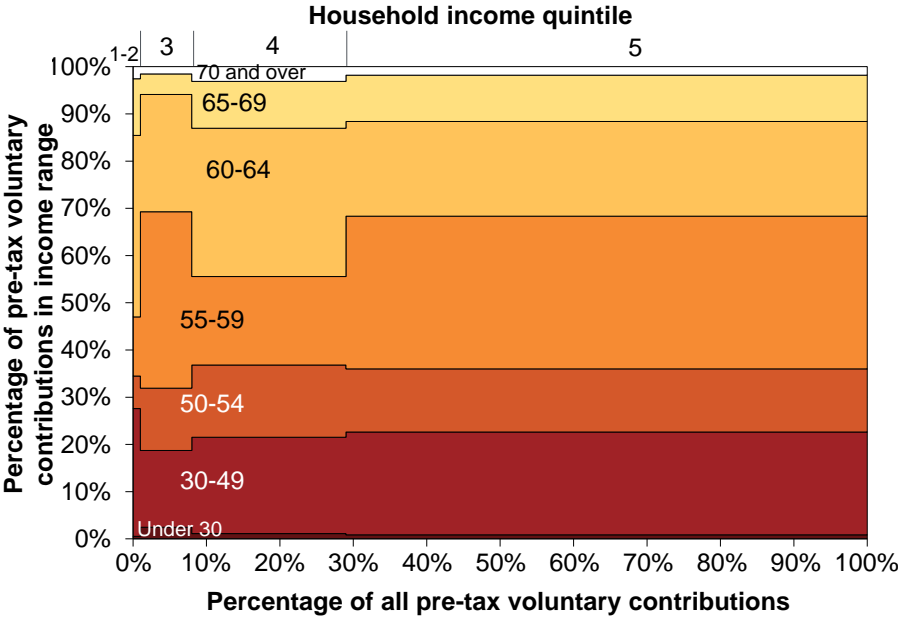


Notes: Includes reportable salary sacrifice contributions and contributions from post-tax income for which the taxpayer has claimed a tax deduction for 2012-13.

Source: Grattan analysis of ATO (2015h) and ATO (2015i).

Figure 65: The bulk of salary sacrifice contributions come from older, higher-income households

Percentage of salary sacrifice contributions by household age, 2011-12

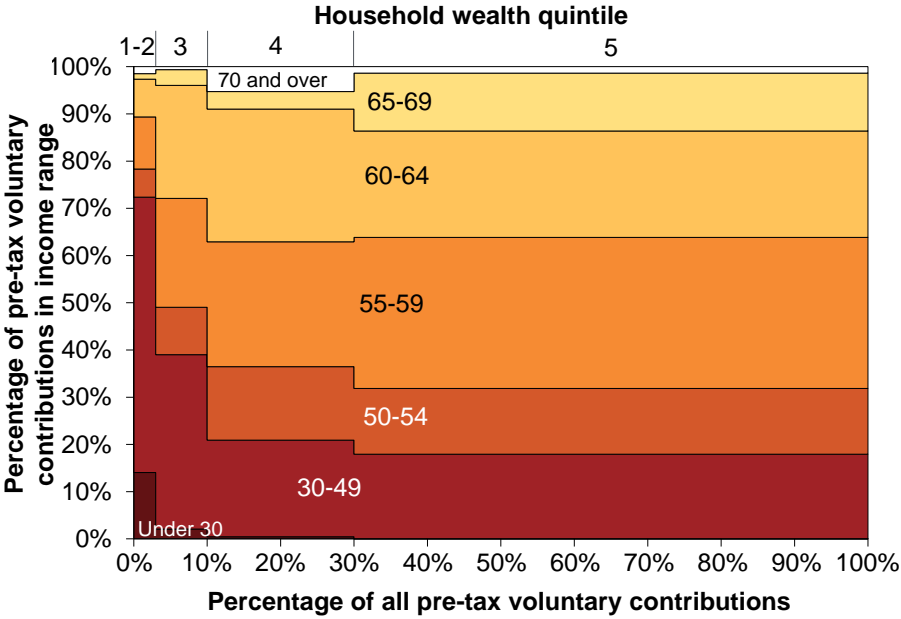


Notes: Excludes multiple family households

Source: ABS (2013b); Grattan analysis

Figure 66: The bulk of salary sacrifice contributions come from households that already have substantial savings

Total salary sacrifice contributions by household age, 2011-12



Notes: Excludes multiple family households

Source: ABS (2013b); Grattan analysis.

Figure 67: Older, high-income households are more likely to salary sacrifice

Proportion of households making salary-sacrifice contributions

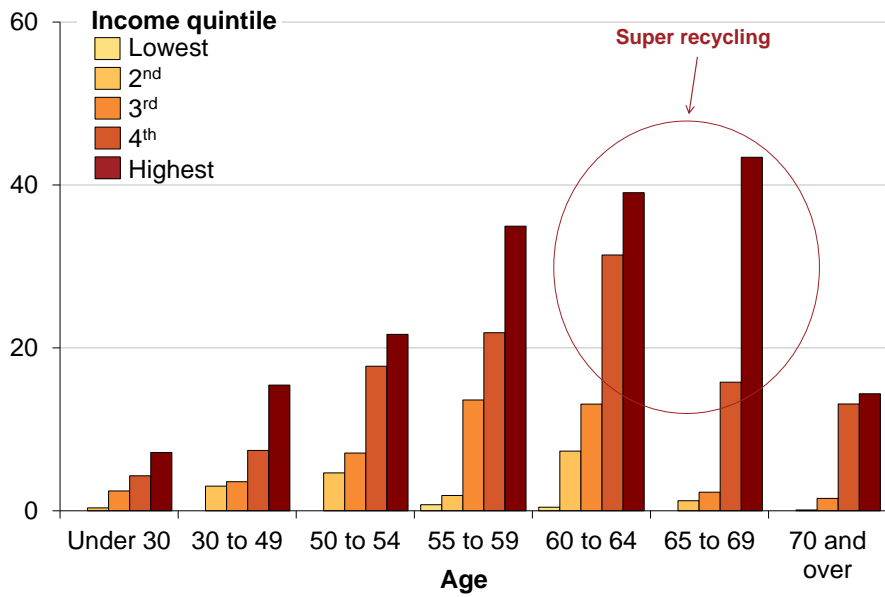
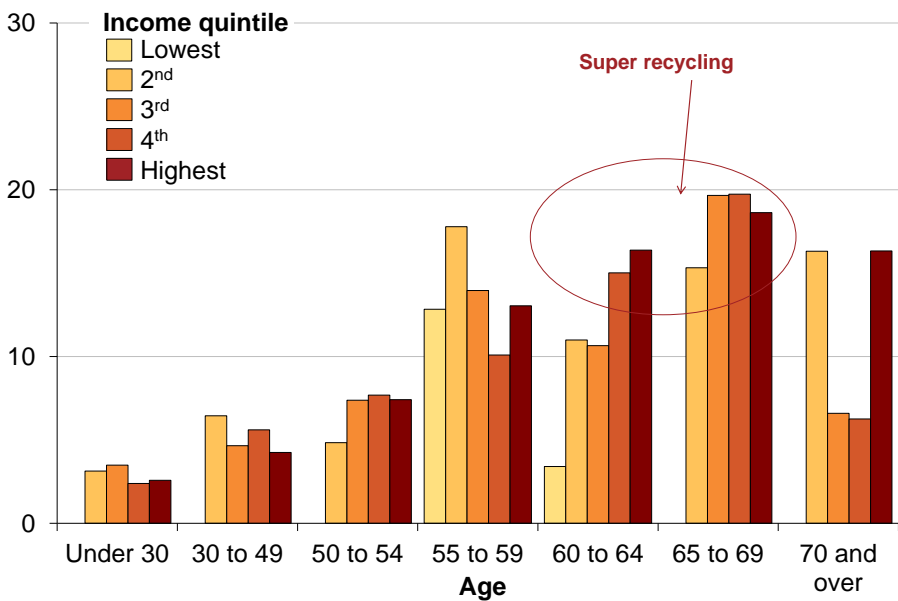


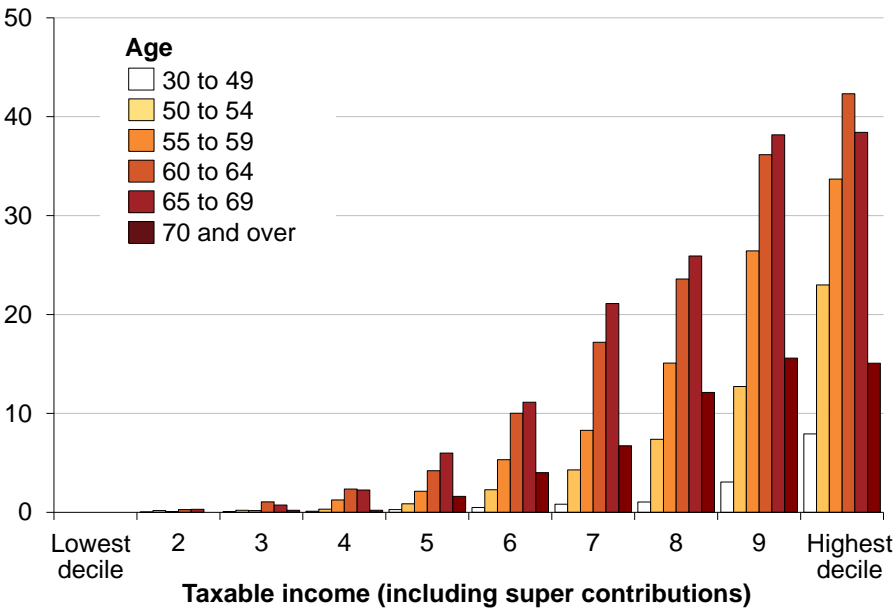
Figure 68: Older, households are more likely to sacrifice a large part of their salary into superannuation
 Proportion of income salary sacrificed by households making salary-sacrifice contributions, per cent



*Notes: Includes all sacrificed superannuation contributions made by a member of the households; multiple family households have been excluded from the dataset.
 Source: ABS (2013b); Grattan analysis.*

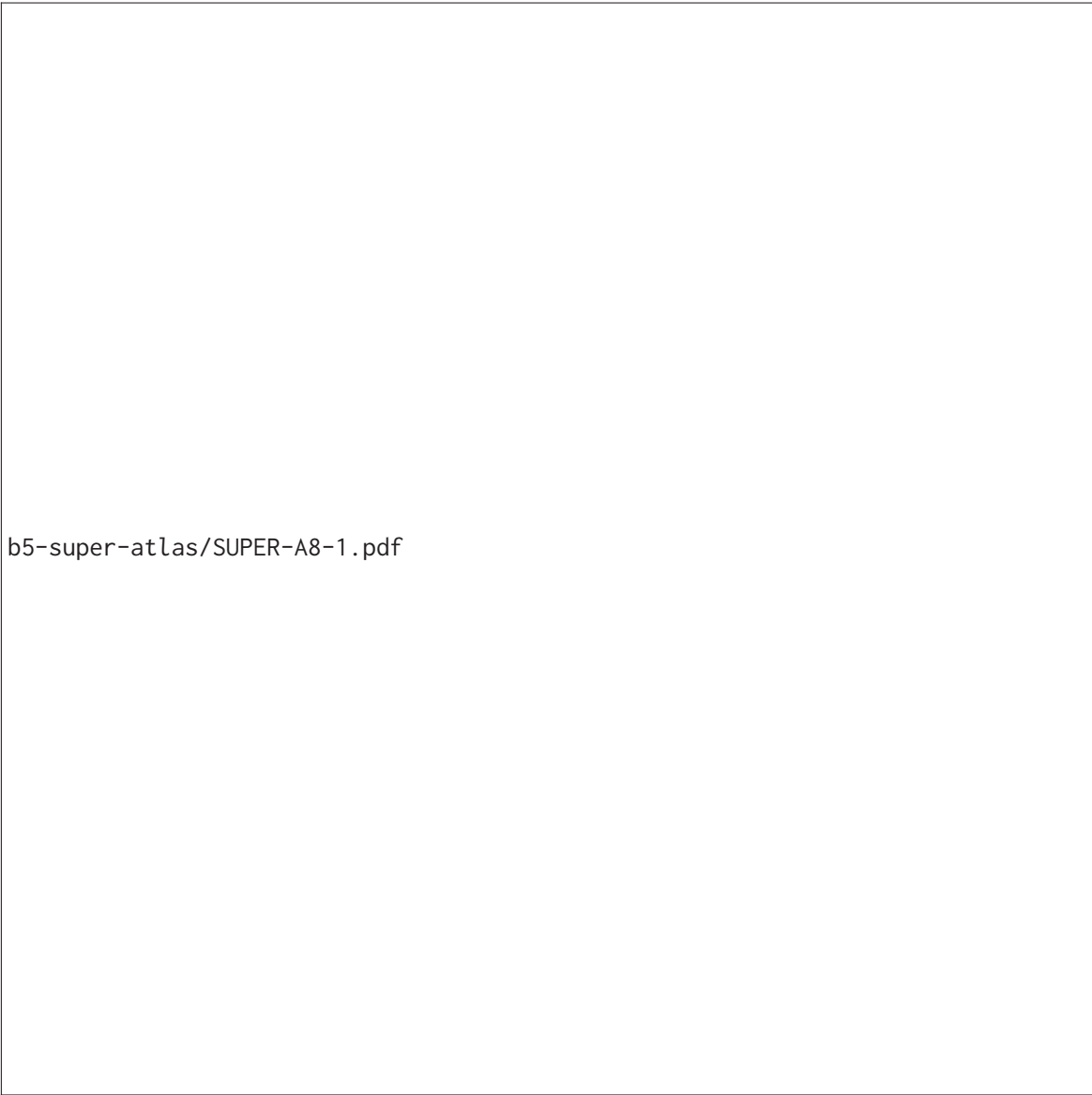
Figure 69: Most taxpayers making large voluntary pre-tax contributions are older high-income earners

Share of age and income cohort making concessional voluntary contributions to superannuation of more than \$10,000 in a year, per cent



Source: ATO (2015i).

Figure 70: Voluntary contributions are dominated by over-55s contributing from post-tax income
Average contributions by tax bracket by type of contribution, (2012-13 dollars)



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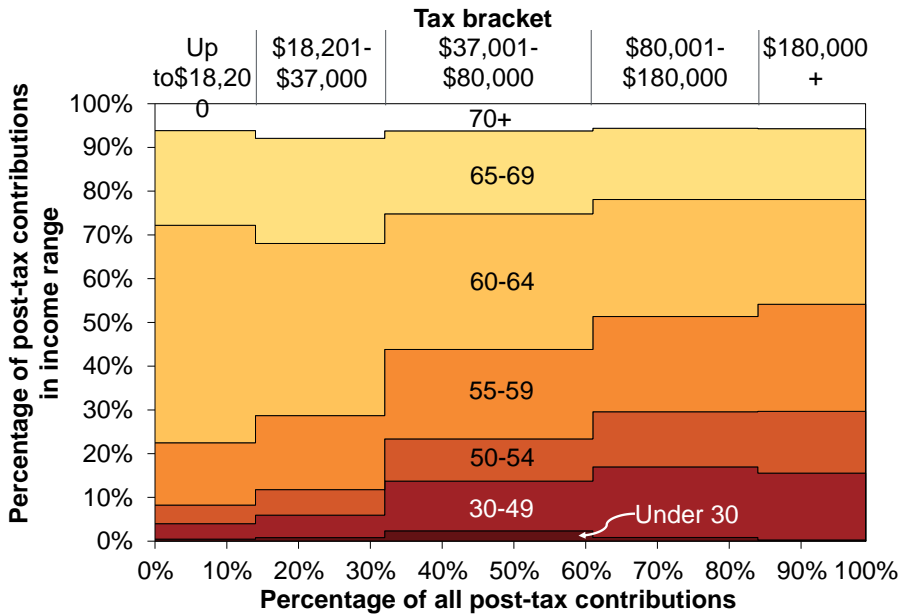
Notes: *Vide supra*: Figure 63.

Most of the post-tax contributions come from older, higher income households that tend to already have already accrued large super account balances. Although those aged 60 to 69 represent just 11 per cent of all taxpayers, they make more than half of all post-tax contributions (Figure 71).

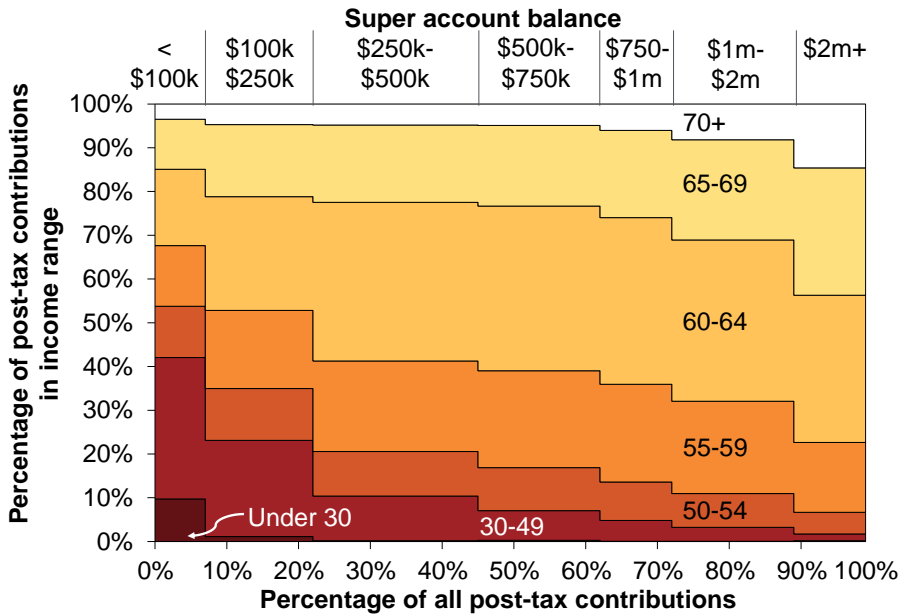
Voluntary post-tax contributions are much more common amongst older taxpayers, particularly those aged over 50 (Figure 72 on page 231).³²⁵ In 2012-13, one in three taxpayers aged 60 to 64 made a post-tax contribution, averaging over \$37,000.

Taxpayers that have already accumulated large superannuation account balances are much more likely to make further large post-tax super contributions (Figure 74 on page 232). Well over 40 per cent of taxpayers with super balances of more than \$500,000 make a post-tax contribution, averaging over \$50,000.

**Figure 71: Voluntary post-tax contributions are mostly made by those who:
... are older and on high incomes**

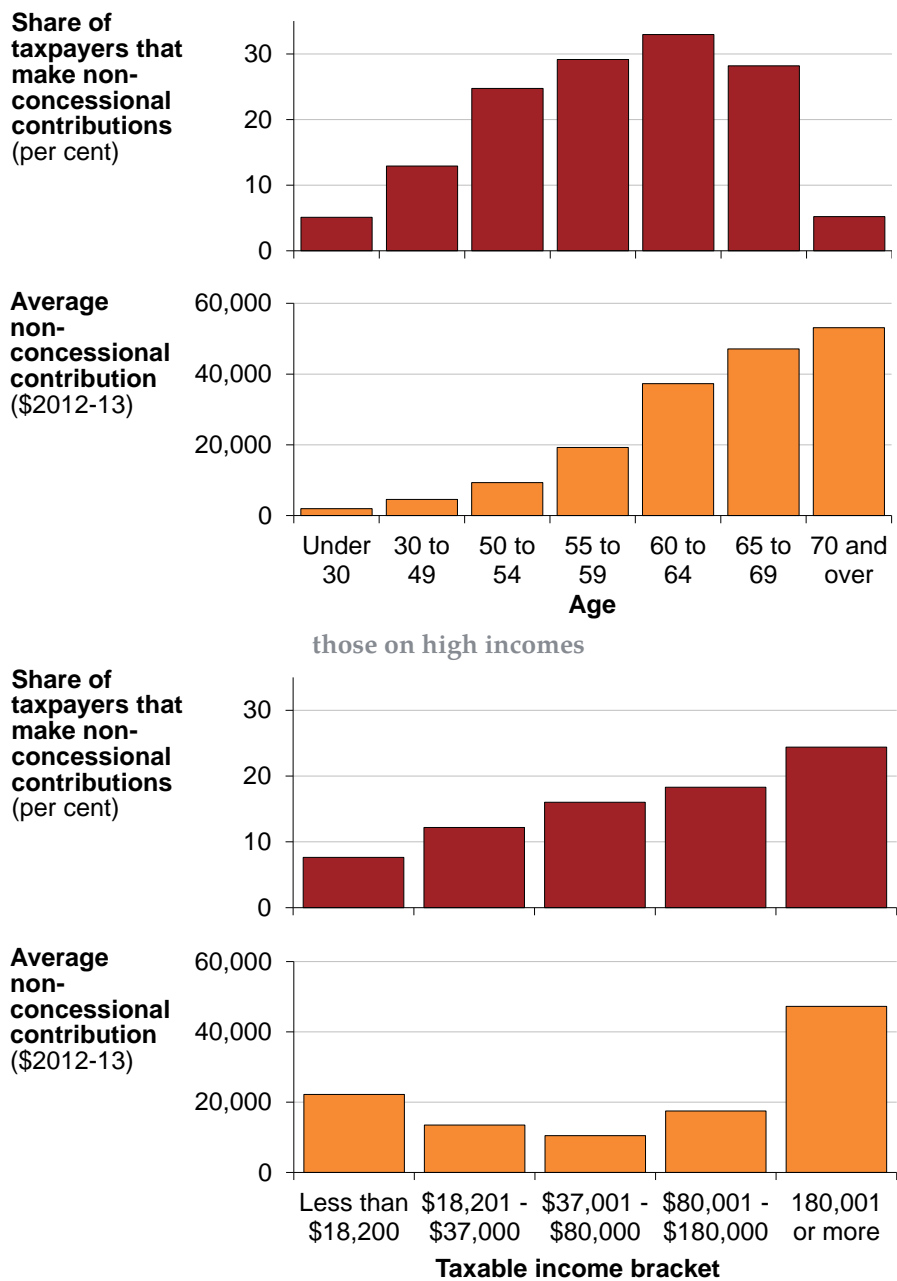


... already have high superannuation balances



Source: ATO (2015h); Grattan analysis.

Figure 72: Who is more likely to make larger post-tax contributions
those close to retirement

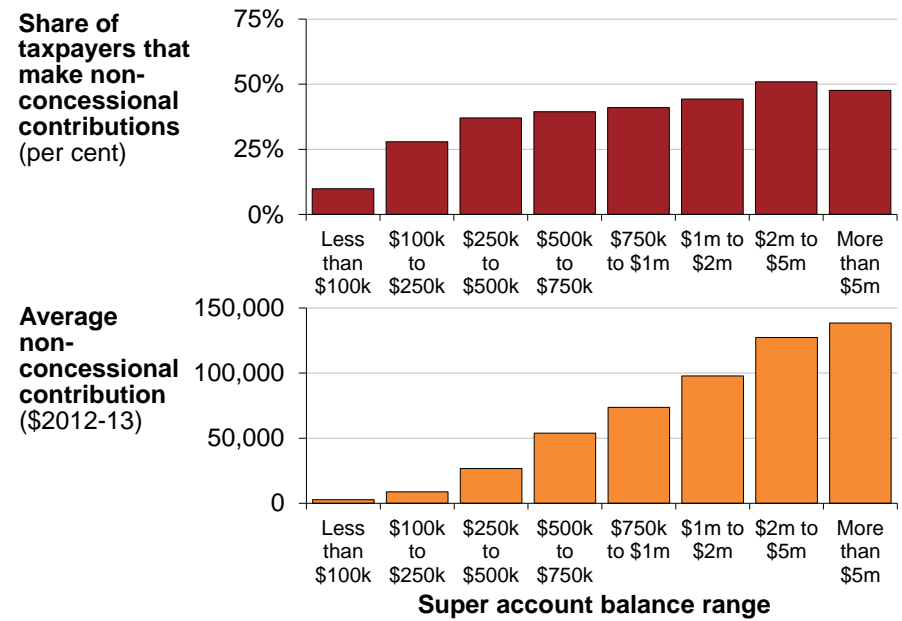


Notes: As per Figure 63. This shows the average contribution among individuals in that income tax and age bracket that made a post-tax contribution in 2012-13. It is not comparable with analysis elsewhere in this report which averages across all taxpayers in that income tax bracket, regardless of whether they contributed.

Source: ATO (2015h) and ATO (2015i); Grattan analysis.

Figure 74: Those with large super balances

Average post-tax contribution and share of taxpayers in each super account balance range that make a contribution, 2012-13



Notes: Excludes those taxpayers and post-tax contributions for which the ATO is unable to identify their account balances. The statistics for the 2012-13 income year were sourced from 2013 individual income tax returns processed by 31 October 2014 and member contributions statements received before 29 October 2015.

Source: ATO (2015b).

B

Benefits of super recycling

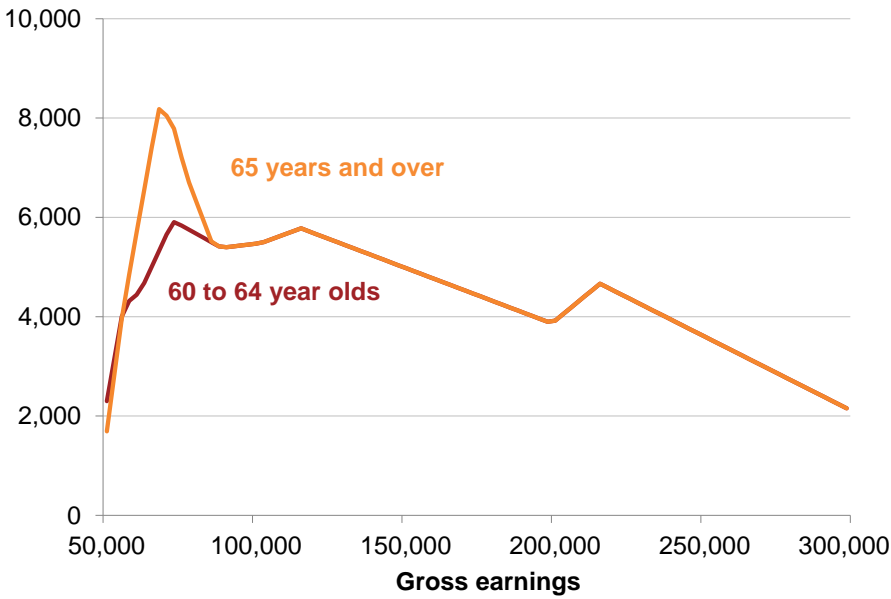
Tax-free superannuation benefits for over 60s permits middle- and high-income earners to substantially reduce their tax liability by recycling wage income through their superannuation fund, irrespective of whether these workers are actually saving for retirement.

Wage earners aged over 60 can withdraw money from superannuation tax-free.³²⁶ They can reduce how much tax they pay on wage income and immediate consumption by contributing up to the concessional cap out of their wage income, and then withdrawing the funds from superannuation the next day to consume immediately. Since workers only pay 15 per cent tax on the income contributed to super, rather than their marginal tax rate, the tax savings can be substantial. For workers aged between 60 and 64 years earning between \$65,000 and \$150,000, this strategy reduces the amount of tax paid by over \$5,000 (Figure 75 on the next page). The tax benefits for workers aged 65 years and over are even larger.³²⁷

Access to superannuation for older workers, such as via ‘transition to retirement’ rules for those aged below 65, was designed to allow individuals to move from full-time to part-time work without reducing their incomes, using superannuation withdrawals compensate for lower wages.³²⁸ However, recent evidence suggests that these rules are mainly used by high-wealth individuals to reduce their tax bills while they continue to work full-time.³²⁹

Figure 75: Wage earners aged over 60 can significantly reduce their tax by recycling their incomes through superannuation

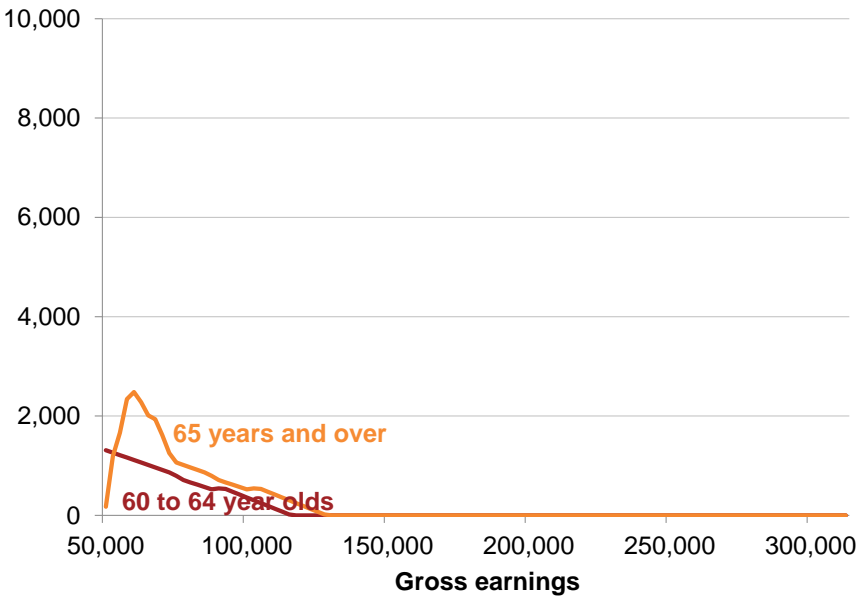
Annual tax avoided by recycling, 2015-16



Notes: See page 397.

Figure 76: An \$11,000 cap on concessional contributions would reduce the payoff from super recycling

Annual tax avoided (2015-16 dollars)



Notes: See Figure 75 on the facing page.

C

Approaches and measures for tax rates on savings

C.1 Approaches to taxing savings

Many OECD countries adopt an '**EET approach**' for taxing retirement savings, where withdrawals are taxed at a person's marginal tax rate, and contributions and earnings are tax-exempt. An EET system defers tax revenue until retirees draw down their retirement savings, allows progressive taxation of retirement incomes, and helps to align super taxes with lifetime incomes.

Other countries adopt a '**TEE approach**' where contributions are taxed at progressive marginal rates of personal income tax, but earnings and benefits are tax-exempt. A TEE approach produces similar results as an EET system, except revenues are collected up front. A TEE system also tends to tax higher income earners more heavily since progressive income taxes are levied during the peak earning years, rather than at retirement when consumption tends to be lower.

The 'EET' and 'TEE' approaches do not tax the 'risk-free' return to savings. Taxing the normal, or 'risk-free' return to savings means that the effective rate of tax on the real value of savings increases the longer an asset is held.³³⁰ However, a TEE approach also leaves untaxed the 'returns to risk' on returns earned in excess of the risk-free rate.³³¹

Australia's hybrid income tax system taxes many forms of savings in similar ways to either EET or TEE approaches. For example, Australia

already takes a TEE approach to taxing owner-occupied housing, the largest form of household savings.

For superannuation savings funded from pre-tax income, Australia applies a unique '**tte approach**' where contributions and earnings are taxed at 15 per cent (earnings become tax-free in retirement), but withdrawals are untaxed. Treasury argues that Australia's tte system for pre-tax contributions generally produces similar lifetime tax treatments of retirement savings as both EET and TEE systems.³³² In fact, over a lifetime, less tax is generally paid by middle- and high-income earners on pre-tax contributions to super than under a TEE system, whereas low-income earners pay more in tax (Figure 37). This is because Australia's tte system does not tax superannuation savings made from pre-tax income at progressive rates, unlike the TEE and EET approaches adopted in most OECD countries.³³³ Superannuation contributions made from post-tax income pay more tax than the TEE approach, but less than savings into investments outside of super, which are subject to income tax (or 'tTE approach') (with exceptions discussed at Figure 37). Post-tax contributions to super can be described as subject to a hybrid 'tTE' tax treatment. This report generally calculates effective tax rates on savings relative to an EET approach (Section 2.5).

However, the EET and the TEE approaches are not the 'natural' way to tax retirement savings. While they distort savings decisions less than comprehensive income taxes (a tTE treatment), *all* taxes distort decisions in some way. The optimal tax treatment of savings for retirement or otherwise depends on their costs relative to other taxes. And those costs include economic impacts and judgments about fairness.

C.2 Measuring tax rates on savings

Figure 37 and Figure 56 of this report present estimates of the effective tax rates on different savings vehicles. Effective tax rates measure how taxes on income, including any taxes on the return to savings, affect the resources available to individuals to consume at different points in their lives. Comparing effective tax rates to a TEE approach shows the

degree to which taxes on savings result in a bias for or against future consumption.

When measuring the effect of tax on the return to saving, we have to choose which taxes to include in the calculations. We include personal income taxes, and the taxes paid by superannuation funds on contribution and fund earnings.

However, we exclude corporate income taxes already paid out of company earnings returned to equity investors. In a small open economy savers can invest at a given (risk-adjusted) rate of return determined on world capital markets. Therefore corporate taxes affect the price of stocks but not the rate of return received on stocks after taxes on corporate profits have been paid.³³⁴ An extension of this approach is that dividend imputation credits actually reduce the effective income tax rates paid by equity investors below the statutory income tax rate of the investor.³³⁵

We also exclude taxes on property holdings such as land taxes and council rates since such taxes tend to be capitalized into the price of the asset, and so don't affect the post-tax rate of return received by most investors, who purchase the asset after the tax has been introduced.³³⁶

IV

A GST reform package

Overview

A well-designed GST reform package could support economic growth, make the tax and transfer system more progressive and give governments more budgetary options. Proposals to increase or broaden Australia's 10 per cent goods and services tax (GST) abound. Current governments face many challenges, such as funding growing healthcare costs, reducing deficits, and cutting inefficient taxes. A higher GST could fund any of these initiatives – although perhaps not all of them.

Increasing the GST or applying it to more things is preferable to most other means of raising revenue. A broad-based tax on consumption drags on growth less than most other taxes. Broadening the GST base to include fresh food, health and education would be more efficient, and would reduce compliance costs compared to narrower coverage. But increasing the rate of the GST would be a satisfactory second best.

Extending the GST to cover many of the categories currently exempt could raise **\$17 billion** per year. Alternatively, **increasing the rate to 15 per cent** would generate around **\$27 billion**.

The regressive impacts of a broader or higher GST can be mitigated by higher welfare payments and targeted tax cuts. The welfare and tax changes we propose protect the most vulnerable while also minimising the economic cost of the changes.

New household-level modelling informs our proposed compensation package. The report works through the implications of a reform package that increases the rate to 15 per cent. Spending around **30 per cent** of

the additional revenue from a higher GST **on higher welfare payments** would leave most of the bottom 20 per cent of income earners better off. These increases can be structured so there is no change in the incentive to work for most recipients.

There are concerns that these welfare payments may be eroded over time. Overcompensating the most vulnerable recipients should ease this concern. A substantial boost to payments would leave most recipients better off than otherwise for many years.

Modest income tax cuts are also part of our proposed package. Committing a further **30 per cent of additional revenue to income tax cuts** would allow the government to shave **2 to 2.5 percentage points off** the bottom two tax rates. Along with higher welfare payments, tax cuts of this magnitude fully offset the increase in GST for most low and middle income households – those earning up to \$100,000 a year – while also providing some benefit for those further up the income distribution. These tax cuts will increase work incentives for low to middle-income taxpayers, who are most responsive to changes in effective tax rates.

However, not everyone can be fully compensated. Government budgets are in deficit, and it is not politically or practically feasible for governments to bridge the gap with spending cuts alone.

Around **40 per cent or \$11 billion of the additional revenue** from a higher GST would be left over after welfare increases and tax cuts. At least some will need to go to state governments to help them address their looming hospital funding gap, as the price for their support of the change. This would leave a little – but not much – to reduce the Commonwealth's budget deficit, or to pay for other tax cuts that promote economic growth.

1

Australia should raise more from the GST

Commonwealth and state government budgets are under pressure. The Commonwealth Government has run deficits for six years, with another four forecast. And state governments face looming pressures because spending in health and education is growing faster than GDP.

While spending reductions are needed, tax changes that increase revenue collections will also need to be part of the solution. In this context, Grattan is releasing a series of papers outlining revenue measures that governments should adopt to improve their fiscal position. Raising more revenue from the GST, if done well, could be a fair way to improve government budget positions without too much drag on the economy.

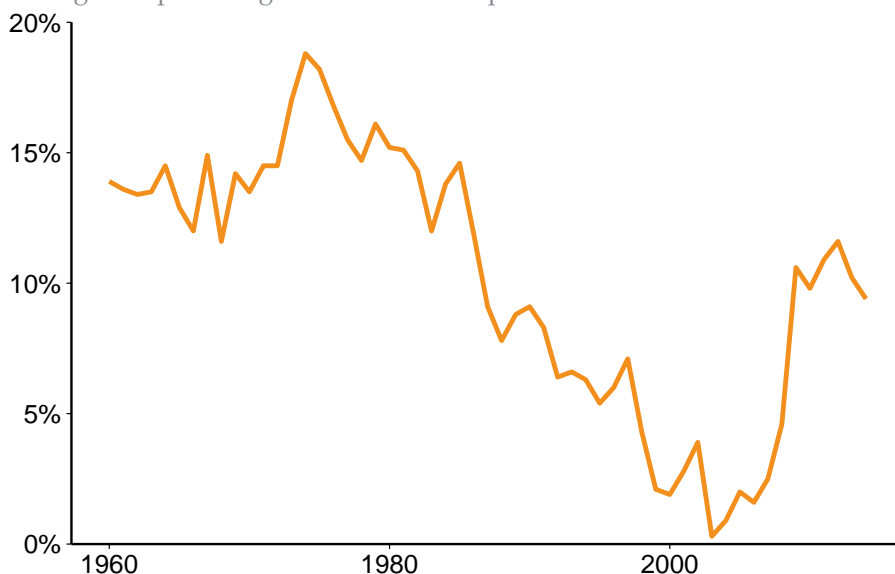
1.1 Australia's GST is low relative to overseas

The GST is a 10 per cent consumption tax levied on final consumption of goods and services other than fresh food, health, education, water, childcare, financial services, rent and a few other smaller expenditure categories.

GST revenues are collected by the Commonwealth Government and are then distributed to state governments as untied grants. The GST is distributed according to determinations of the Commonwealth Grants Commission, which tries to ensure that states have resources to provide services at the same standard as each other.³³⁷

Figure 77: Households are savings more ...

Savings as a percentage of household disposable income



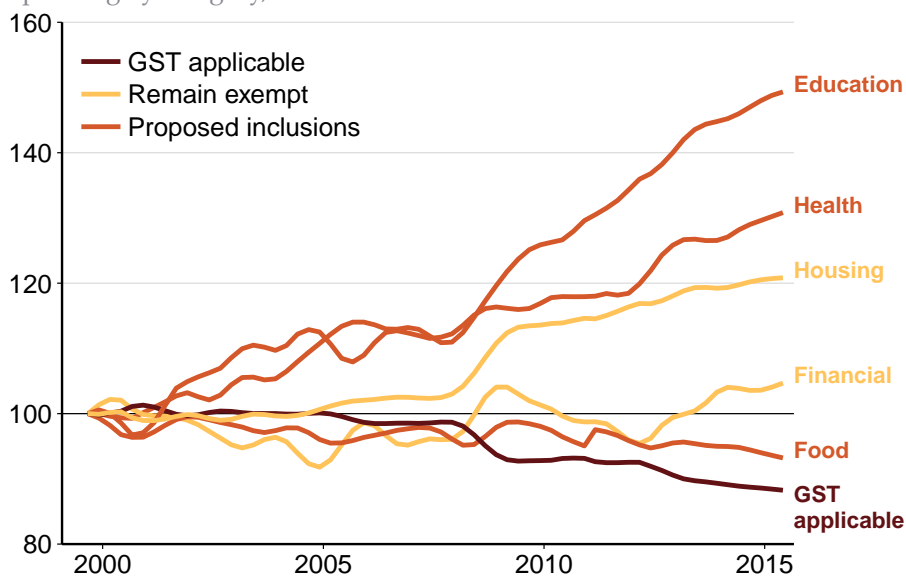
Notes: Household saving calculated as a residual item by deducting household final consumption expenditure from net household disposable income. Net disposable income is calculated by deducting depreciation from gross disposable income. See: ABS (2007).

The GST raised \$55 billion in 2014-15.³³⁸ This was around 12 per cent of government revenues in Australia – well below the average of 20 per cent for all OECD countries. And Australia's GST revenue as a share of GDP was half the OECD average in 2012. Indeed, Australia relies less on its broad-based consumption tax to raise revenue than all but two OECD countries.³³⁹

Australia's GST coverage is also narrow by international standards. It applies to about 47 per cent of consumption, below the OECD average of 55 per cent, and well below New Zealand where the GST covers 96 per cent of all goods and services consumed.³⁴⁰

Not only are Australia's revenues from broad-based consumption taxes low by international standards, they are shrinking relative to the economy. In the decade to 2014-15, GST revenues fell from almost 4.0 to

Figure 78: ... and spending less on GST-liable goods and services
 Spending by category, 1999 = 100



*Notes: Some food and financial services are subject to GST but because we cannot identify them separately in the National Accounts we have classified these categories as GST exempt for this analysis.
 Source: ABS (2015a); Grattan analysis.*

3.4 per cent of GDP. Households saved more of their incomes (Figure 77 on the preceding page) and what they spent increasingly went on GST-exempt items, particularly housing (Figure 78).³⁴¹

There is no obvious reason for these trends to reverse in the foreseeable future. Savings rates are now closer to long-run averages, with low savings rates in the early 1990s and 2000s looking like a historical anomaly.³⁴² The proportion of household incomes spent on health is forecast to grow.³⁴³ And the share of incomes spent on housing may also continue to increase: land supply is finite, and new housing supply is struggling to meet the demands of a growing population.³⁴⁴

The GST has not been – and without reform may never be – the ‘growth’ tax the states were originally promised.³⁴⁵

1.2 Consumption taxes harm the economy less than many other taxes

Broad-based consumption taxes such as the GST are relatively efficient taxes. They drag less on economic efficiency than many state government taxes including payroll taxes³⁴⁶ and stamp duties.*

Consumption taxes are efficient for many reasons. They are relatively difficult to avoid³⁴⁷ and create fewer distortions in decisions to work, save and invest.

A consumption tax treats current and future consumption equivalently, so it creates no distortion in savings decisions. By contrast, income taxes somewhat deter savings by taxing the returns on those savings. Generating more revenue from taxes on consumption should reduce this distortion. But the economic payoff may not be large: tax rates make relatively little difference to savings decisions of high-income earners who do most of the saving.³⁴⁸

An increase in consumption tax also acts as a lump sum tax on accumulated wealth, and so collects more from households such as retirees that are living off savings. The economic drag from these increased tax collections is low. Such households otherwise contribute far less to tax collections than do working households on equivalent incomes.[†] And their contribution relative to younger households is falling as a result of superannuation tax breaks. Our Wealth of Generations report showed that households over 55 are reducing their share of tax paid, despite increasing wealth relative to younger households.³⁴⁹ Low income older households will receive additional welfare as compensation for price increases through our proposed compensation package (Chapter 3).

Income taxes affect the incentives to work more than consumption taxes. Both taxes reduce the amount that can be purchased from an hour of work. In theory a labour income tax and an equivalent consumption tax have an identical effect on work incentives.³⁵⁰ But in practice, consumption taxes may discourage working less than income taxes

*See Box 2 on page 70.

†See Chapter 3 on page 23.

because their impact on spending power is less obvious. Consumption taxes are less salient: there is some experimental economics evidence that people notice lower nominal wages (due to income tax) more than lower real wages (due to a consumption tax).³⁵¹ Treasury estimates that a broad-based consumption tax causes a somewhat smaller economic drag than a flat rate labour income tax.³⁵²

Further, the combination of income tax scales and the withdrawal of means-tested welfare benefits can discourage working because they result in low rates of take home pay. The disincentives are larger for low-income workers and those working part time (Section 3.4).³⁵³ Higher income tax rates as a result of bracket creep can materially reduce workforce participation of middle-income earners.[‡]

Overall, higher consumption taxes should hurt the incentives to work, save and invest less than higher income taxes. Incentives to work can be improved if income tax cuts introduced with the GST are targeted at low and middle brackets (Section 3.4). And potential disincentives to work as a result of higher welfare benefits to compensate poorer households for a higher GST can be managed if the compensation package is carefully designed. (Section 3.3).

[‡]See Figure 3 on page 18.

2

A broader base or higher rate?

GST revenue collections can be increased either by broadening the range of items that are subject to the tax ('broadening the base') or by increasing the rate above the current 10 per cent. Economists generally favour broadening the base because it is simpler and more efficient. But increasing the rate could be a satisfactory 'second best' if it is too politically difficult to broaden the base. A brave government might do both.

2.1 The GST could be broadened

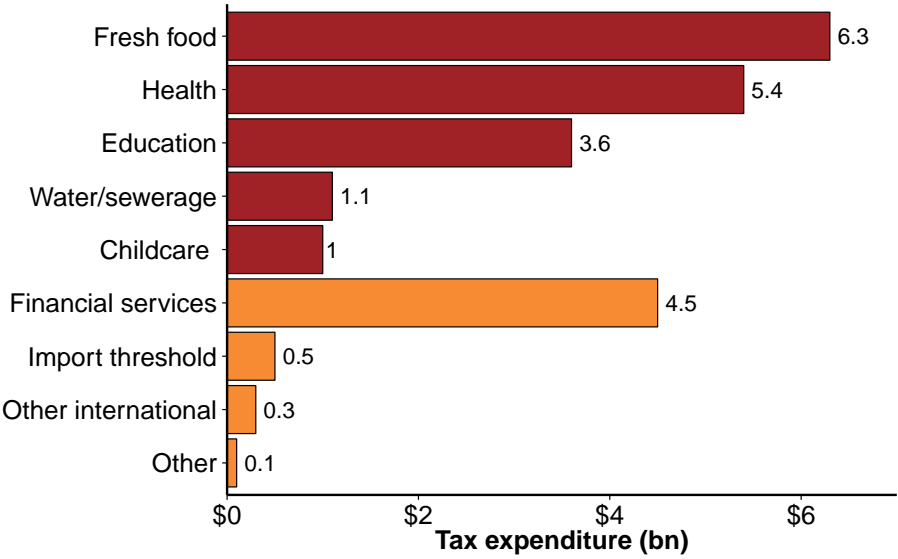
Australia's GST covers 47 per cent of the potential consumption base. This is well below the OECD average of 55 per cent (Section 1.1).

Several expenditure categories are currently excluded from the GST.³⁵⁴ Broadening the base to include fresh food, education, health, childcare, water and sewerage could raise over **\$17 billion** (Figure 79 on the following page), based on household spending levels in 2014-15. Revenues would increase over time, as household spending on these goods and services grows.³⁵⁵ This figure takes into account the effects of changes in consumer behaviour due to the increased prices in these categories.

This would leave exemptions in place for financial services, existing residential housing, and some other smaller spending categories. These are currently 'input taxed'. Financial service providers pay GST on their inputs but do not charge GST to customers. As a result, households are under-taxed because there is no tax on the value-added component of

Figure 79: Including fresh food, health, education, and other categories in the GST could raise over \$20 billion

Potential GST revenue of excluded items, 2014-15



Notes: Excludes housing services as a comparable estimate is not available.

Source: Treasury (2015c); Grattan analysis.

financial services, and businesses are over-taxed because they cannot claim GST offsets for the taxes on the inputs for these services.³⁵⁶

Similarly, home owners pay GST on the costs of maintaining and upgrading their house, but there is no GST levied on the 'imputed rents'. In order to maintain neutrality between owner-occupiers and investors, GST is not applied to rents for investment properties.

Ideally, these services would be taxed in the same way as other consumption.³⁵⁷ But taxing the full value added of these services is complex. It is not easy to determine the appropriate margin on which to calculate the tax.³⁵⁸ Consequently, these categories are excluded from value added tax in almost all OECD countries.³⁵⁹

For **financial services**, the South Australian Government has proposed a 'financial institutions duty' which is broadly equivalent to the GST but easier to implement.³⁶⁰ The duty is a supplementary tax on the margins between the rates charged by financial institutions and the rates at which they borrow. There remains some administrative complexity – for example, determining the best way to exclude business banking³⁶¹ – but such a duty is worth considering as a way to tax the 'value added' from financial services.

The Australian Government has already announced proposed changes to the **GST treatment of imports** from 1 July 2017. Imports worth less than \$1000 are currently exempt from the GST. Under the new policies, GST will apply to all imported digital goods and services and physical goods.³⁶² The requirement to collect and remit GST will be imposed on the overseas vendor. Only vendors with an Australian turnover of \$75,000 will need to register for and charge the GST.

The policy imposes a fixed cost on overseas retailers selling to Australians, as they would need to implement systems that apply specifically to any purchaser based in Australia. This impost would be relatively small for retailers that sell large volumes to Australians, like Amazon and Netflix. Some of these have already suggested they will register for the GST.³⁶³ However, it is not clear what legal recourse will be available

to the government if overseas vendors do not choose to register.³⁶⁴ The former Treasurer Joe Hockey argued that 'global pressure' would force retailers to comply.³⁶⁵

2.2 Increasing the GST rate

An alternative to broadening the base of the GST is to increase the rate. Australia's 10 per cent rate is low by international standards. It is the fourth lowest value-added tax rate in the OECD, and considerably below the OECD average of 19 per cent.³⁶⁶

Increasing the rate of the tax from **10 to 15 per cent** could raise as much as **\$27 billion**, based on GST collections in 2014-15. This does not factor in behavioural change, although it is unlikely that much revenue will be lost from people shifting their spending towards GST free goods and services.³⁶⁷ As discussed in Box 6, consumption of GST exempt categories (particularly fresh food, health and education) is not affected much by their price relative to other goods and services.

2.3 Broadening the GST will make it simpler, more efficient, and more durable

A broader base for consumption taxes minimise distortions in decision making. When purchases of all goods and services are taxed at the same rate, people consume the goods and services they value most, given their price. When differential tax rates apply then there are welfare losses: people are induced to consume relatively more of the lower taxed goods and less of the higher taxed goods than they would otherwise prefer.³⁶⁸ This is particularly true when different tax treatment is applied to goods or services that are substitutes. For example, remedial massage attracts GST while both osteopathy and chiropractic services are GST-free.³⁶⁹ Broadening the GST would remove these distortions.

There are other reasons to favour a broad-based tax. Exemptions create administrative costs for businesses that deal with both exempt and non-exempt goods, and compliance and enforcement costs for tax administration agencies.³⁷⁰ And grey lines create opportunities for tax

avoidance and lobbying to exclude particular goods.³⁷¹ While arguably most of these costs have already been sunk, new fronts in the debate open up from time-to-time.³⁷²

In a recent national poll, a majority of senior Australian economists favoured broadening the base of the GST rather than increasing the rate.³⁷³ Most thought it would increase efficiency and simplicity. By contrast, the one third who disagreed (the balance were undecided) were either sceptical about the net efficiency gains or had doubts that compensation would be adequate to address the effects of a more comprehensive GST for those on low incomes.

Including spending on education and health in the GST will also help address the problem of 'base erosion'. Spending on health in particular is expected to rise faster than income (Section 1.1). Including health and education in the GST base will ensure revenues from the tax better keep pace with economic growth, as well as aligning more closely with state government expenditures.

On the other hand, a 15 per cent GST would raise more money than broadening the base. This is attractive given the need for Commonwealth and state governments to address their revenue shortfalls in the most efficient way. If higher revenues are a priority, then a simultaneous rate increase to 12.5 per cent and base broadening – which would raise about \$35 billion a year – would be the most efficient way to achieve them.

2.4 Social purposes of existing exemptions could be served better by other means

Some defend the existing exemptions because they send consumers worthwhile price signals to consume more healthy fresh food and to spend more on private health and education in ways that reduce the pressures on the public systems.

However, GST exemptions are an inefficient way to pursue these ends. There are any number of goods and services the government might want

to promote or deter. But broad tax exemptions are a blunt instrument for fine-tuning consumption habits. There are few items with market failures so large that they justify governments imposing differential tax treatment despite the efficiency costs.³⁷⁴ For these items, government can design 'sin taxes' specifically aimed at the problems.³⁷⁵ For example, if governments want to use taxes to encourage better diet, then a high tax rate targeted at foods high in sugar and salt would be much more effective than a relatively small shift in the price of all processed food.³⁷⁶ In any case, empirical evidence indicates that there would be relatively little change in consumer behaviour if government broadened the GST to include fresh food (Box 6).

Others argue that a GST on private health and education services will give public providers an advantage over private providers. But governments don't aim for a level playing field in health and education: they explicitly provide higher subsidies for those using the public systems.

A more serious objection is that charging GST on private health and education could reduce total government revenue if it led people to switch from less subsidised private services to more subsidised government services. But the evidence suggests that switching would be limited (Box 6). And in any case, there is now evidence that the government subsidy provided to public schools is not much greater than the subsidy for private schools once the relative disadvantage of the student base is taken into account.³⁷⁷

Box 6: Change in consumer choices due to a broader GST

Broadening the GST will increase the relative price of fresh food and private health and education services. But empirical evidence suggests that behaviour won't change much as a result.

Treasury finds that demand in the **fresh food** category is inelastic – that is, a price rise will not lead to much change in consumption. It estimates that a 10 per cent increase in tax on food would only reduce consumption by 1.6 per cent (Treasury (2015c)).

A study for the Rural Industries Research and Development Corporation using data from the ABS Household Expenditure Survey also concluded that demand for fresh foods such as milk, bread and fresh vegetables does not change much if relative prices change. The estimates suggest that a 10 per cent increase in price would reduce consumption by between 2 and 7 per cent for these categories. For fresh fruit and other dairy, consumption is estimated to fall 10 per cent if prices rise by 10 per cent. Purchases of various types of meat (beef, lamb, pork, chicken) are estimated to respond even more to changes in price (Ulubasoglu et al. (2015)).

However, these estimates only capture changes in demand if prices change for only one type of food, such as pork. Many of the people no longer buying pork will switch to buy more of other types of meat, or other fresh food. It is likely that people will reduce their overall consumption of fresh food by less than these category estimates if fresh food prices increase across the board.

Studies of private health insurance in Australia and internationally have found that consumers are not very responsive to price changes. Estimates

of the price elasticity of supplementary private health insurance (insurance that provides more choice or faster access relative to universal health care) range from between 0.2 and -0.5 , suggesting that demand would fall less than 5 per cent in response to a 10 per cent GST (Cheng (2013)).

Demand for hospital insurance is likely to change even less with a GST. Policies such as lifetime health cover loading, and the Medicare levy surcharge, provide strong incentives for those aged over 30 or on higher incomes to maintain private cover unless prices increase dramatically (ATO (2015g)). Consequently, Treasury estimates that demand for **private medical and health services** may only fall by 1.4 per cent in response to a 10 per cent GST.

However, governments may face pressure to reduce co-payments for some health services if price increases disproportionately affect disadvantaged groups. This would somewhat offset potential revenue gains from applying the GST to these services.

Treasury's elasticity estimate for **private education services** suggests that a 10 per cent tax on education will lead to a 10 per cent decrease in demand. But this includes the effects of reductions in demand for discretionary courses for which students are less likely to switch to public providers. Price changes are likely to have much less impact on schooling choices. Historical trends in Australian **private school enrolments** suggest that parents are not particularly price sensitive. Between 1990 and 2007, average fees roughly doubled in real terms for both Catholic and Independent schools. During this period their enrolment share *increased* by around two and five percentage points respectively (Nous Group (2011)).

Box 7: Buying reform – the GST and carbon price compensation packages

The introduction of the GST in 2000 was accompanied by cuts to personal income tax and increases in welfare benefits.

Personal income tax changes costing around **\$13 billion** a year included: an increase in the tax-free threshold; a reduction in tax rates at the lower end; and an increase in the threshold for the top marginal tax rate.

The objective of this consumption tax / income tax ‘swap’ was to improve the efficiency of the tax system by improving incentives for work.

Pensions and other social security payments were also increased by 4 per cent across the board to compensate welfare recipients for higher prices following the introduction of the GST. These increases cost around **\$2 billion** in 2002-03.

Family payments were increased even more, at a cost of around **\$2.5 billion** a year. These increases were designed to compensate for the higher cost of living following the introduction of the GST and to provide greater recognition of the costs of raising a family.

In 2002-03, the GST raised around **\$30 billion while other taxes worth \$25 billion** – wholesale sales tax and state indirect taxes – were abolished (or proposed to be abolished) as part of its introduction. Overall, the package **overcompensated households** by about **\$12 billion** a year.

While the package was sold on the basis that everyone would be better off, the structure of the tax cuts meant the middle class benefited in particular.

Overall, the package increased inequality. Saunders (2004) shows that incomes at the 90th percentile increased markedly relative to the 10th percentile in the year following the introduction of the GST.

In contrast, the Household Assistance package for the **carbon price** pushed money towards those at the bottom of the income distribution.

Around half the **\$4 billion** revenue from the first year of the carbon tax was given to households as compensation.

The compensation package included higher family payments and pensions, and tax cuts to all taxpayers earning up to \$80,000. The assistance package actively targeted households at the lower end of the income distribution, with the goal of fully offsetting the cost of living increases for **low-income households** and helping to meet the increases in costs for **middle-income households**.

Around 90 per cent of households received some compensation. There was also a fund to ease transition costs for business and community sector organisations. Overall the package over-compensated households for the increases in living costs: the average assistance of \$10.10 per week was higher than the average cost increases of \$9.90.

Sources: Costello (1998), Treasury (2002), Eccleston (2006), Treasury (2011), Treasury (2012a) and Parliamentary Library (2011).

3

A targeted compensation package

Opposition to increasing Australia's GST is often motivated by concerns about how low-income households would be affected. If governments want to ensure that disadvantaged households are not left significantly out of pocket, compensation will be required. A compensation package should also maintain incentives for workforce participation, particularly for low- and middle-income earners, who are most responsive to changes in effective tax rates. This means a combination of tax cuts and higher welfare payments.

But any GST reform package aiming to provide revenue to state governments to fund growing health and education spending,* or to reduce government deficits, must be revenue positive. Some people will need to pay higher net taxes. Even if the package is budget-neutral, the political need to over-compensate low-income households in order to protect the most disadvantaged will lead to some other households paying more tax in total.

This will be difficult for governments that have become accustomed to 'buying' tax reform. The GST and the introduction of the carbon tax were both accompanied by a package of generous tax cuts and increases to welfare benefits that left very few households worse off (Box 7 on page 262). A history of yielding to demands that there be 'no losers'

*The decision in the 2014-15 Commonwealth budget to withdraw from the National Health Reform Agreement and to no longer fund growth in real per person hospital spending precipitated the current public discussion about increasing the GST. See: Section 4.3 on page 42.

has changed the political economy of reform. Politicians have arguably become less adept at prosecuting the case for difficult changes.³⁷⁸ And the public have come to expect that medicine will always arrive with a spoonful of sugar.³⁷⁹ But without revenue-positive reforms, the budget pressures we outlined in Part I will only continue to increase.

The other challenge for the federal government is reconciling GST reform with its claim that it will not increase the tax burden.³⁸⁰ Even budget-neutral GST reform will increase taxes as a share of the economy because some money will be spent on compensating people on welfare. To stop the tax burden increasing, all the GST revenue would have to be given back as income tax cuts. Any associated increase in welfare payments would then *increase* the deficit – unlikely to be tenable in a period when the government is trying to do the opposite.

Our proposed package balances the need for fiscal consolidation with fairness and efficiency. It overcompensates the bottom 20 per cent of the income distribution on average, mainly through higher welfare payments. In terms of their real purchasing power, most of the poorest Australians would be no worse off, and the majority would be better off. Modest tax cuts focused on the low and middle thresholds would maintain or improve the incentives for work participation and ensure that most low- and middle-income earners are also better off. Around 40 per cent of the additional revenue would be left over. The potential uses for this money are discussed in Chapter 4.

3.1 GST has slightly more impact on low-income households

Many claim that the GST should not be increased because it would be unfair to low-income households.³⁸¹ The argument is that governments should seek to protect the welfare of the bottom 20 per cent of taxpayers because they are obliged to protect the welfare of the most vulnerable.³⁸²

The fairness of the GST can be judged in different ways.

In *absolute amounts*, a GST collects far more from high-income households: the exemption for fresh food, for example, saves the richest 20 per cent of households around \$1000 per year, compared to an average of \$420 per year for the poorest 20 per cent of households.³⁸³

However, the fairness of a reform is often judged by looking at the *percentage* of a person's resources affected.

Poorer households pay substantially more GST *as a proportion of their income* because they spend more of their incomes than richer households. Savings rates increase with incomes.³⁸⁴

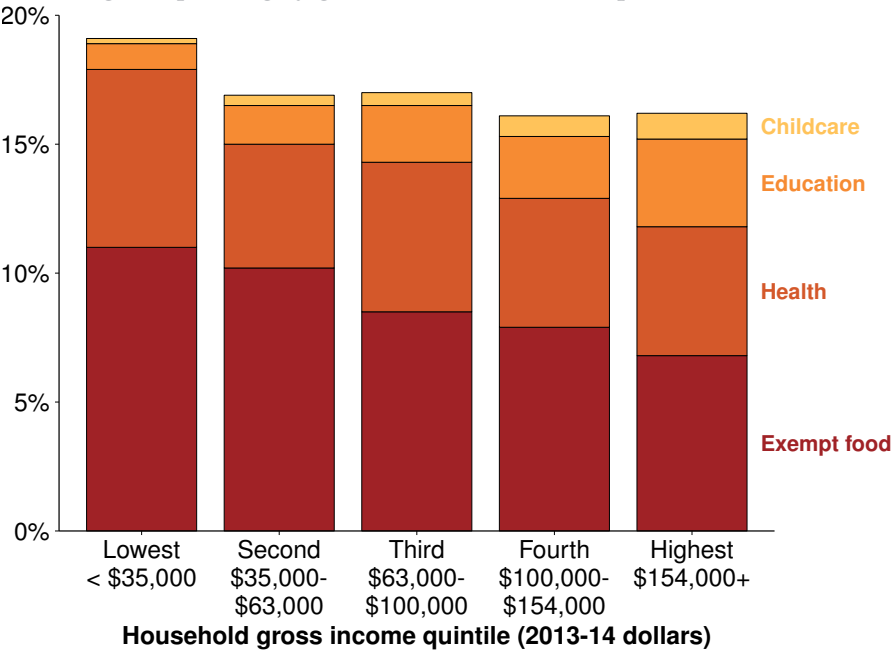
But a GST is less regressive when the tax burden is considered as a *percentage of consumption*. It is arguable that this is a better measure of the fairness of a consumption tax. Most households that are low-income at a point in time – students, retirees, or the short-term unemployed – have much higher lifetime incomes. These people smooth their consumption by borrowing or drawing down on their savings when their income is low. At these times they pay more consumption tax as a share of income. They pay a lower share when their earnings are higher. Consequently, the proportion of current consumption paid in tax can give a better indication of the tax burden on a household over their lifetime.³⁸⁵

All households pay a similar amount of GST as a proportion of their consumption.³⁸⁶ Broadening the GST to include fresh food, and private spending on health and education would lead to a bigger increase in GST as a share of consumption for lower income households. Lower income households spend a little more on fresh food and health as a proportion of spending, which are currently exempt from GST. This outweighs their lower relative spending on education and childcare, the other major categories of expenditure currently exempt from GST, as shown in Figure 80 on the next page.

Overall, the differences are small: if the GST were broadened and purchasing patterns are unchanged, poorer households would pay on average an extra \$19 per \$1000 spent, compared to \$16 per \$1000 spent for the top 20 per cent of households.

Figure 80: Poorer households devote a little more of their spending to goods and services included a broader GST

Percentage of spending by gross household income quintile, 2009-10



Source: ABS (2013b); Grattan analysis.

If the GST rate were raised but not broadened, high-income households pay slightly more: \$26 per \$1000 spent compared to \$25 per \$1000 spent by poorer households. Of course, these averages conceal substantial variation in spending patterns between people in a given income group (Section 3.2).

While some argue that a tax can be fair providing it doesn't disproportionately impact poorer households, many are concerned by tax reforms that would take *any* resources from the most vulnerable. To ensure the fairness of our GST reform proposal, we structure a compensation package so that **on average the poorest 20 per cent of households are at least fully compensated for the higher tax.**

Fairness – and political pragmatism – also supports some compensation for middle income households. Our package ensures that most **households earning up to \$100,000 are compensated for at least 75 per cent of the cost of the higher GST.**

Introducing changes to the GST as part of a broader tax reform package which includes more progressive measures – such as better targeting of superannuation tax concessions as argued in Part III – would share the burden of tax reform more equally across the income distribution and help to boost public faith in the fairness of the reforms.

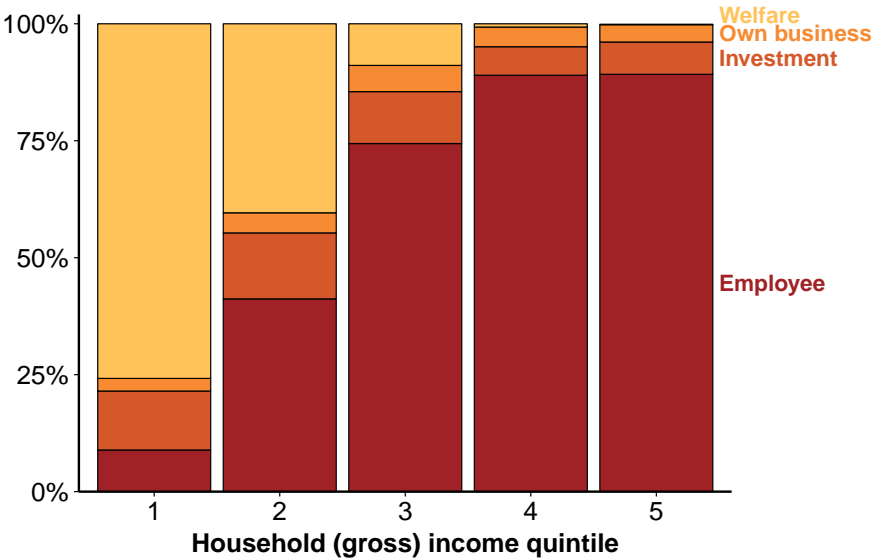
3.2 Higher welfare payments can limit the impact of a higher GST on poorer households

However fairness is measured, governments can largely mitigate the effects of GST changes on lower income households through the welfare system.

For the majority of households at the bottom 20 per cent of the income distribution – those earning up to around \$36,000 a year – government payments are the main source of income. Forty per cent of the next poorest 20 per cent of households receive most of their income from government. Unsurprisingly, those further up the income distribution

Figure 81: Government benefits are the main source of income for most of the poorest households

Percentage of households by main source of income, 2013-14



Notes: See page 398.

Source: ABS (2015c); Grattan analysis.

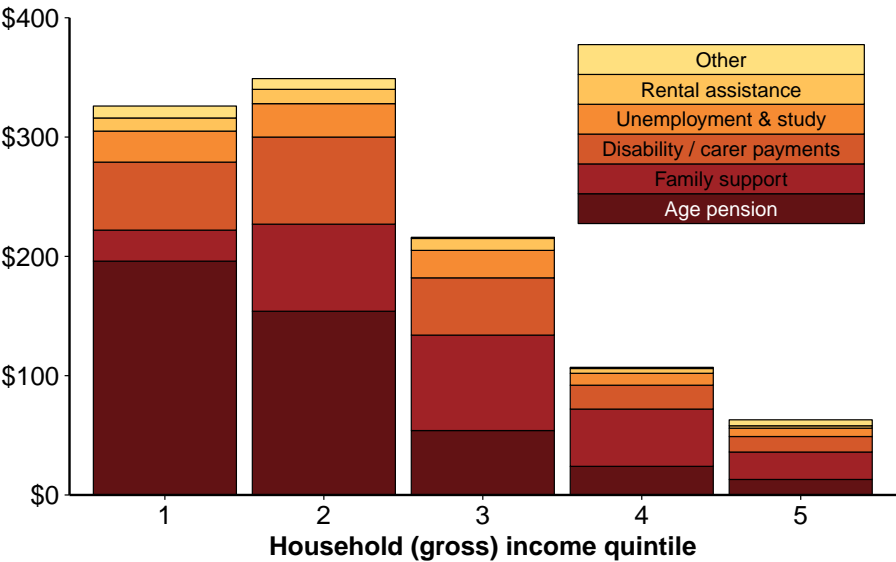
generate most of their income through employment and investments, and very few rely primarily on government benefits (Figure 81).

It follows that targeting compensation through the welfare system is the most direct way to compensate the poorest households. Income tax cuts will not help them much as they pay very little income tax.

The poorest 20 per cent of households currently account for just over 10 per cent of total spending on the goods and services we have proposed to include in a broader GST and would contribute around 8 per cent of extra revenue if the GST rate was increased.³⁸⁷

If these households could be targeted directly, then spending 8-10 per cent of the revenues from the GST would be enough to ensure that they are no worse off on average after their higher expenses. The remaining

Figure 82: Higher welfare payments would also benefit some richer households
 Average welfare payments per week by household gross income quintile,
 (2013-14 dollars)



Notes: See page 398.
 Source: ABS (2015c); Grattan analysis.

80 per cent of households, with higher incomes, would bear most of the net burden of the tax increase.

In reality, however, compensation through higher welfare payments would not be perfectly targeted. Only 30 per cent of welfare payments go to the bottom of 20 per cent of households (Figure 82). To ensure that the poorest fifth of households are *on average* no worse off, welfare benefits would have to be increased to the point where they would benefit some higher income households as well, and so would cost much more than 10 per cent of the increased GST collection. Tighter targeting would be possible if the taper rates for payments were increased, but this would substantially reduce incentives to work (Section 3.3).

Because low-income people also have diverse patterns of spending, it would cost even more again to provide sufficient compensation to

ensure that relatively few individual households in this group would be disadvantaged by the changes.

Given both imperfect targeting and differences in GST burden, spending around **\$8 billion**, or 30 per cent of revenues from increasing the GST rate to 15 per cent on higher welfare benefits would ensure that the poorest households are generally more than compensated for the higher costs. A policy of overcompensation is justified because of the risk that compensation may be eroded over time (Box 8).

Distributing this money in the same proportion as existing welfare spend³⁸⁸ would imply substantial increases in welfare payments (Table 10 on the next page). Effectively, the base rate of all payments would increase by around 5 per cent. **Two in three households in the bottom income quintile** would be **better off**, with more than half receiving back more than 125 per cent of their additional cost of living increases (Figure 83 on the facing page).

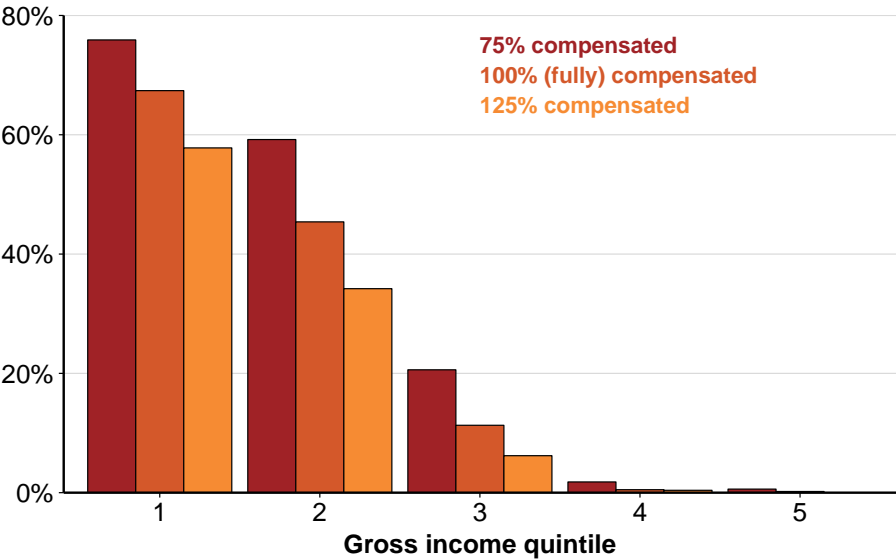
People on most full-welfare payments will be better off on average. The average single person on a full disability payment renting would have 1.4 per cent more to spend after accounting for their additional GST payments. While a couple of Newstart renting their home will have around 0.6 per cent more to spend. These represent modest but real improvements in the standard of living for these people.

Very few people on the full rate of Newstart or the Disability Pension will be undercompensated. Around a third of full Age Pension recipients remain undercompensated, but this group is more likely to have other income sources to draw on to support higher spending (Table 10).

Changes that over-compensated most households receiving Newstart would recognise the substantial financial distress of these households,³⁸⁹ and the possibility that higher payments may increase workforce participation by making it easier for individuals to present themselves well or to maintain their readiness for work. There is a broad consensus amongst welfare groups, economists and business lobbies that Newstart payments are too low.³⁹⁰ The rising gap in living standards between

Figure 83: Most of the poorest households will be better off, some substantially so

Percentage of each quintile compensated by 75%, 100%, and 125% of the expected price increase after higher GST and higher welfare payments



Notes: See page 398.
Source: ABS (2013a); Grattan analysis.

Table 10: Impact of GST compensation package on selected welfare benefits and household compositions

Benefit	Household type	Avg. change in disposable income (%)	Proportion under-compensated
Full Age pension	Couple, home-owners	0%	36%
Newstart	Couple, 2 children, renters	0.8%	9%
Disability	Single, no other income, renter	1.4%	21%

Notes: Based on welfare benefits and spending patterns from 2009-10 because this is the most recent year for which such data at the household level is available.
Source: Grattan analysis.

those receiving Newstart (and other allowances) and those receiving a pension is due to less favourable indexation for Newstart.³⁹¹

This analysis overestimates how many people in the bottom quintile would be worse off. The ABS survey used for calculating the impacts of taxes appears to have a substantial number of households that misstate their income. About 0.6 per cent of all households (by definition in the bottom quintile) are recorded in the ABS survey as having zero or negative income, and another 1.9 per cent have incomes less than Newstart for a single person of \$11,682 per year (2009-10). Despite their very low incomes, these households spend on average as much as households in the second income quintile. If all these households have incomes reflecting their spending, then 73 per cent of the lowest income quintile would be fully compensated by our proposed package, rather than 67 per cent as shown in Figure 83 on the previous page.³⁹²

Inevitably some poorer households will not be fully compensated. This is an unfortunate reality of any revenue-positive tax reform. Increasing welfare payments to ensure that *no one* on low incomes is worse off – in terms of spending power – would substantially increase the cost of the package. But reform should not require that *no one* goes backwards. Some in the bottom 20 per cent will be losers; many more will be winners.

Our analysis of the lowest 30 per cent of people at the bottom of the income distribution who would be undercompensated does not identify any one particular group systematically disadvantaged by the proposals. Those left worse off by the compensation package are spread across the age distribution and include people receiving welfare as well as people reliant on private income. Almost half of the low-income earners not fully compensated have net wealth of more than \$500,000.³⁹³ Some could be business owners or investors who have understated their income. Some are probably households, such as part-pensioners, drawing down on their assets to finance consumption.

Box 8: Will welfare benefits get eroded over time?

Previous experience in both Australia and New Zealand highlights the risk that compensation can be eroded over time. Increases in welfare benefits to compensate for the introduction of New Zealand's GST were cut sharply after a change of government.^a In Australia, despite increases in Newstart following the introduction of the GST in 2000 and CPI indexation, the single adult Newstart rate has been eroded by cost of living increases so that it now buys less than it did before the GST was introduced.^b Of course, Newstart may have been eroded even further without GST compensation.

But recent budget proposals to index pensions at inflation rather than average weekly earnings met a hostile public reaction, and were abandoned in favour of tightening eligibility for those who need pensions least.^c Indeed a series of decisions over the last decade to increase pensions above average weekly earnings^d suggests that concerns about the longevity of compensation for pensioners may be exaggerated.

On the other hand, concerns about the value of Newstart are based on recurring political decisions to reduce payments relative to average wages. These concerns might be addressed if increases to the GST were accompanied by a substantial real increase in Newstart. Even if it were eroded over time, a large increase would leave most of those on Newstart substantially better off for some time. This might be the political price for welfare groups to support increases to the GST.

^aDavidson (2000)

^bACOSS (2012)

^cMorrison (2015)

^dDaley, D. Wood, Weidmann et al. (2014, p. 24)

The fact that some people will be slightly worse off will make reform politically harder, but there is no principled reason to preserve the precise rank order that applies today to those in the bottom 20 per cent.

In any case, it is reasonable to ask that some on lower incomes – just like others in the population – contribute to paying for the improvements in government healthcare which that benefit them,³⁹⁴ but come at a growing cost to budget bottom line.³⁹⁵ Improvements in access to or quality of health services funded by the GST will provide benefits to all Australians. These benefits are in addition to the financial compensation modelled in this paper.

3.3 Increased welfare payments can be designed so there is little effect on work incentives

Compensation can be structured so that incentives to work do not change much. If welfare payments are increased by a fixed amount, but the rates at which benefits reduce (as incomes go up) do not change, then effective tax rates for current welfare participants are also unchanged (Box 10 on page 282).

The main impact on work incentives will be for those people brought into the net for welfare benefits. These people will face higher effective marginal tax rates as any additional income they earn will result in the loss of some welfare benefits. However, our estimates suggest this group is relatively small – the package might add about 10,000 Newstart recipients to the 680,000 who currently receive this payment.³⁹⁶

3.4 Income tax cuts can compensate the average lower income household

Modest income tax cuts should be part of a GST reform package.

Appropriately targeted income tax cuts will help to moderate the effect of a higher GST on work incentives. By increasing the prices of many goods and services, a higher or broader GST reduces the real purchasing power of take home pay. But income tax cuts mean that workers will have bigger pay packets.

This partial 'swap' of income taxes for consumption taxes will provide an economic dividend. However, the economic gain will depend on the design of any income tax cuts: cuts targeted at low and middle income earners are likely to increase workforce participation more than reductions in the top marginal rate only paid by a small number of taxpayers who usually work full time (Box 9 on the next page).

While some argue that cuts at the upper end should be prioritised to spur entrepreneurial activity,³⁹⁷ our tax system already provides numerous incentives for starting a business, such as deductibility of losses, a 50 per cent discount on capital gains income and a host of small business capital gains exemptions.³⁹⁸

If the purpose of GST reform is to reduce future deficits, to fund reductions in taxes that drag more on economic growth, or to help state governments fund rising healthcare costs, there is a limit to the money available to fund income tax reductions. Given our proposed welfare package, spending any more than 30 per cent of the revenue on income tax cuts would not leave enough funds to make a meaningful dent in deficit reduction, tax reform or the future health funding 'gap'.

We propose a package of income tax cuts that helps protect the welfare of lower and middle income households. Spending 30 per cent of additional GST revenues allows for modest income tax cuts in the low to middle brackets.

For example, using \$8 billion of the additional \$27 billion of revenue from a 15 per cent GST would allow a reduction in the bottom tax bracket from 19 per cent to 16.5 per cent and a reduction in the next bracket from 32.5 to 30.5 per cent. If, instead the GST is broadened, 30 per cent of the revenue from a broader GST would support cuts to approximately 17.5 per cent and 31.5 per cent for the same brackets (Table 11 on page 279). To put them in context, these tax cuts would have a similar impact on average tax rates as three to five years of forecast bracket creep. Households higher up the income scale would also receive substantial benefit from these tax changes.

Box 9: Impact of taxes on labour supply

There is a comprehensive literature on the effect of taxes on labour supply decisions. Two review papers – Meghir and Phillips (2008) and McClelland and Mok (2012) – summarise this work and nominate the findings for which there is consensus or near consensus.

Their conclusions are broadly consistent. Almost all the studies referenced find that men's hours of work are unresponsive to tax changes. This is because most men work full time. But for men with low levels of education, the decision of whether to work is somewhat affected by tax and welfare incentives (Meghir and Phillips (2008)). For highly educated men, tax rates make almost no difference to work decisions. But tax rates do affect their taxable incomes: high-income taxpayers are more likely to convert income into more lightly taxed forms – such as capital gains – when tax rates are high (Meghir and Phillips (2008)). They are also able to respond by shifting their income into a period when their tax rates are lower – such as retirement (McClelland and Mok (2012)).

On the other hand, empirical studies invariably find that tax and welfare benefits have a much greater bearing on working decisions for women with young children: they affect both the decision to work and the number of hours worked. However, the CBO paper finds the responsiveness of women's labour supply decisions in the US is falling as their workforce attachment grows.

Taken together, these studies suggest that tax rates have the most effect for people on low and middle incomes deciding whether to work or whether to increase their hours. If one objective of tax reform is to increase workforce participation, then tax cuts should focus on the low to middle brackets.

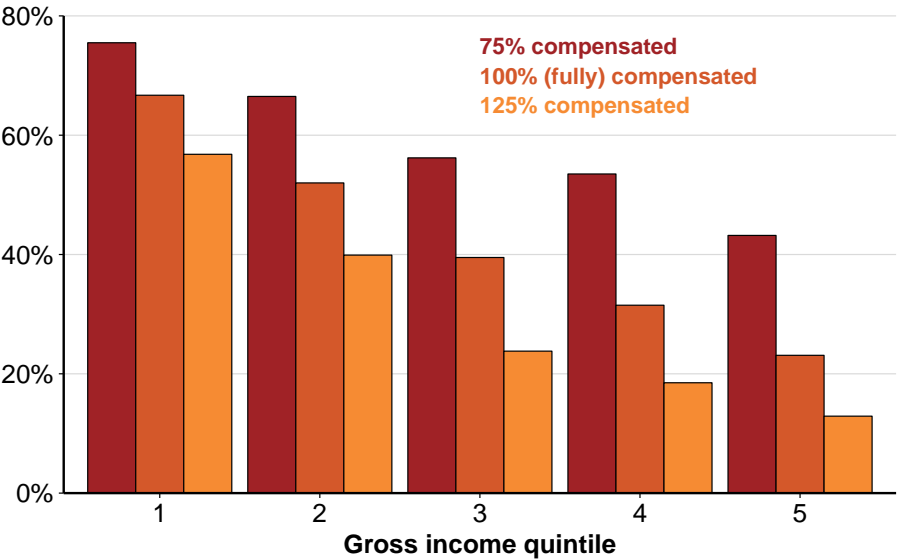
Table 11: Proposed income tax cuts

Tax bracket	Current tax rate	Rates with higher GST	Rates with broader GST
\$0 – \$18,200	0%	0%	0%
\$18,201 – \$37,000	19%	16.5%	17.5%
\$37,001 – \$80,000	32.5%	30.5%	31.5%
\$80,001 – \$180,000	37%	37%	37%
\$180,000 and over	45%	45%	45%

Notes: Excludes Temporary Budget Repair Levy (2% of income over \$180,000 until 2016-17).

Figure 84: Welfare increases and income tax cuts would offset higher GST for most lower-income households

Percentage of each quintile compensated by 75%, 100%, and 125% of the expected price increase after higher GST and higher welfare payments



Notes: See page 398.
Source: ABS (2013a); Grattan analysis.

Figure 84 shows the combined effect of our package with a higher GST, lower income tax rates and higher welfare payments.

Most households in the bottom 40 per cent – with incomes up to \$63,000 annually – would end up ahead under our package.³⁹⁹ Middle and upper middle income households on average would come out behind, but not by much: lower income taxes and higher welfare payments would offset three quarters or more of the effects of a higher GST for households in the third and fourth income quintiles (Figure 84). The average fall in disposable income for these households is 0.6 per cent.⁴⁰⁰

Of course, other changes to income tax rates would distribute the benefits differently, with different costs to the budget, as shown in Table 12 on the next page.

Politicians might be tempted to try to fully compensate all low- and middle-income households. But because GST affects different households in very different ways, it is extremely expensive to ensure there are no losers. Tax cuts to fully compensate almost every household earning up to \$100,000 for a 5 per cent increase in the GST would have cost approximately \$23.5 billion in 2012-13 – and this would be an underestimate of the budgetary impact today.⁴⁰¹ This would be in addition to the \$8 billion in additional welfare payments required to compensate the most vulnerable (Section 3.2). Together, the amount spent on compensation, in excess of \$30 billion, would exceed the additional \$27 billion in revenue collected. It is simply not possible to fully compensate most households this far up the income distribution with a package that doesn't increase budget deficits.

There will also be calls to find ways to compensate those that fall outside of the tax and transfer net. The largest and most vocal group in this category are self-funded retirees. When the GST was introduced in 2000, self-funded retirees received one-off cash payments – a savings bonus and a self-funded retiree bonus worth up to \$3000⁴⁰² – to compensate them for the higher cost of living associated with the GST.

Such payments are expensive – the estimated impact in 2000-01 was \$1.3 billion and would be much higher now for an equivalent package – and not justified. Self-funded retiree households are not amongst

the vulnerable: there are few self-funded retirees in the poorest 20 per cent of Australians households. Any retirees with incomes at this level would qualify for at least a part-pension. Nor can the payments be justified on the grounds of fairness, given that self-funded retirees currently pay far less tax than a working household on the same gross income.⁴⁰³

Table 12: Budgetary impact of income tax rate changes

Tax bracket	Current tax rate	Budgetary impact of 1 percentage point change, billions (2015-16)
\$0-\$18,200	0%	
\$18,201 - \$37,000	19%	\$1.9
\$37,001 - \$80,000	32.5%	\$2.3
\$80,001 - \$180,000	37%	\$1.3
\$180,001 +	45%	\$0.7

Box 10: Structuring welfare payments to reduce disincentives for work

Means tested welfare payments reduce work incentives. If welfare recipients start earning income, they not only pay tax on each dollar of income earned but also forego some of their benefits. The impact on work incentives is moderated by a 'taper' which reduces benefits gradually as incomes increase.

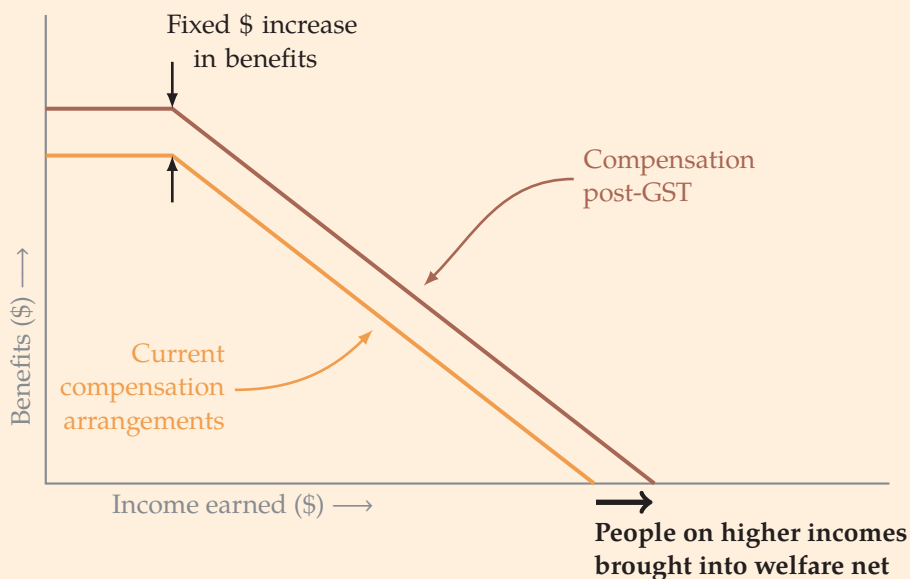
If the same 'taper' is maintained, then higher welfare payments have little impact on incentives to work. If welfare increases by a fixed dollar amount for all recipients (whether they are receiving a full or part benefit) then there is no change to the taper. For almost all levels of income, the dollar value of payments withdrawn with each additional dollar earned is the same under the new compensation arrangements (Figure 85 on the facing page).

By contrast, a proportional increase in benefits would make the taper rate steeper, increasing effective tax rates for those on particularly low incomes.

However, even a fixed dollar increase in benefits will have some effects on incentives to work.

First, because higher welfare payments will increase real income for some recipients, this could make working less attractive relative to welfare benefits. However, it is not clear this effect will be substantial given that the proposed increase in payments is relatively small, and welfare payments will generally remain well below wage levels.

Figure 85: A fixed dollar increase in welfare payments maintains the marginal incentive to work



Second, some people will face higher EMTRs because they are brought into the welfare net. People on incomes a little above the previous cut off point will now receive a (modest) welfare benefit (Figure 85). This increases their effective tax rate because they will now forego this benefit as their income increases. However, the number of people affected is modest – we estimate, for example, that with the compensation we propose, an extra 10,000 people might qualify for some Newstart payment, a small number relative to the 680,000 or so that currently receive Newstart.

4

The uses of GST revenue

If the GST is broadened or raised, governments will have additional revenue of between \$7 and \$11 billion a year after paying for the compensation package we have proposed. This additional revenue might:

- reduce the hospital funding 'gap' of state governments;
- reduce the Commonwealth's substantial deficit;
- fund other tax cuts, over and above the income tax cuts focused on the lower thresholds proposed as part of the compensation package.

The federal politics are likely to require that at least some of the GST revenue improves the net budget position of the states and territories. Ultimately, it will be necessary to broker a deal that will be acceptable to both Commonwealth and states. States are unlikely to be enthusiastic about surrendering the principle that all GST revenue is transferred to them. So the Commonwealth will also need to reduce tied grants to fund the compensation package.

4.1 Some of the GST increase will need to go to state governments

State and Territory governments are likely to demand a sizeable share of additional GST revenue as a minimum price for their cooperation. This would consume a substantial portion of the additional revenue raised by changes to the GST, net of the compensation package.

Government health spending in Australia – and in developed countries around the world – has consistently grown much faster than the economy over the last 20 years.⁴⁰⁴ And while there is clearly scope to reduce costs in parts of the system,⁴⁰⁵ there have been apparent dividends from higher spending – life expectancy and years lived free from disability have increased.⁴⁰⁶

Under the Council of Australian Governments National Health Reform Agreement, the Commonwealth agreed to share the costs of efficient growth in hospital activity, initially meeting 45 per cent of the cost growth, rising to 50 per cent in 2017.⁴⁰⁷ However, under changes announced in the May 2014 budget, the Commonwealth announced that its support for state health spending would only grow in line with inflation and population growth – far below the expected growth in health spending. (See Section 4.3 on page 42 in Part I.) State governments would have to fund all increases in real spending per person for hospitals.⁴⁰⁸

This decision will have a large and growing impact on state government budgets. The Commonwealth estimates that by 2024-25 the changed policy will reduce its nominal transfers to the states for hospitals by around \$15 billion.⁴⁰⁹ By 2054-55, the reduction in spending for hospitals will be many times larger. Similar policy decisions in schools funding will reduce nominal Commonwealth spending on schools by \$6 billion by 2024-25.⁴¹⁰

States are unlikely to cooperate with changes to the GST unless the changes make a material net contribution to state budgets. Although the GST legislation technically requires the consent of all states and territories for amendments to the rate or base,⁴¹¹ the Commonwealth Parliament can ignore this requirement, by simply repealing the section requiring state and territory consent.⁴¹² Nonetheless, it would be politically unwise for the Commonwealth to pursue reforms without substantial state government support. But without some net contribution to their budgets, it is difficult to see why state governments would

cooperate with the Commonwealth to increase the GST, considering all the political costs such support would entail.

The minimum price for a deal is likely to be around \$5 billion a year – roughly half the health funding withdrawn by the Commonwealth by 2021-22, and roughly half the additional revenue available after compensation if the GST is raised to 15 per cent.

4.2 GST increases could also reduce the Commonwealth's substantial deficit

Any additional GST revenue could go to reducing the Commonwealth's substantial deficit. The Commonwealth has posted structural deficits for the last 8 years. Based on current policies, these deficits are likely to continue. Projections that show these deficits being reduced quickly over the next four years of the forward estimates seem optimistic. Budget repair will almost certainly require both tax increases and spending reductions.⁴¹³ Tax increases through the GST are likely to distort economic activity less than most of the alternatives, and definitely less than bracket creep, which is the dominant driver of the Commonwealth's planned return to surplus. Half of the available additional revenue from raising the GST to 15 per cent – \$5 billion a year – would reduce the Commonwealth's budget deficit by around 15 per cent.⁴¹⁴

4.3 GST increases could also fund other tax reductions

The additional GST revenue could instead fund other tax reductions, including further income tax cuts,⁴¹⁵ cuts to corporate taxes,⁴¹⁶ or state stamp duties.⁴¹⁷ The relative merits of these proposals are beyond the scope of this paper. Roughly speaking, additional revenue of \$5 billion from the GST could fund:

- a reduction in marginal income tax rates of close to one percentage point for every bracket⁴¹⁸ (this would be in addition to the cut in income tax rate for the lower two brackets described in Section 3.4);
- a general cut of 2 to 3 percentage points for corporate taxes;⁴¹⁹ or
- a cut in the rate of state stamp duties by a third.

4.4 Federalism makes introducing such a package more challenging

A package that raises GST collections and delivers enough to all governments involved would shake up existing federal-state financial relations.

Raising the GST will impose political costs on both Commonwealth and state and territory governments. Such a reform would require – as a matter of political reality – the support of the Commonwealth Government and a majority of the state governments. This support is unlikely unless both the Commonwealth and state and territory governments achieve a net benefit.

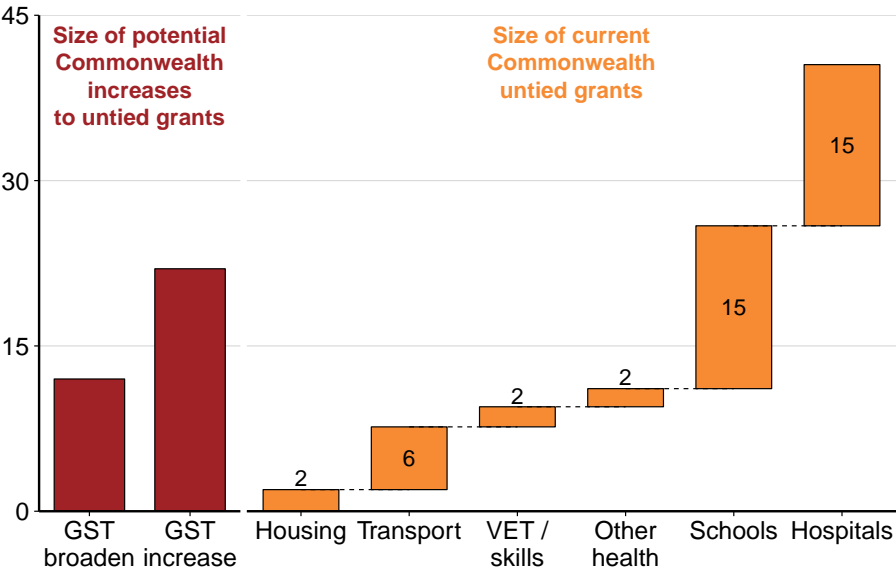
But a politically plausible compensation package for increasing the GST to 15 per cent, such as that described in Chapter 3, would effectively cost the Commonwealth budget **\$16 billion** a year – \$8 billion in tax cuts and \$8 billion in higher welfare payments – if it did not pocket any of the revenue.

There are different ways the Commonwealth could fund this cost.

The Commonwealth could retain a portion of the GST collected. But the states and territories will be reluctant to abandon the current principle that the Commonwealth passes on all of the GST it collects. Any sign that the Commonwealth intended to retain some of the GST revenue would probably be seen by the states as the thin end of the wedge unless it was part of a ‘big bang’ reform to federal-state relations such as the one proposed recently by the South Australian premier. Having got its hands on some GST, it would be very tempting for a cash-strapped Commonwealth to retain a bigger portion in the future. The states and territories would be right to be suspicious: the Commonwealth has a long track record of reducing grants to the states when it faces budget pressures, effectively transferring Commonwealth budget problems to the States.

Alternatively, the Commonwealth could reduce some of the tied grants that it provides to the states, while commensurately increasing untied GST funding.⁴²⁰ Many state governments would find this attractive,

Figure 86: Cuts to tied grants would need to occur in politically sensitive areas
Commonwealth transfers to states by sector, billions, 2015-16



Source: Treasury (2015a, Budget paper 3, Table 2.2).

so long as they received a material increase in funding overall as an incentive for their cooperation. Indeed, delivering the states greater autonomy in the service areas where they have jurisdiction is seen as important objective of reform to federal-financial relations.⁴²¹

However, it is likely to meet political opposition. Lobby groups would be reluctant to see tied-payment funding earmarked for their policy area converted to untied funding that states might choose to spend elsewhere. For example, independent school groups are likely to oppose a reduction in tied grants for independent school funding even if there is a commensurate increase in untied funding. They would fear that State governments might subsequently reduce funding to independent schools.

The scale of funding involved exacerbates the problem. If the States insist on continuing to receive the entirety of GST collections as untied grants, then the Commonwealth would need to reduce tied grants

by around \$22 billion a year if the GST rate is increased to 15 per cent.⁴²² This would offset the hits to the Commonwealth budget from the compensation package as well as providing some improvement to Commonwealth revenue collections.

Commonwealth transfers to the states will total \$108 billion in 2015-16 of which \$50 billion are for tied grants. A reduction in tied grants of \$22 billion a year would require the Commonwealth to untie funding for either of schools or hospitals, or all other areas (Figure 86 on the previous page).

But these challenges are not insurmountable. Over time giving states greater control over their spending will arguably improve efficiency and accountability⁴²³ – potential additional dividends for GST reform.

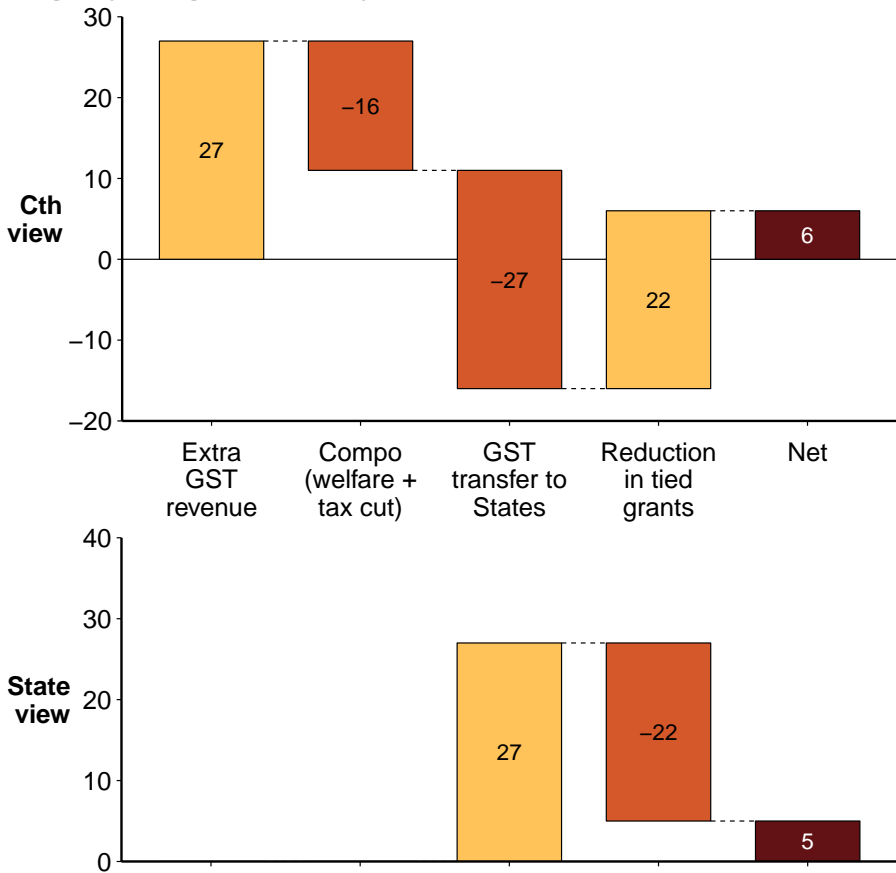
It may possible to transition to this reform with additional funds from a higher or broader GST initially tied (perhaps based on the existing profile of tied grants) with an increasing proportion becoming untied over time. This may help overcome some of the political challenges of reducing tied grants, although it would increase the complexity of the change.

Overall, the package we propose provides a sizeable boost to revenues for both the Commonwealth and state governments (Figure 87 on the facing page).

No doubt, both levels of government will quibble about their respective shares. But there is a deal to be done that would support economic growth, make the tax and transfer system more progressive, and give the state and Commonwealth governments more budgetary options.

Figure 87: A GST package can boost revenues for both Commonwealth and State Governments

Budgetary changes, \$ billion / yr, 2014-15



Source: Grattan analysis

V

Negative gearing and the capital gains tax discount

Overview

A substantial change to Australia's tax arrangements is long overdue. The interaction of a fifty per cent capital gains tax (CGT) discount with negative gearing distorts investment decisions, makes housing markets more volatile and reduces home ownership. Like most tax concessions, these tax breaks largely benefit the wealthy.

These two measures in combination allow investors to reduce and defer personal income tax, at an annual cost of \$11 billion to the public purse. Our proposals to wind back the discount and negative gearing would save the Commonwealth Government about **\$5.4 billion a year**

The discount on capital gains tax is designed to maintain incentives to save and invest. Because taxes apply to nominal income, inflation would otherwise erode part of an investor's capital gains. Given actual returns, many investors have been overcompensated for inflation.

Policy has overzealously protected savings at the expense of competing considerations. The economic benefits of tax neutrality for savings are small: those with high incomes save almost the same amount regardless of the tax rate. Providing a discount means that other taxes must be higher, and they impose greater economic costs. The 50 per cent discount also encourages investors to focus too much on investments with capital growth rather than annual income. And it undermines income tax integrity by creating opportunities for artificial transactions to reduce tax.

Reducing the capital gains discount to 75 percent would provide a better balance between these competing considerations and would raise about **\$3.7 billion** a year.

Negative gearing allows those who borrow to invest to use losses to reduce tax on wages and salaries. In Australia negative gearing goes beyond broadly accepted principles for offsetting losses against gains. It diverts capital from more productive investments without greatly increasing housing supply. Like the CGT discount, negative gearing primarily benefits those on high incomes.

Australia should follow international practice, and not deduct losses from passive investments from wage and salary income. This change would raise **\$2 billion** a year in the short term, falling to **\$1.7 billion** as losses start to be written off against positive investment income. Other proposals, such as restricting negative gearing to new properties or limiting the dollar value of deductions, leave too many problems in place and introduce additional distortions.

These changes will improve housing affordability – a little. We estimate housing prices would be up to 2 percent lower than otherwise. Rents won't change much, nor will the rate of new development. With tight constraints on supply of land suitable for urban housing, most of the impact will be felt via lower land prices. The changes will not cause housing markets to collapse: their effects on prices are small compared to factors such as interest rates and supply of land.

Phasing in change would reduce price shocks and make the reforms easier to sell. It is better than grandfathering current holdings, which would increase complexity, limit the additional tax collected for many years, and be unfair to new investors, especially younger ones.

Recommendations

1. Reduce the capital gains tax discount for individuals and trusts to 75 percent
 - Phase in a 25 per cent discount over ten years through reducing the value of the CGT discount by 2.5 percentage points each year.
2. Limit negative gearing. Quarantine passive investment losses so they can only be written off against other investment income
 - Do not allow losses on passive investments to be written off against unrelated labour (wage and salary) income
 - Allow losses on passive investment to be written-off against all current year and future positive investment income, including interest, rental income and capital gains
 - Continue to allow losses from unincorporated business – sole traders and partnerships – to be written off against wage and salary income, subject to current restrictions
 - Do not create other exceptions – allowing the write off of losses up to a limit, on one or two properties, or on new properties
 - Phase in over ten years by reducing the proportion of losses that can be written off against wage and salary by ten percentage points each year.

3. In the longer term, aim to align the tax treatment across different types of savings

- Reduce taxes on other savings income such as net rental income and bank deposits so as to align with the tax treatment of capital gains
- Reduce and target the tax incentives for superannuation in line with the recommendations in Part III.

1

Commonwealth budgets are under pressure

In five of the last six years, the Commonwealth Government has posted headline deficits of more than 2 per cent of GDP. Assuming revenue and spending projections are correct, Australia is on track for more than a decade of deficits between 2008 and 2019, with Commonwealth net debt projected to peak at 18.5 per cent of GDP in 2017-18,⁴²⁴ higher than any point in the last 45 years.⁴²⁵

As Part I highlighted, reaching surplus in the next five years depends on higher income tax collections through bracket creep and optimistic assumptions about economic growth, the terms of trade and spending restraint.

The most vulnerable assumption is that growth will return to its long-run trend. The International Monetary Fund recently joined a growing group of economists who believe that long-run economic growth in developed countries including Australia will be slower than in the past.⁴²⁶

The government's fiscal strategy relies heavily on these optimistic projections. But hoping for the best is not a budget management strategy. It simply justifies putting off hard decisions, and shifts the costs and risks of budget repair onto future generations. Our research has previously shown that each year the government runs a \$40 billion deficit it increases the lifetime tax burden for households headed by a person aged 25 to 34 by \$10,000.⁴²⁷

To bring their budgets back to balance, governments will need to undertake reforms on both the revenue and spending sides. History suggests that successful budget repair usually requires simultaneous revenue increases and spending reductions.⁴²⁸

Over the past two years, the Commonwealth Government has focused publicly on spending cuts to reduce deficits. Ironically, the dominant component of planned budget repair was revenue increase, particularly through fiscal drag. (See Chapter 1 on page 12.)

While spending control remains important, some revenue measures could make a meaningful contribution to budget repair with little collateral damage. Recent Grattan papers have shown how governments could improve their fiscal position by targeting superannuation tax concessions, broadening the base or increasing the rate of GST and introducing a broad-based property levy. This report shows that reducing the capital gains tax discount and limiting negative gearing could also make useful contributions.

2

The capital gains discount

A capital gain is the increase in the value of an asset. Capital gains are taxed when the asset is sold and the gains are realised. The 50 per cent capital gains tax discount means that the tax rate paid on capital gains is half the rate for other forms of income.

The purpose of providing a tax discount for capital gains is to reduce the bias income tax creates against savings and investment. But this efficiency benefit needs to be balanced against the costs.

Tax concessions for capital gains reduce government revenue collections. Other, more distorting taxes, must then be higher. The concessions also distort investment choices because other forms of investment income – such as bank interest – are taxed without discount. Tax concessions for capital gains undermine the integrity of the income tax system by creating opportunities for artificial transactions to reduce income tax. They also reduce the progressivity of the tax system because capital gains are far less evenly distributed than other forms of income.

Given these costs and benefits, is the capital gains discount set at the right level? While retaining some discount can be justified – primarily because a part of the capital gain is produced by inflation that in principle should not be taxed – the current discount is too generous given the range of competing considerations.

Figure 88: Individuals earn most capital gains through real estate and shares
Realised capital gains by source 2013-14, billions

Notes: Information is for individuals that completed a CGT schedule. Other assets include business assets and trust distributions that include a capital gain.
Source: ATO (2016b)

2.1 The size and distribution of capital gains

Australian entities – individuals, companies, and superannuation funds – accrued about \$74 billion of income through capital gains in 2013-14. Individuals accrued 45 percent of capital gains and gained more from real estate than any other source. By contrast, companies and trusts gained relatively little from real estate (Figure 88). Individuals are more likely than institutions to own real estate because progressive state land taxes discourage large property holdings and institutional real estate investment.*

These capital gains are taxed as part of the income of individuals, companies and superannuation funds. In 2013-14, capital gains tax raised around \$7.5 billion, around 3 per cent of total income. This is expected to have climbed to \$8.9 billion in the following year.⁴²⁹

2.2 Capital gains receive a range of tax advantages

Before 1985, capital gains were not taxed in Australia. Since then, the tax treatment of capital gains has varied, but they have always been taxed at a lower rate than wage and salary income (Box 11 on the next page).

For individuals and unincorporated small businesses, 50 per cent of their capital gains on assets held for more than one year are excluded from income. This means the effective tax rate paid on these gains is half

*See Part II. Most institutions invest in commercial property through Real Estate Investment Trusts because company structures do not allow the pass through of tax benefits (such as depreciation allowances).

Box 11: A short history of capital gains tax changes

Before 1985 capital gains were untaxed in Australia. Taxes on capital gains were introduced to improve the integrity of the tax system, which was undermined by taxpayers recharacterising regular income as capital to avoid tax.⁴³⁰

Broader taxes on capital gains were introduced to improve the integrity of the tax system, which was undermined by taxpayers reclassifying regular income as capital to avoid tax.⁴³¹ Taxing capital gains in the same ways as other income was also seen as more equitable.⁴³²

Between 1985 and 1999, real capital gains (sale proceeds minus the original purchase price adjusted for inflation) were taxed at a taxpayer's marginal income tax rate.

As the Ralph Review of Business Taxation recommended, the Howard Government removed indexation adjustments so that tax was applied on nominal gains. To offset the removal of indexation, tax on capital gains income was discounted by 50 per cent for individuals and 33 per cent for superannuation funds for assets held for more than a year. Capital gains of small unincorporated businesses were also discounted by 50 per cent.

When this regime was introduced, it was argued that it would stimulate capital markets and make the Australian regime more internationally competitive.⁴³³

the rate applied to other forms of income. Owner-occupied housing is an exception – capital gains on homes are not taxed at all.⁴³⁴

Superannuation funds pay tax on capital gains at 10 per cent (a discount to the 15 per cent they pay on earnings).

Large corporations pay tax on their capital gains at the corporate rate of 30 per cent, which is the same rate as their income.

Capital gains also receive other less explicit tax advantages compared to recurrent income. First, capital gains are taxed on sale rather than as they accrue. This deferral of tax is akin to the government providing the investor with an interest free loan. This substantially reduces the effective tax rate paid on gains, with the tax benefit increasing if the asset is held for longer.

With the 50 per cent discount, this deferral over 15 years for a top marginal rate taxpayer reduces the effective nominal tax rate on capital gains from 32 per cent to 28 per cent. (Figure 89 on the facing page.)

Second, investors are also able to choose the time of an asset's sale to minimise taxes on capital gains. They can reduce their tax by selling assets when their income is low, such as after retirement, so they are taxed at a lower marginal rate.

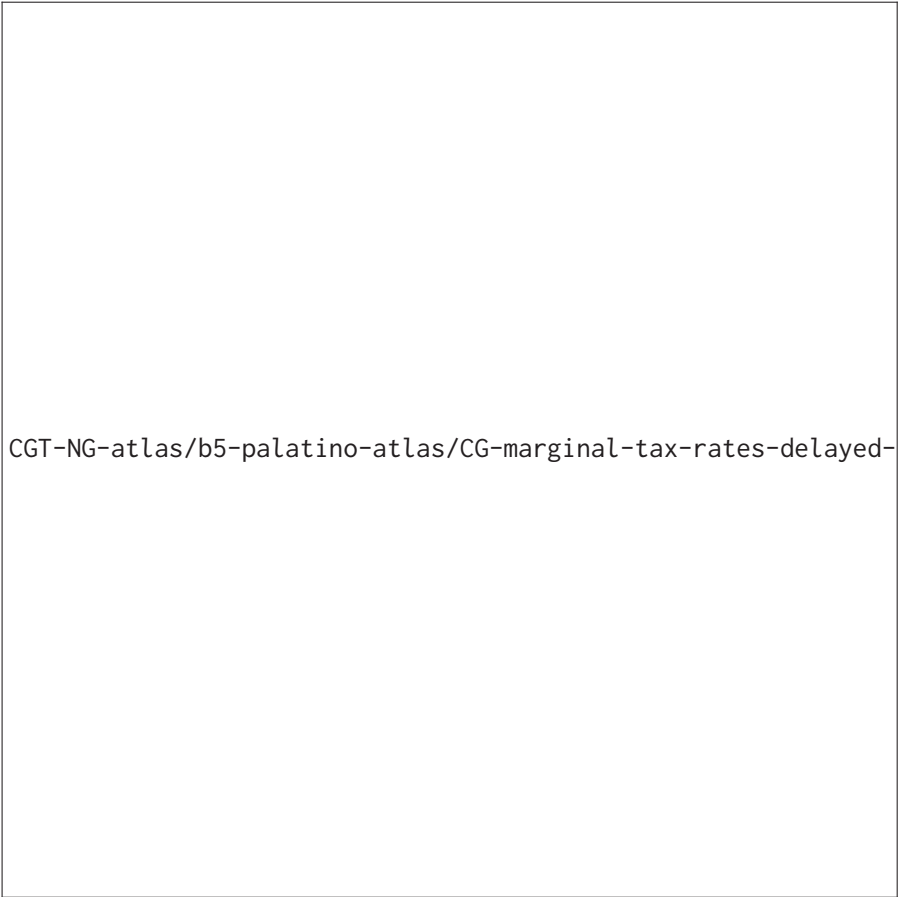
Some Australians, particularly high income earners, wait until retirement to realise capital gains. Those 65 and older are much more likely to sell assets than those who are younger (Figure 90 on page 308).

The benefits of waiting can be substantial. A person paying the top rate of income tax of 47 c (including Medicare levy) who times the sale of an investment after 15 years for when they are in the lower tax bracket would reduce the annual nominal tax rate on that investment from 28 per cent to 25 per cent. (Figure 89 on the facing page.)

The flip side of the benefits to waiting is that taxing capital gains can lead to asset lock-in. Investors are discouraged from selling assets they have held for a long time, even when it would make economic sense to

Figure 89: The delay in realising capital gains substantially reduces the effective tax rate

Nominal effective marginal tax rates on savings

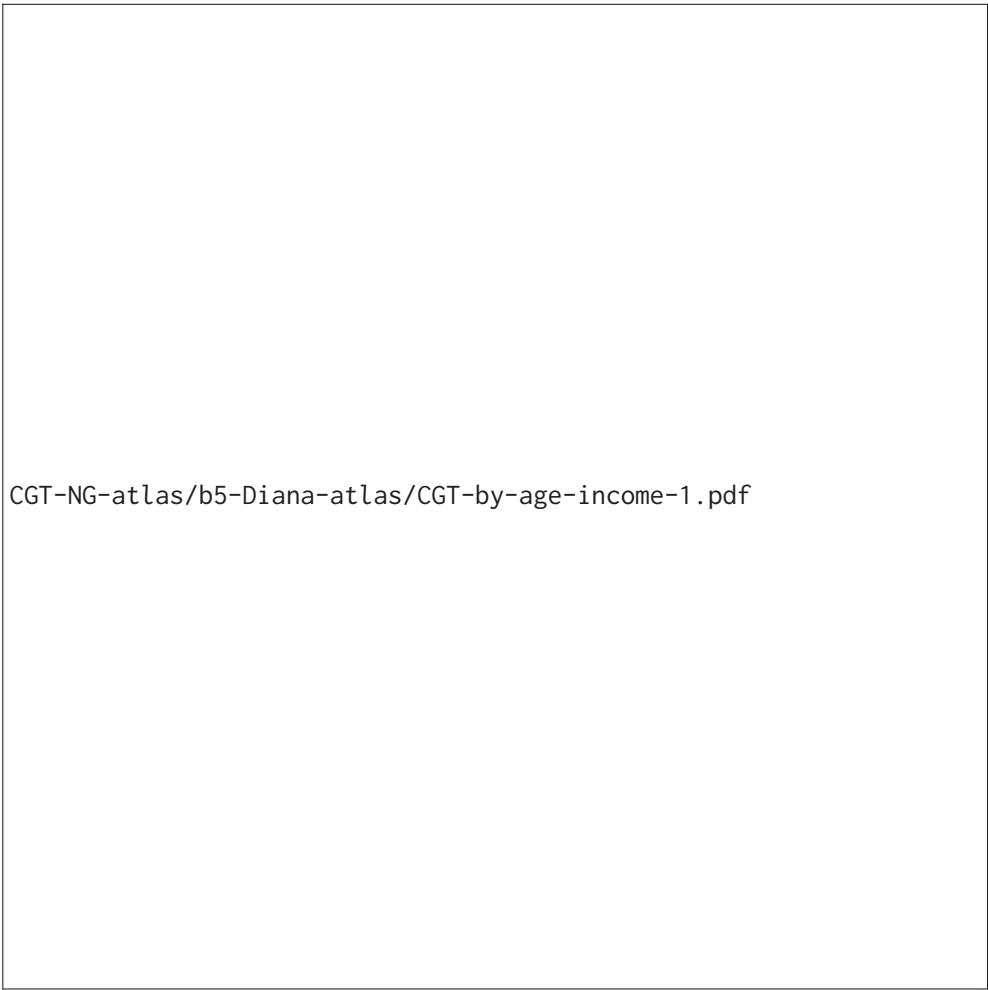


CGT-NG-atlas/b5-palatino-atlas/CG-marginal-tax-rates-delayed-1.pdf

Notes: Assumes 3 per cent nominal income return, 5 per cent nominal capital gain. All returns reinvested to maturity. All gains are realised at investor's nominal tax rate of 47 c, except final scenario where the investor realises at 34.5 c marginal rate. Effective tax rate calculated as reduction in annual returns because of tax divided by untaxed return.

Source: Grattan analysis

Figure 90: Older taxpayers are more likely to have capital gains than younger taxpayers, for all age groups at almost all income levels
Probability of net capital gains



CGT-NG-atlas/b5-Diana-atlas/CGT-by-age-income-1.pdf

do so, because they would then pay tax on their accrued gains. More detail is provided in Appendix A on page 368.

2.3 Some discount is justified to adjust for inflation

In Australia, taxes on savings income, including capital gains, are levied on nominal returns, which include inflation. Because inflationary gains are not 'income' in a true sense,⁴³⁵ some discount on returns to savings is justified. But the 50 per cent discount has overcompensated property investors for inflation over time.

A capital gains tax discount is an imperfect adjustment for inflation. The effective tax rate on real returns will depend on both the rate of inflation and the level of returns. (See Box 12 on page 311 and Appendix B on page 372.)

The 50 per cent discount has overcompensated property investors for inflation over the past 15 years. Since the introduction of the capital gains tax discount in 1999, house prices have grown annually by an average of 7.3 per cent.⁴³⁶ Inflation over this period averaged 2.9 per cent annually.⁴³⁷

In contrast, long-term share investors who experienced low average capital returns because of the global financial crisis would have been better off paying tax on their real capital gains. Share prices have only grown by 3.3 per cent a year since March 2000.⁴³⁸

Of course, investors in both property and shares received ongoing investment income from rents and dividends that meant their net returns were significantly higher than those from capital gains alone. Indeed, given historical rental yields and capital growth, an investor in the top tax bracket selling a property held for 15 years paid an effective real tax rate of 32 per cent on their returns, compared to 47 per cent on their labour income.

Lower future returns would mean somewhat higher effective tax rates. Capital growth for real estate may well be lower in future, as in the last two decades asset prices were boosted by falling interest rates. Interest

rates are unlikely to fall much from their current levels, around the lowest in recorded history.⁴³⁹

2.4 What is the 'right' tax rate on capital gains?

Beyond compensating for the effects of inflation, the right tax rate for earnings on savings, and capital gains in particular, depends on a range of competing considerations.

In an ideal taxation world, taxes on savings should leave investors neutral between consuming today and consuming tomorrow. In other words, no investor should be penalised for saving. To achieve this ideal, there should be no tax on the component of savings returns known as 'returns to waiting', or the 'risk-free rate'.⁴⁴⁰ This component of returns is not reward for risk-taking or skill but simply for forgoing access to money for a period.

The right tax rate on savings could be even lower if governments are seeking to promote entrepreneurship through the tax system. On the other hand, there are good reasons to impose taxes on capital gains higher than this theoretical ideal.

First, all societies need taxes, all taxes impose costs, and the cost of taxes on savings must be balanced against the economic cost of raising revenue through other taxes. Taxes on savings are more economically desirable than many other taxes because they don't have much effect on behaviour. People who can afford to save will tend to do so regardless of the tax rate.

Second, higher taxes on capital gains reduce the incentives for tax avoidance: taxpayers structuring transactions so that earnings are re-classified as capital gains to attract the lower tax rate.

Third, higher taxes on capital gains reduce distortions in investment choices. Other forms of investment income – such as bank interest – do not receive concessional tax treatment.

Box 12: Inflation and returns dictate tax rates on real gains

When taxes are levied on nominal returns, as they have been since the capital gains discount was introduced, tax rates on real gains depend on both the inflation rate and the level of returns.

Consider an investor, Surya, who has \$10,000 worth of shares. The shares pay no dividends so all her returns are through capital growth. The shares increase in value by 8 per cent over the first year while inflation is 2.5 per cent. If she were to sell the shares at the end of the year her nominal return would be \$800. Her real (inflation-adjusted) return is \$540.

If she paid **tax directly on her real gain** at the 47 per cent top marginal tax rate, she would pay \$252 in tax. So her **real after-tax return would be \$288**. If instead she **paid tax on her nominal gains that had been discounted by 50 per cent** then she would pay tax of \$188 (47 per cent tax on half her nominal gains of \$800) and thus receive a **real after-tax return of \$352** (*i.e.*, her real return of \$540 minus the \$188 tax). Therefore, in this scenario with returns at 8 per cent and inflation at 2.5 per cent, she is much better off being taxed on her nominal gain with the 50 per cent discount than being taxed directly on her real gains.

However, the opposite is true if returns are low. If Surya's shares only increase in value by 3 per cent annually, her nominal return would be \$300 and her real (adjusted for inflation) return would be \$49. If she paid tax on real gains her tax would be \$23 and she would make **real after tax returns of \$26**. In contrast, if she is taxed on 50 per cent of her nominal gains she pays tax of \$70 and makes a **real after tax loss of \$22**.

Finally, higher taxes on savings, and capital gains in particular, limit growth in inequality. Higher taxes on capital gains can act as de facto wealth taxes.

The next two sections discuss the considerations for and against maintaining the current concessional tax treatment of capital gains in more detail.

2.5 Arguments for maintaining a significant tax concession for capital gains

2.5.1 Not distorting decisions between consumption today and saving for tomorrow

Taxes on income from savings, including capital gains, reduce incentives to save.⁴⁴¹ In effect, taxes on returns to savings make future consumption more expensive relative to current consumption, so people have incentives to consume more and save less. Taxes on savings also somewhat reduce the incentives to work today, by lowering the payoff from working to save for the future.⁴⁴² In the theoretical ideal, taxes would leave people neutral between consumption today and consumption tomorrow.

Although economists do not all agree, many proponents of ‘optimal tax theory’ – including the Mirrlees tax review in the UK – advance the view that the way to achieve this neutrality is to not levy tax on the risk-free returns to savings (Box 13 on the facing page).⁴⁴³ Others such as Banks and Diamond (2008) conclude that it may still be optimal to tax the risk-free return to savings, albeit at a lower tax rate than other income.⁴⁴⁴

The corollary of exempting the risk free returns from tax is that what are known as ‘excess returns’ – the other component of returns to savings – should be taxed.⁴⁴⁵

For property investors paying tax at the top marginal rate, the current capital gains tax regime has taxed their excess returns at almost the same effective rate as income over the past 15 years, as shown in Figure 91. In

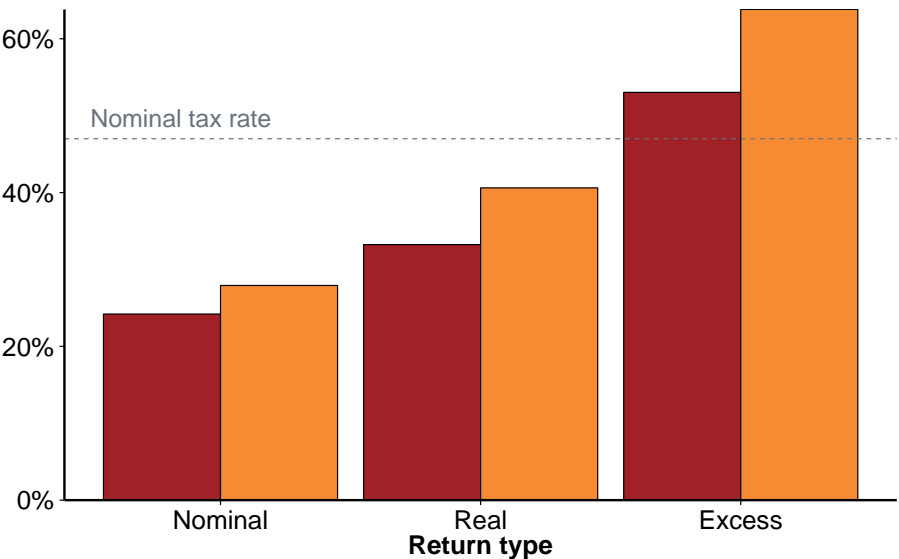
Box 13: What are risk-free returns?

One component of returns to savings is the risk-free rate. Most people prefer to have a thing today rather than acquiring the same thing tomorrow. So people need to receive some compensation for deferring consumption. Of course, different people may care more or less about waiting: those on lower incomes tend to put more of a premium on immediate consumption than those on higher incomes. The (nominal) risk-free rate also includes compensation for inflation – increases in the general price level that erode purchasing power.

The average cost of waiting is often described in finance as the ‘risk free’ rate. The proxy used to measure this rate is the interest rate paid on government debt where there is minimal risk of default, and the investor only gets a return for waiting.

Figure 91: The effective tax rate on excess returns for property has been close the income tax rate over the past 15 years

Effective marginal tax rates on savings



Notes: See page 398.

Source: Grattan analysis

other words, the current regime has delivered results very close to the theoretical ideal for those that held assets over the period.

But that may not last. The effective tax rate on excess returns will vary with total returns, inflation, and changes in the risk-free rate. If investment returns are lower in the future, then effective tax rates on excess returns would be higher than over the last 15 years (Figure 91), and might deter saving to some extent.

On the other hand, the theoretical ideal implicitly assumes losses and gains are taxed symmetrically. But this is not the case. Capital gains are taxed on realisation and at the time of the investors' choosing (Section 2.2) whereas losses can be written off against taxable income each year. As we show in Chapter 4, this means that effective tax rates are lower for negatively geared investments than for investments fully

financed from savings as is assumed in Figure 91 on the preceding page. Effective tax rates for investors under a range of alternative return scenarios and tax rates are summarised in Appendix B.⁴⁴⁶

2.5.2 Maintaining incentives for risk-taking and entrepreneurship

A tax discount for capital gains is also sometimes justified on the basis that taxing capital gains will deter entrepreneurship and risk taking by reducing the returns to selling a successful business.⁴⁴⁷ But this effect is unlikely to be large. Other factors that influence entrepreneurship and risk-taking behaviour are far more significant to returns than the tax on any gains ultimately made.⁴⁴⁸

One plausible reason for taxing excess returns at the same rate as income is that taxes on risk-taking should be similar to taxes on working. Obviously there need to be some rewards to taking risks. But on the other hand, why should the after-tax returns to risk-taking be higher than the after-tax returns to working?

Some argue that capital tends to be more mobile than labour, and so should be taxed less to keep it from moving. Yet taxes on savings by individuals are generally levied where the individual lives, rather than where the capital is invested. Investors are not that much more mobile than workers.

In any case, most capital gains for individuals are from property and sharemarket investments (Figure 88 on page 304). Specific small business exemptions are a far more targeted way to address any tax disincentive for entrepreneurial effort. A number of other exemptions are already in place to limit the effects of capital gains tax when assets or businesses are sold (Box 14 on the next page). It is arguable that these are overgenerous.

2.6 Arguments for lower tax concessions for capital gains

The 'optimal' tax on savings discussed in the previous section assumes that the only considerations are achieving neutrality between savings and immediate consumption.

Box 14: Small business capital gains tax exemptions

Small business owners enjoy a range of generous exemptions from capital gains tax. They can receive exemptions for the sale of active assets up to a lifetime limit of \$500,000. For those under 55, the proceeds must be paid into a complying super fund to receive the exemption ('retirement exemption').

There are also CGT exemptions for people over 55 that are retiring and selling business assets held for more than 15 years (the '15-year exemption'). A lifetime cap of \$1.395 million applies to the retirement exemption and the 15-year exemption.

Small business owners also receive rollover relief, allowing them to defer all or part of a capital gain for two years or longer on the sale of active assets, provided they acquire a replacement asset or make capital improvements to an existing asset.

In its recent innovation statement, the Government announced further capital gains tax relief for investors in start-ups. Investors receive a ten-year exemption from capital gains tax so long as they hold the investment for at least three years.

Given this raft of concessions, it has been described as a 'mystery' that small business ever pays any capital gains tax.

Source: ATO (2014a), Department of Innovation (2015) and Ingles (2015, p. 6)

Yet of course other considerations exist. Indeed, it is not obvious that the trade-off between savings and immediate consumption should even be the *primary* consideration for setting taxes on savings, apart from the relative ease with which it can be modelled.

2.6.1 Balancing the costs of other taxes

If savings taxes are lower, then other taxes need to be higher than otherwise. Inevitably these taxes impose costs of their own – all taxes distort behaviour from an untaxed ideal. So *how much* savings taxes distort behaviour must be compared with the size of distortions due to other taxes that would otherwise be higher.

In fact, taxes on savings probably do not do much to distort total savings from ideal levels. Savings behaviour is relatively unresponsive to tax rates.⁴⁴⁹ Empirical evidence mainly suggests that changes in tax rates affect investors' choice of investment much more than the total amount saved. This is particularly the case for those on high incomes, who tend to save the most.[†]

By contrast, the *actual* distortions due to other taxes may be quite high. For example, for middle-income women with children, take home pay can be very low after paying income tax and giving up welfare and paying for childcare. These costs substantially reduce workforce participation.⁴⁵⁰

2.6.2 Reducing distortion between investment choices

Providing a tax discount for capital gains but not for other investment income does distort where people choose to invest.

[†]See Treasury (2015b, p. 59) as well as Section 2.6 on page 135 for a summary of the literature on the impact of tax concessions on retirement savings efforts. While most studies look at tax concessions for retirement savings, a review of the experience of tax-preferred savings accounts in 11 OECD member countries also suggests that high-income people are most likely to participate in tax preferred savings plans but tax preferred accounts only create new savings when people of moderate incomes participate in them. See: OECD (2007).

Capital gains have substantial tax advantages relative to annual earnings. The capital gains discount magnifies the tax advantages because capital gains are not taxed until they are realised (Figure 89 on page 307). In contrast, Australia's current tax system does not adjust for the effects of inflation on bank deposits, which are assets disproportionately held by the least well off.⁴⁵¹ Rental income, bond yields and returns from overseas shares are also taxed at full marginal rates.

Taxing capital gains more lightly than most other savings income creates an incentive for investors to choose riskier assets that return more via capital gain. In conjunction with generous rules for deductibility of interest costs, the tax system creates strong incentives for debt-financed and speculative investments (Section 3.1). As a result, Australians invest more in property and less in bank deposits than economic fundamentals would suggest is ideal.

The efficiency losses generated by the different tax treatment of different forms of savings are likely to be much larger than from the weight of taxes on capital in general.⁴⁵² Of course, the economic cost of differing tax treatments is also an argument for taxing savings earnings less rather than taxing capital gains more. But substantial budget deficits leave little room to reduce taxes on other forms of savings income. Consequently, the most plausible way in practice to reduce the distortions between different forms of savings is to increase the taxes on capital gains Section 4.4 on page 344.

However, increasing taxes on capital gains will increase the incentives to invest in owner-occupied properties and in superannuation, which already enjoy even larger tax concessions than capital gains. People would be encouraged to invest even more in their principal residence, by renovating, and purchasing bigger and better-located homes.

There is some truth to these concerns, but they shouldn't be overstated.

First, there is at least a plausible rationale for encouraging additional investment in owner-occupied housing,⁴⁵³ the biggest single component of wealth.⁴⁵⁴ Governments have deliberately promoted home ownership

because of the social benefits including enforced savings, social stability and community involvement.⁴⁵⁵ Therefore, further widening the tax advantage for owner-occupied housing by reducing the CGT discount may not necessarily be a net social cost.⁴⁵⁶

While some tax incentives for superannuation might be justified, the current regime is too generous and poorly targeted. Grattan Institute's 2015 report, *Super tax targeting*, argues that they should be wound back.[‡] In the meantime, failure to reform superannuation should not hold back capital gains tax reform.

Second, reducing the discount might not lead to much greater investment in owner-occupied housing and superannuation. Households already hold 40 per cent of their assets outside these areas, even though they give up substantial tax advantages.⁴⁵⁷ This is presumably because people want savings in forms that are available for use before retirement and without having to sell their home.

2.6.3 Maintaining the integrity of income tax collections

Tax concessions for capital gains can increase 'revenue leakage' as taxpayers convert what many people would intuitively view as labour income into capital gains, in order to pay less tax.⁴⁵⁸ Protecting the income tax base is a key reason for taxing capital gains in most OECD countries⁴⁵⁹ and prompted the introduction of a general capital gains tax in Australia in 1985 (Box 11 on page 305).

Traditionally, this type of tax shelter has been the preserve of the wealthy. Examples include paying executives with shares or stock options,⁴⁶⁰ and reorganising private corporations to convert dividend income into capital gains.⁴⁶¹ Negative gearing (discussed in Chapter 3) effectively converts wage income into more concessionally taxed capital gains (Section 3.1).

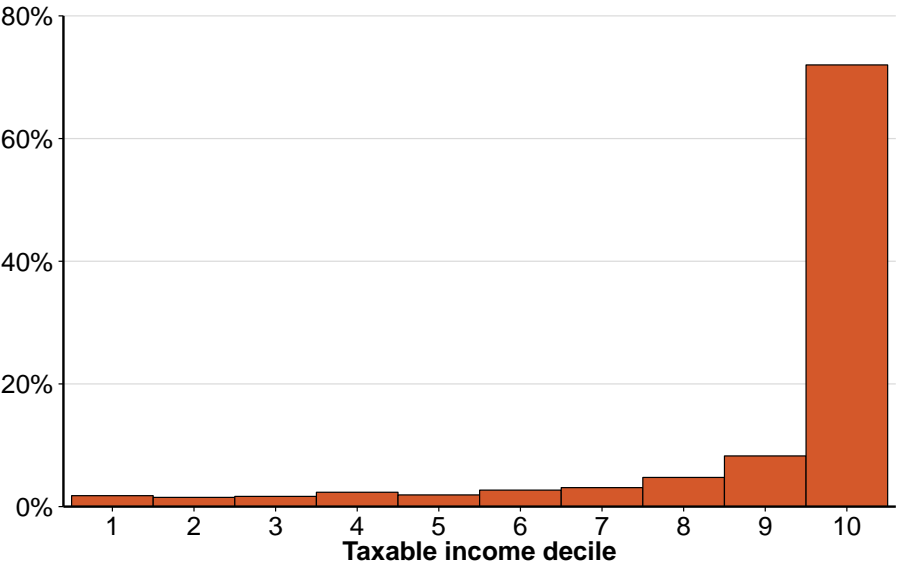
[‡]See page 113 in Part III.

2.6.4 Maintaining the progressivity of the tax system

If returns to savings are not taxed, inequality will almost certainly widen. The top ten per cent of wage and salary earners receive about a third of all wages and salaries (before tax). They tend to save a greater proportion of their income than people who earn less.⁴⁶² And they are more likely to invest in higher risk and return assets, including assets where a higher proportion of the total returns are from capital gains. Indeed, as Figure 92 shows, the top ten per cent of individual income earners received 55 per cent of all investment income, and 67 per cent of all capital gains income.

Figure 92: Most capital gains are earned by those in the highest income decile

Proportion of net capital gains by income decile (2013-14)



Source: Grattan analysis of ATO (2016b)

The proportion of gains accruing to those on high incomes may be somewhat skewed by the fact that capital gains are lumpy, so some lower income earners will have relatively high taxable incomes in the year they realise gains. But even if we look at the distribution of gains by taxable

incomes *before* capital gains, almost 40 per cent of gains are earned by the top 10 per cent of income earners. Another quarter is earned by those with very low taxable income⁴⁶³ – these tend to be two groups: over 50s who have waited until retirement to realise gains, but have much higher lifetime incomes (Section 2.2); and some younger Australians, potentially partners of high income earners receiving distributions of capital income through structures such as trusts.⁴⁶⁴ All of this only further demonstrates that capital gains accrue disproportionately to those who are already well off.

Some inequality is acceptable if it is a consequence of some people working harder, or taking more risks, than others. But if the returns on savings concentrate resources even more than wage inequality, then the reinvestment of the returns on savings can lead to continued increases in the concentration of wealth – what Thomas Piketty described as an ‘endless inegalitarian spiral.’⁴⁶⁵

Critics of Piketty’s work, most notably Matthew Rognlie, argue that over the long-term, diminishing marginal returns should ultimately put a brake on the share of total income earned by capital rather than labour.⁴⁶⁶ However, Rognlie’s finding that higher house prices (and associated economic rents) have been the dominant driver of the growth in the capital share of national income⁴⁶⁷ does not undermine Piketty’s thesis. Indeed, these findings suggest that so long as tight planning and zoning restrictions remain in place, those that can afford to save (and buy houses) are likely to keep capturing a growing share of national wealth.⁴⁶⁸

Higher taxes on capital gains can break the cycle because they act as *de facto* wealth taxes.⁴⁶⁹

Another cause for concern is that tax concessions for capital gains make Australia’s income tax system less progressive than its income tax regime suggests. While some may want a less progressive system, tax concessions are generally a poor way to achieve this, because they are inherently less transparent than changing the marginal rates of income tax. For value choices such as the progressivity of the tax system, the

public debate is best served by making the distribution of the tax burden as transparent as possible.[§]

2.7 Some discount may be justified but on balance the current treatment of capital gains is too generous

When policy makers consider the taxation of capital gains, they must balance the competing considerations discussed above.

All tax systems face this challenge. Most OECD countries offer some type of discount or concession for capital gains,⁴⁷⁰ although the hurdles to qualify for the most generous concessions can be high (Appendix C).⁴⁷¹

If the tax treatment of nominal capital gains simply aims for neutrality between immediate consumption and savings, then capital gains would be taxed a little more lightly than at present, under most scenarios for future returns.⁴⁷²

Yet this one-eyed treatment needs to be balanced against other considerations. Perhaps the most important is that people tend to save almost the same amount irrespective of the tax rate on savings.⁴⁷³ Higher taxes on capital gains would increase tax collections, help to repair the Commonwealth budget and provide room to reduce other taxes with higher economic costs. Higher taxes on capital gains would also reduce the tax bias toward capital gains and away from income producing assets, so that investment patterns would better reflect the economic fundamentals. They would also improve the integrity of the income tax system.

Given that the tax is calculated on nominal (pre-inflation) capital gains, there remains some basis for continuing to offer a tax discount on gains. Reducing the discount from 50 per cent to zero – in other words, taxing capital gains at the income tax rate – would substantially increase the real effective tax rate on savings. As we show in Chapter 5, a 25 per cent discount for capital gains would provide a fairer balance.

[§]See page 135 in Part III.

3

Negative gearing

Negative gearing allows taxpayers to subtract the losses they make on investments from their taxable income, including wages. It has been widely used by property investors over the past 15 years.

Negative gearing in Australia goes beyond generally accepted principles for offsetting losses against gains. It distorts investment decisions and increases the volatility of housing markets. Among its anti-social effects it reduces home ownership⁴⁷⁴ and the availability of long-term rentals, but does not materially increase housing supply. It reduces tax collections, imposing pressures on the budget and creating the need for higher taxes or deficits. And it is regressive, benefiting those on high incomes much more than those on low incomes.

3.1 Negative gearing provides a tax shelter against wages

Australian tax law allows investors to write off investment losses against their taxable income. For property investments, losses are defined as investment expenses in excess of rental income.⁴⁷⁵ The greatest expense – about half the costs of property investors – is the nominal interest on borrowing to purchase the asset.⁴⁷⁶

A property is **negatively geared** if interest payments contribute to the rental losses.

The interaction of negative gearing and tax concessions for capital gains provides some investors with a sizeable tax advantage. Taxes on capital

gains are discounted by 50 per cent and only paid when the asset is sold. But negative gearing arrangements allow investors to deduct losses from wages and salary income that would otherwise be taxed at the full marginal rate. In some cases, negative gearing can allow a wage earner to pay less tax than if he had not invested at all, despite also making profits on his investment (Box 15 on page 326).

Tax deductions from wage income may also generate a 'psychic pay-off' for some investors – the pleasure of an immediate reduction in tax. As an investment strategy, negative gearing only makes sense if the expected capital gains exceed the rental losses over the life of the investment. But for some investors, reducing taxes on their wages has become one of the primary goals. Investment advisors have warned against investors placing too much emphasis on tax breaks and not enough on the financial returns to the investment.⁴⁷⁷

With the right investment strategy, an investor can use this asymmetry in the tax treatment of gains and losses to pay less tax in total and later despite receiving additional investment income (Box 15 on page 326).

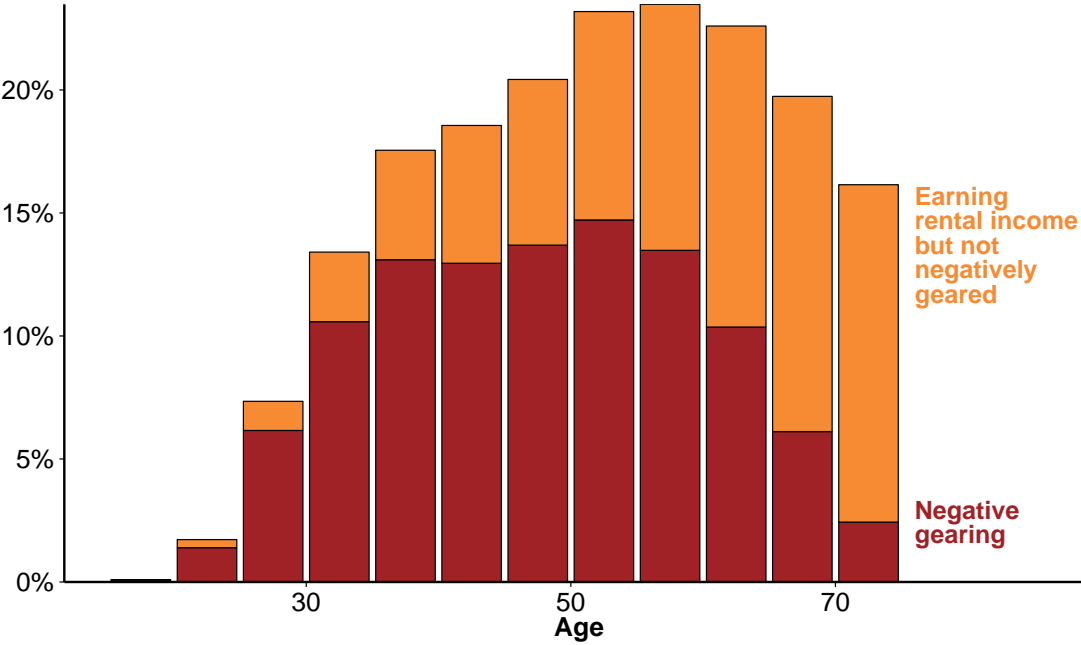
The attractiveness of using investment losses to reduce taxes on wage income is evident in the age profile of those negatively gearing property. Borrowing so much that the investment makes an annual loss is popular amongst those of working age, but far less prevalent amongst over 60s who are less likely to have labour income that can be offset by the tax loss. More than 70 per cent of those under 60 with investment properties make rental losses compared to less than 35 per cent of investors over 60 (Figure 93 on the next page).

Of course, not all investments are negatively geared. Some investors do not borrow at all, and others are 'positively geared' – the annual income on their property investment exceeds the annual costs of maintenance and interest.

Negative gearing is used much less for investments outside of housing. Investors in assets other than real estate, such as equities or unincorporated businesses, are less likely to borrow some of the funding, and

Figure 93: More people negatively gear property investments in their peak earning years

Percentage of 2013-14 taxpayers within each age group



Notes: Taxpayers over the age of 70 are not disaggregated in taxstats and have been presented as having ages 70-75.

Source: Grattan analysis of ATO (2016b).

Box 15: Using negative gearing to reduce taxes on wage income

High income investors can maximise the tax shelter on their wage income by borrowing to invest in assets that generate less in recurrent income and more through capital gains.

Suppose Dan, a lawyer earning \$250,000 a year, borrows \$750,000 (interest only) to purchase a \$750,000 investment property. Interest on the loan is 6 percent a year and the property generates a rental return of 2.5 percent each year. Most of the property's return is via capital appreciation of 5 percent each year.

In the first year, Dan makes a loss of \$26,000 on the property and reduces the tax he pays on his \$250,000 salary by \$13,000. His rental losses decline over time as the property appreciates. After five years, Dan has reduced taxes on his wage income by a total of \$70,000. If he sells the property after five years he will realise a capital gain of \$210,000 and pay tax on the gain of just under \$51,000.

Because of the asymmetry of tax treatment of gains and losses, Dan pays \$8,700 less tax in total over five years than if he had not purchased the house. So despite his profit of more than \$86,000 on the investment, in effect he pays no tax on this profit, actually receiving a tax bonus.

usually do not borrow so much that these investments are negatively geared.

Total lending to individuals for share investments is at most \$19 billion,⁴⁷⁸ compared to individuals' direct share holdings of about \$550 billion, and compared to borrowings of \$548 billion from banks for housing investor lending.

When individuals do borrow to invest in equities (known as a 'margin loan'), the investments are seldom negatively geared. Equities investors are generally only negatively geared (that is, make losses after interest costs) when they use debt to finance at least 70 per cent of their investment. The *average* leverage of those who borrow to invest in shares is about 27 per cent.⁴⁷⁹ Usually the maximum leverage permitted is about 75 per cent. And few margin-lending investors leverage more than 65 per cent of the value of their equity portfolio.⁴⁸⁰

Similarly, very few loans to invest in unincorporated businesses will be negatively geared. Banks are understandably reluctant to lend to businesses that do not have enough cash flow to cover interest payments. Total interest costs for unincorporated businesses were \$1.5 billion in 2013-14⁴⁸¹ (much smaller than negative gearing against property), and much of this would have been incurred by profitable businesses. Total losses by unincorporate businesses were \$4 billion (see page 352 in Section 5.2.3); many of these businesses would not have borrowed.

3.2 Negative gearing goes beyond generally accepted principles for offsetting losses against gains

The ability to deduct expenses incurred in generating assessable income is part of the normal operation of the Australian tax system, and applies to a wide range of investments and business activities. If losses were not deductible but gains were taxed, the asymmetry would make high-risk (high expected return) assets a less attractive investment. Deductibility of interest payments in theory also maintains tax neutrality for investors choosing between debt and equity financing.⁴⁸²

But there is no theoretical basis for deducting losses on investments from entirely unrelated income such as wages. This is reflected in provisions that limit the deduction of business losses from wage and salary income.⁴⁸³

In some areas of tax and welfare policy, loss write-offs are already restricted. There are a number of limits on the deduction of business losses from wage and salary income.⁴⁸⁴ And income test calculations for welfare payments do not allow people to reduce their taxable income through investment losses. Income tests for Family Tax Benefit Part A and Part B, Child Care Benefit are all based on 'adjusted taxable income', which adds back any investment losses.⁴⁸⁵ As a result, negative gearing is most restricted for those on lower incomes.

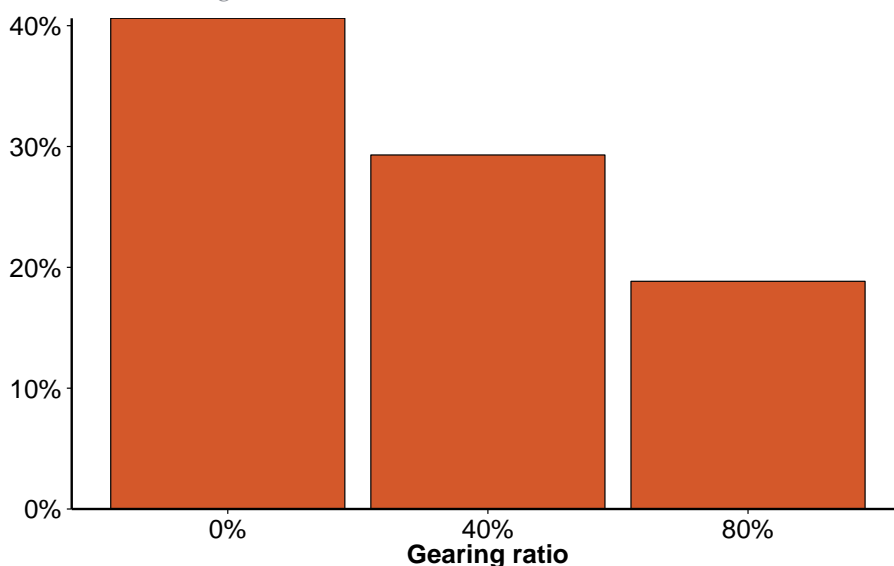
Very few advanced economies allow investment losses to be written off against wage income (Appendix D). The United States only allows loss write-offs against other forms of 'passive' income.⁴⁸⁶ The UK only allows deductions against the same class of income, so for example, losses on investment property can only be used to reduce tax on income or capital gains from other investment properties. The Netherlands does not allow any deductibility of losses from investment housing (Appendix C).⁴⁸⁷

3.2.1 Bias towards higher leverage

The asymmetry between the tax treatment of gains and losses makes debt financing of investment more attractive. Investors can write off their costs, including their nominal interest costs, in full each year. Gains, by contrast, are taxed concessionally and only when realised. A high-income taxpayer who invests in a rental property will enjoy substantially lower real effective marginal tax rates if she finances that property through borrowing instead of through existing savings. The higher she gears the property, the lower will be her effective marginal tax rate (Figure 94 on the facing page).

The 2010 Henry Tax Review described this asymmetry between gains and losses as 'among the greatest tax-induced biases to the savings

Figure 94: Effective tax rates depend on amount of borrowing
Real effective marginal tax rate



Notes: Assumes 3 percent nominal rent income, 5 percent capital gain per year, 2.5 percent inflation, 5 percent interest rate on borrowing, 50 percent CGT discount, and 47 percent marginal tax rate. The property is held for 15 years and then sold.

Source: Grattan analysis

choices of households'.⁴⁸⁸ This asymmetry weakens the argument that retaining the deductibility of losses is necessary to maintain tax neutrality.

While this bias towards higher leverage applies to all investments, in practice it encourages greater investment in property because bank lending rules allow greater leverage for property than for other assets such as shares (Section 3.1 on page 323).⁴⁸⁹

3.2.2 Bias towards capital gains not annual returns

The interaction of negative gearing and capital gains tax also biases the choice of investments. It means that for a given overall return, an investor will prefer an asset that pays less in the way of recurrent income and more in the way of capital gain.

As the RBA notes:⁴⁹⁰

... in most countries the earning of rental income is seen as the most important reason for investing in rental properties. ... This seems to stand in contrast to the situation in Australia where properties are commonly marketed on the presumption that they do not earn positive taxable income for a considerable period.

Seelig et al. (2009) echoes the RBA view, finding that the majority of property investors saw capital gains as more important than rental income in motivating them to invest in property.⁴⁹¹

3.2.3 Investors have responded to these tax incentives

These biases are not just theoretical arguments. They are revealed in the changed behaviour of investors since capital gains tax changes increased the attractiveness of negative gearing from 1999.

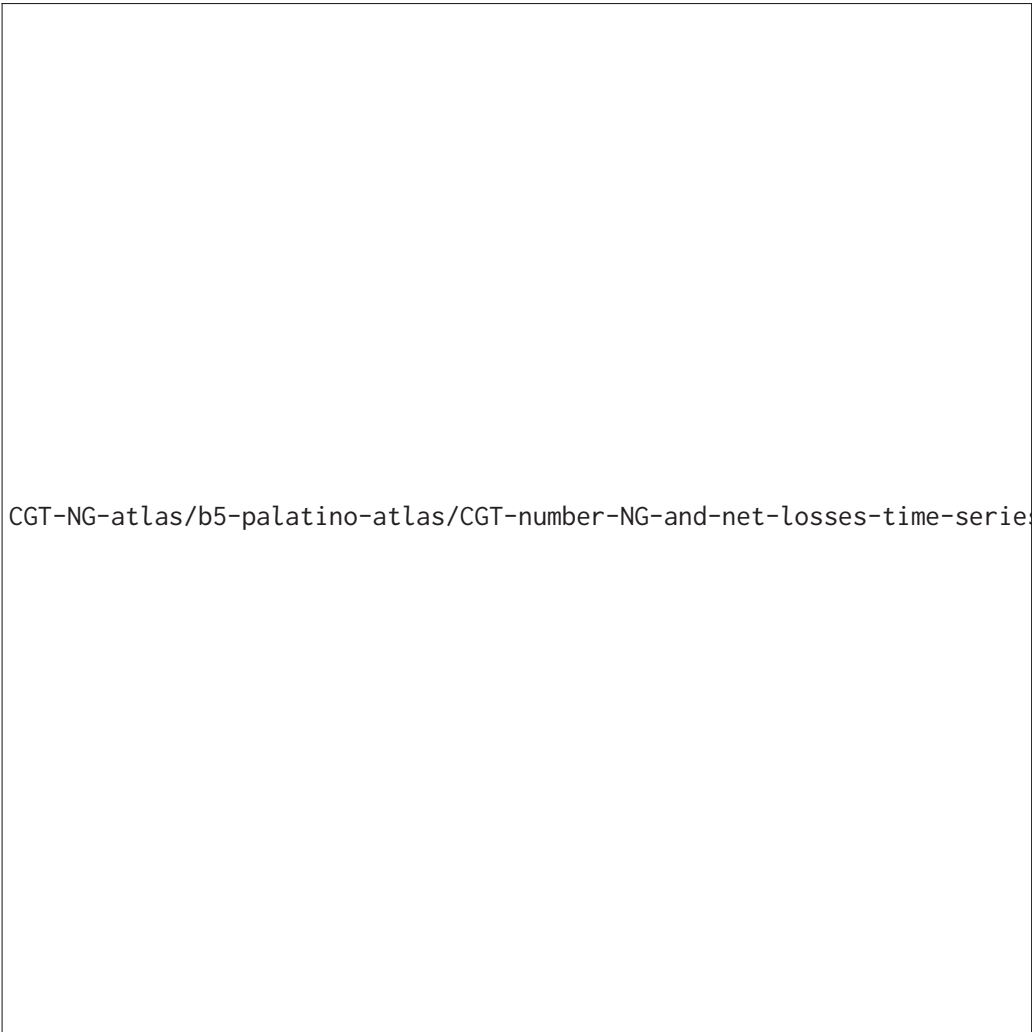
Negatively geared residential property investments have grown rapidly over 20 years, particularly after 1999 when the capital gains discount changed from taxing all real gains to taxing half of nominal gains. Over 15 years the number of taxpayers making losses on residential property has almost doubled, as has the size of the average loss in real terms (Figure 95 on the facing page).

Seelig et al. (ibid.) find that around half of investors would not have invested in property if negative gearing had not been available.⁴⁹² Meanwhile there has been little change in the number of positively geared investors. Almost all the additional investors in property over the last 15 years were negatively geared (Figure 96 on page 332).

Another indication of the increase in negative gearing is that interest deductions as a proportion of rents rose from 46 to 84 per cent of gross rental payments in the 10 years to 2007-08. When interest rates subsequently fell, interest deductions as a proportion of gross rents fell to 55 per cent in 2013-14.⁴⁹³

In their eagerness to pursue tax minimisation strategies, Australian landlords have moved from being collectively profitable, to accruing

Figure 95: The number of negatively geared investors has grown faster than number of property investors, and much more than their losses.
1999-00 = 1.

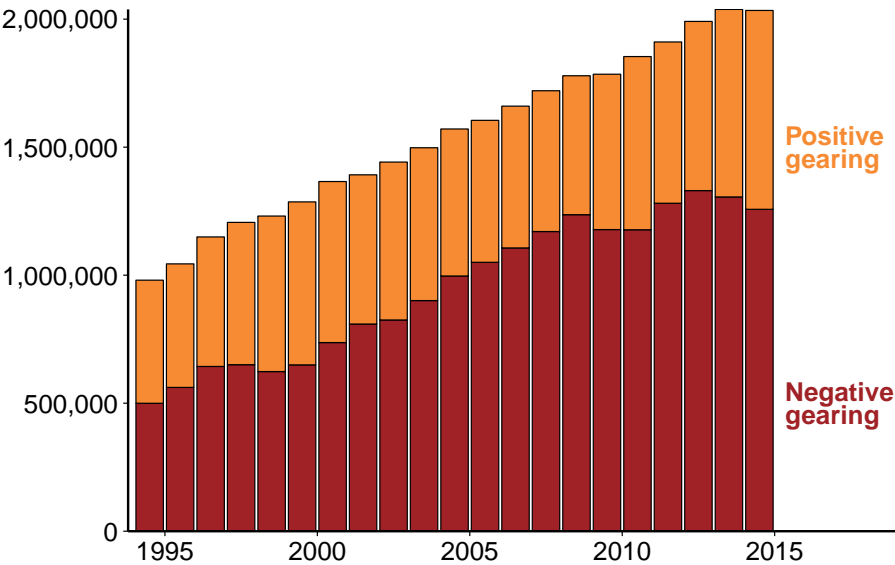


Source: Grattan analysis of ATO (2016b).

billions in net rental losses each year. In 2013-14, 1.3 million landlords reported collective losses of \$11 billion. And total net rents have been consistently negative since the introduction of the CGT discount

Figure 96: Almost all the growth in property investment since 1994 has been because of loss-making landlords

Number of landlords, 1993-94 to 2013-14



Source: Grattan analysis of ATO (2016b).

(Figure 97 on the facing page).⁴⁹⁴ Losses are reducing only because interest rates have fallen.

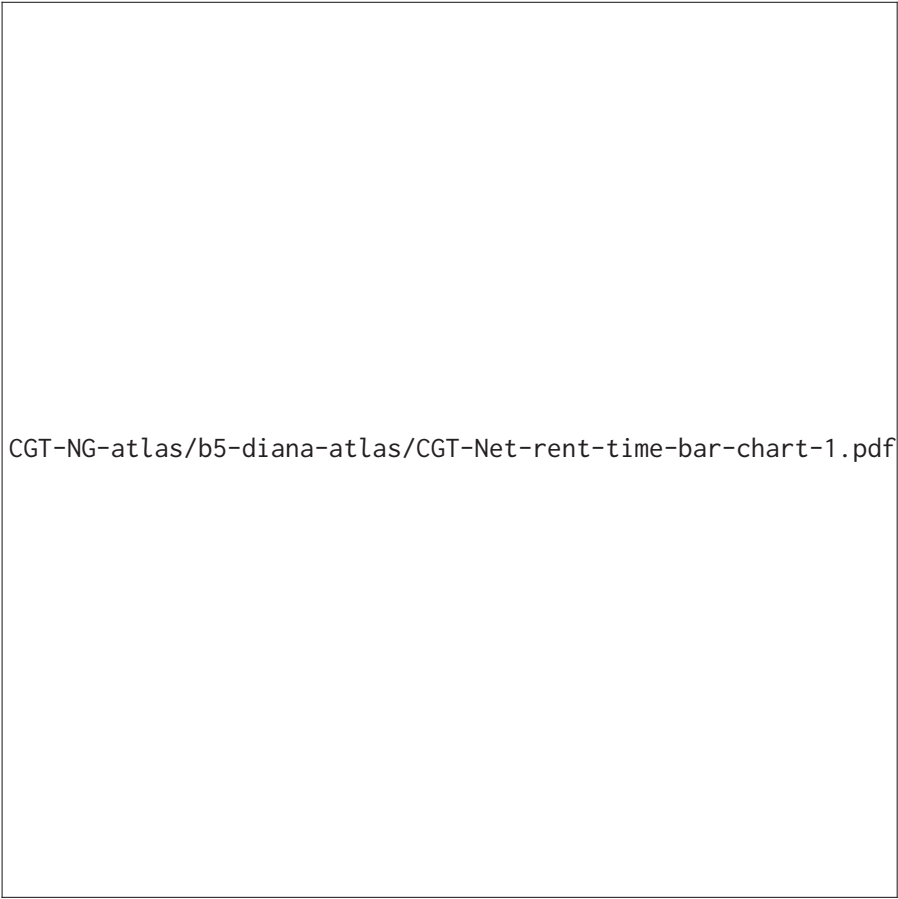
3.2.4 Property churn

The tax advantages encourage those with negatively geared properties to ‘churn’ investments. Over time, properties do not stay negatively geared. Rents tend to rise with increases in the value of wages, whereas the tax-deductible loan value cannot be increased. So an investor who wants to stay negatively geared needs to sell, and then purchase another property with borrowings that are again a large proportion of the investment.

Consequently, negatively geared investors turn over their investments more often. G. Wood and Ong (2010, p. 28) show that 40 per cent of all investors with rental properties retained their property at the

Figure 97: Since the introduction of the capital gain tax discount, rental losses have been large, overwhelming profits

Total real net rent (profit – loss), individual taxpayers, (2014-15 dollars)



Source: ATO (2016a)

end of a five-year period. Yet amongst investors who were negatively geared, only 20 per cent retained ownership. And a greater proportion of negatively geared landlords than other landlords purchased another property after selling.⁴⁹⁵

3.3 The distortions caused by negative gearing have undesirable social consequences

Negative gearing has many undesirable consequences. It reduces rates of home ownership. It reduces the availability of long-term rentals. It increases the volatility of housing markets, increasing the risks to the Australian financial system.

The favourable tax treatment reduces home ownership because it increases the after-tax returns to geared property investors but not homeowners. The increase in geared investing has made it harder for prospective owner-occupiers to afford to buy homes. Investors now account for more than half of new loans for housing, up from 29 per cent two decades ago.⁴⁹⁶ This is one reason (though by no means the only one) why rates of home ownership are falling among younger age groups.

The higher churn of properties encouraged by negative gearing also exacerbates a lack of secure long-term tenancies in Australia. Most of Australia's housing stock is owned by landlords with only one or two properties, because progressive land taxes significantly reduce the returns from larger landholdings. (See page 78 in Part II.) As many of these landlords are negatively geared, and want to turn over their properties in order to stay negatively geared, most Australian landlords are reluctant to agree to long-term tenancies. Their political interests have also led to Australian tenancy law providing much less security for tenants than in other countries.⁴⁹⁷

The Reserve Bank, the Productivity Commission, the Henry Tax Review, and the Murray Financial System Inquiry have all argued that negative gearing exacerbates volatility in housing markets.⁴⁹⁸ Negative gearing is most attractive as a tax minimisation strategy when asset prices are

rising strongly. So in boom times it further increases investor demand for housing. The opposite is true when prices are stable or falling. Consequently, the greater leverage encouraged by negative gearing arrangements also reduces the stability of the Australian financial system.

There is little evidence that negative gearing has the socially desirable outcome of reducing rents, as Section 4.3 below discusses.

3.4 Negative gearing mainly benefits those on higher incomes

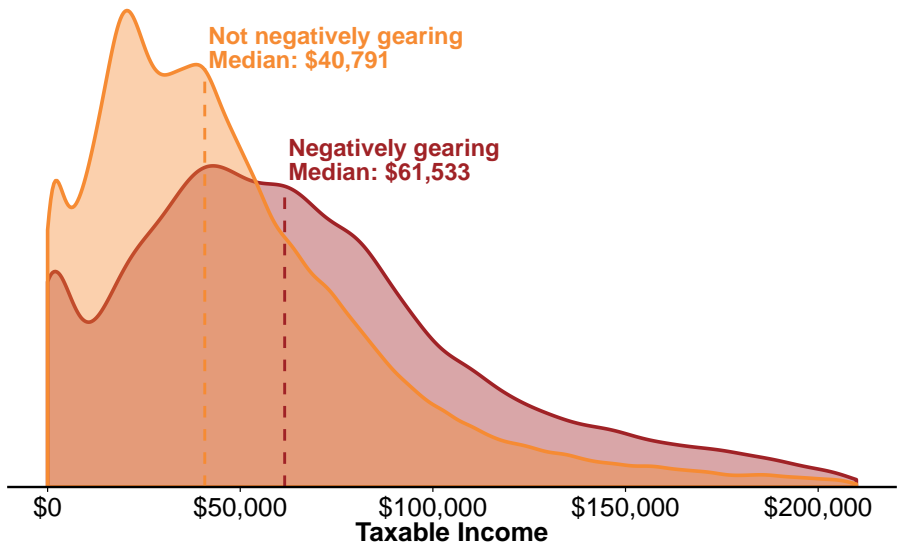
Like most tax concessions on investment, tax benefits from negative gearing are regressive, benefiting those on high incomes much more than those on low incomes. A higher proportion of taxpayers on higher incomes negatively gear and the tax break is usually larger for individuals on higher marginal tax rates.⁴⁹⁹

The fact that negative gearing is regressive is not in itself an argument for change, as mentioned earlier. However, as that section argues, lower taxes on savings can concentrate wealth, and the inherent lack of transparency of tax concessions can undermine the overt choices that exist in income tax scales about the desired level of redistribution. So it is important to understand how the benefits of negative gearing are distributed. This analysis is also relevant to counter claims that negative gearing should be retained because it particularly assists those on middle incomes to build wealth.

A lot of the public debate has centred on claims that most taxpayers negatively gearing have taxable incomes below \$80,000. This is not surprising given that only 20 per cent of taxpayers have taxable incomes this high.

People with higher incomes are more likely to negatively gear, as Figure 98 on the next page shows. The median taxable incomes for taxpayers who negatively gear is \$61,533 compared to \$40,791 for those who don't negatively gear.⁵⁰⁰

Figure 98: More taxpayers on higher incomes negatively gear
Distribution of taxable incomes by negative gearing status, 2013-14



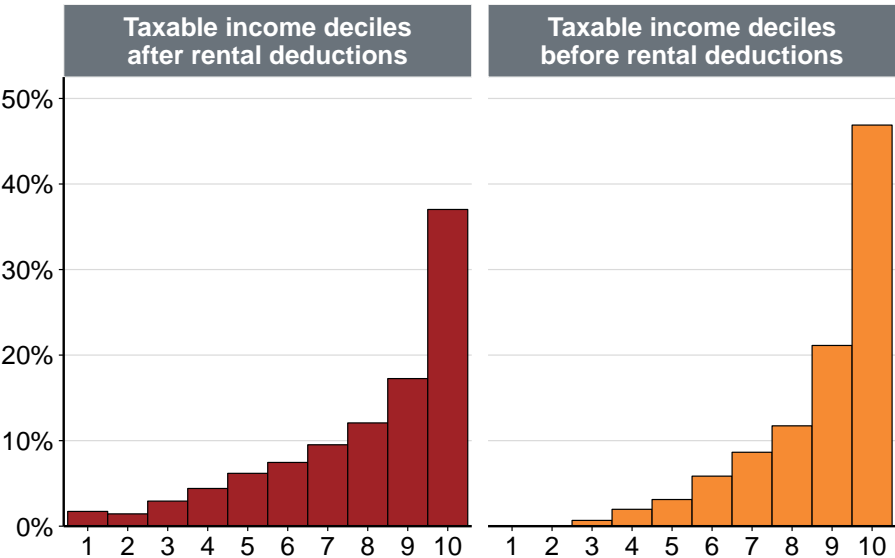
The tax benefits from negative gearing are even more skewed toward high-income earners. They borrow more on average, and with higher marginal tax rates, the deductions are worth more.

Overall, the top ten per cent of income earners before rental deductions receive almost fifty per cent of the tax benefits of negative gearing. The skew does not look quite so bad if taxpayers are grouped by their taxable incomes, as shown in the left hand side of Figure 99 on the facing page. But comparisons based on taxable incomes understate the earnings of those negatively gearing. Taxable incomes are assessed after rental losses. In other words, people who are negatively gearing have lower taxable incomes because they are negatively gearing. The taxable income distribution before rental deductions, shown on the right hand side of Figure 99, shows that those on higher incomes receive the lion's share of the tax benefits from negative gearing.

The skew of negative gearing benefits is also obvious when looking at occupations. Despite claims from the Property Council that lower

Figure 99: Negative gearing mostly benefits those on high incomes, and the difference is especially stark when incomes are measured before subtracting rental interest deductions

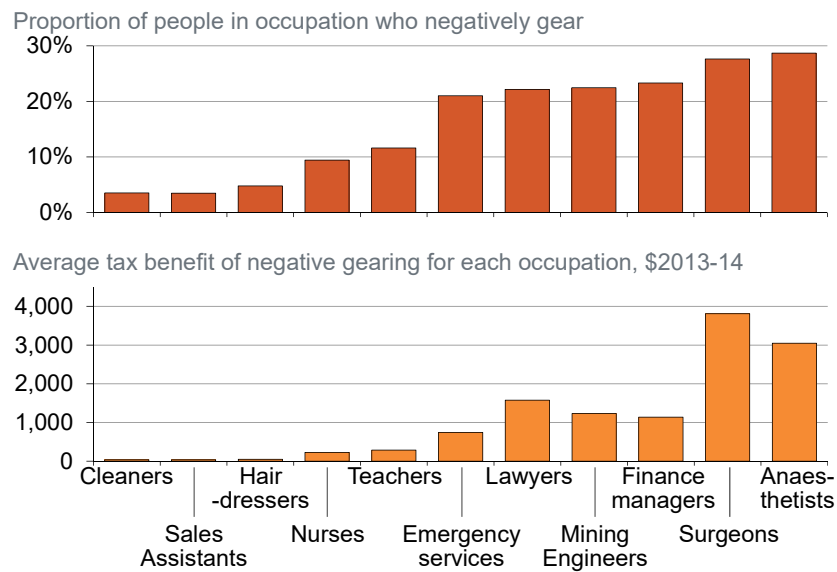
Percentage of each decile's share of the benefit in reduced income tax due to negative gearing (2012-13)



Notes: Taxable income before rental deductions means Taxable Income minus rental loss. Income tax includes medicare levy, LITO, and the temporary budget repair levy but not other tax benefits (e.g. the seniors and pensioners tax offset (SAPTO))
Source: Grattan analysis of ATO (2016b).

paid workers such as nurses, teachers and clerical staff are the 'primary beneficiaries' of negative gearing,⁵⁰¹ analysis of Australian Tax Office (ATO) data shows that a higher proportion of workers in high-wage occupations negatively gear and receive larger average tax benefits when they do so (Figure 100 on the next page).

Figure 100: Those in high-income occupations are more likely to negatively gear, and receive more of the tax benefits



*Notes: Average tax benefits are calculated by deducting average rental losses at the tax rate associated with average taxable income for that occupation.
Source: ATO (2016a).*

4

Impact of changing negative gearing and the CGT discount

Reduction in the CGT discount and changes to negative gearing will affect investor demand, rents and property prices. Yet the impacts will be much smaller than some commentators suggest.

This chapter outlines how the housing market would be affected by the changes we propose to the tax treatment of investments – reducing the capital gains tax discount to 25 per cent and quarantining investment losses so they cannot be written off against wage income. These proposals are explained in more detail in Chapter 5.

Our best estimate is that the changes we recommend might lead to property prices up to 2 per cent lower than otherwise. There will be little impact on rents, or on the rate of new development, even in the long-term.

4.1 Tax changes will somewhat reduce investor demand

Reducing the capital gains tax discount and limiting scope for loss write-offs by changing negative gearing arrangements will somewhat increase effective tax rates for property investors, thereby reducing their demand for property. However, the changes in after-tax returns are unlikely to have radical effects on demand for investment property.

Some investors will switch to other investment opportunities that offer higher post-tax returns. Others might choose to spend more and invest less. But some will also continue to invest in the housing market,

and either borrow less, or simply accept a lower return on investment. Others may put more into their principal residence – choosing a larger or better-located dwelling – rather than investing in a second property.

The extent to which investors will vacate the property market will ultimately depend on how much post-tax returns fall, and how sensitive investor demand for property is to changes in returns (what economists would call the ‘elasticity of demand’).

Our analysis shows that the effective tax increases from our proposed changes to negative gearing and capital gains tax are relatively modest (Section 5.4).

Switching into other asset classes will be limited. Other investments that generate capital gains, such as shares, will also be taxed more under proposed changes to CGT and negative gearing (Chapter 5). Other investments that will be relatively more attractive after the change – for example, bank deposits and superannuation – have very different risks, returns and liquidity. As a result many investors may choose not to switch.

Ultimately people who invest in property take into account a host of factors, including rental returns, risk perception, familiarity with the asset class, and ability to obtain bank finance. Modest changes in tax treatment will not affect their decisions much. (Section 2.4)

Indeed, countries with less generous tax treatment for investment properties – US, Canada, Germany and France, for example – still have plenty of investor activity in housing.⁵⁰²

4.2 House price impacts will be relatively modest

Economic theory suggests that higher property taxes and reduced investor demand will lead to some combination of higher rents and lower property prices. But in urban housing markets with tight constraints on supply almost all the impact will be on residential property prices rather than on rents.

If higher taxes are fully passed through into house prices, they are unlikely to fall by more than about 2 per cent. This reflects the magnitude of the proposed tax changes relative to property prices and the fact that about two thirds of buyers – owner-occupiers – will be not be directly affected by the tax changes (Box 16 on page 346).⁵⁰³

Tax changes that might only drag down house prices by 1 or 2 per cent should be put in perspective. House prices have grown annually by an average of 7.3 per cent since 1999.⁵⁰⁴ Such a tax change corresponds to a few months' growth lost (or a few months to defer a sale).

Consequently tax policy is a minor risk to house price growth. Interest rates, terms of trade, changing expectations about the economy, and zoning and planning policies are much more important. As CBA Chief Executive Ian Narev recently noted:

I can tell you this, having a \$400 billion home loan book: your assumptions on unemployment and what's happening in global interest rates will dwarf whatever assumptions you've got on the modelling about the impact of negative gearing by a factor of—I can't tell you the number. It's a big number.

Such price falls would not lead to widespread negative equity – investors owing their lender more than the value of the property. Even in locations where investment property is concentrated, tax changes would not affect prices by more than 4 per cent (Table 13). And less than 10 per cent of new property loans go to investors with loan to value ratios (LVRs) over 90 per cent.⁵⁰⁵

What's more, tighter macro-prudential controls on bank lending are expected to reduce the proportion of high LVR loans in future.⁵⁰⁶ And few loans stay at such high leverage for long. For the small proportion of investors that remain highly leveraged, higher interest rates pose a far greater risk than changes to the tax treatment of rental losses.⁵⁰⁷

The Australian Government should not shy away from a sound policy because it generates modest house price corrections. This is especially true given that affordable housing is an avowed policy goal. It is difficult for governments to address housing affordability for new buyers while

Figure 101: Rents did not rise when negative gearing was removed in Melbourne, Adelaide or Brisbane

Average rent prices (real compared with overall CPI), 1982 = 1. Grey band indicates the dates when negative gearing was not permitted

Source: ABS (Various years[a])

continuing to offer generous tax breaks to investors that bid up house prices.

4.3 Increases in property taxes will not change rents much

The potential effects of tax changes on rents are perhaps the most contentious. Concerns persist that limiting negative gearing or reducing the capital gains tax discount will reduce the supply of rental properties and push up rents.

To some extent these claims are based on experiences from the 1980s, particularly in Sydney. In 1985, the Hawke Government restricted negative gearing so that rental losses could not be used to reduce tax payable on other income streams.⁵⁰⁸ Rents rose rapidly in Perth and somewhat in Sydney. Two years later, the policy was abolished out of concern for increasing rental prices.

History might have taught a different lesson if fewer of Australia's Prime Ministers and Treasurers came from Sydney. Although the tax changes were nation-wide, inflation-adjusted rents were stable in Melbourne and actually fell in Adelaide and Brisbane (Figure 101). In Sydney and Perth, rent rises were in fact driven not by tax changes but by population growth and insufficient residential construction – due to high borrowing rates and competition from the stock market for funds.⁵⁰⁹

Studies of overseas experience also suggest that changes to the taxation of property investment have limited impact on rents, even over the medium term. These studies find that rent increases in response to tax changes are modest⁵¹⁰ and very slow to take effect, with most impacts not seen for more than a decade.⁵¹¹

Beyond these historical lessons, economic theory and empirical research show that limiting negative gearing or increasing taxes on capital gains does not change rents much. In urban areas where land supply is restricted and rents are determined by location-specific factors such as access to transportation and amenities, tax changes primarily affect property (land) prices rather than rents.⁵¹²

In the short term, tax changes reduce the post-tax investment returns for negatively geared property investors. There will be a one-off decrease in house prices as investors reduce their willingness to pay for property. But because rental yields are calculated as a proportion of property prices, they will rise as house prices fall. This rise will at least partially restore the attractiveness of property investment relative to other investments.

Existing negatively geared investors will have larger post-tax losses to service. They may want to increase rents to maintain their returns. But rents are determined by dynamics of demand and supply, not by the returns that owners are seeking. Rents do not increase just to ensure that buyers of assets get their money back.⁵¹³

Existing negatively geared investors compete to supply rental properties against other property investors with no imperative to increase rents. The tax changes will not affect rental incomes for the one-third of landlords making positive rental profits. And new investors would purchase properties at lower prices that factor in the less generous tax treatment of rental losses. Tenants can beat rent rises by threatening to move to properties owned by these other investors.

Some negatively geared investors may sell their properties to owner-occupiers if tax concessions are less generous. But in the short term this has no impact on rents. Every time an investor sells a property to a renter, there is one less rental property, and one less renter. There is no change to the balance between supply and demand of rental properties. Others may sell to another investor, but one that doesn't rely on negative gearing. Again this doesn't reduce the number of rental properties.

4.4 Impact on new development is also likely to be small

Over the longer term, lower after-tax returns to investors could slow new housing construction and put upward pressure on rents.⁵¹⁴ But the tax changes proposed are unlikely to substantially alter the incentives for new development as some have claimed.⁵¹⁵ One-off price impacts of less than two per cent (Box 16) are unlikely to substantially slow new construction.

The main constraint on new housing is land release and zoning restrictions – especially in established suburbs with good access to jobs and transport.⁵¹⁶ In this environment, any changes to the price of housing are likely to be incorporated into the price of land rather than the amount that people are prepared to pay for developments.

In any case, general tax breaks such as negative gearing are an inefficient way of supporting the rental market.⁵¹⁷ Between 8 and 14 per cent of all investment property lending is for new dwellings.⁵¹⁸ Blanket tax concessions for investors that primarily accrue to existing property owners through higher house prices are a poorly targeted way to increase the supply of new rental developments.

5

Options for reform

The favourable tax treatment of investments – particularly the interaction of the negative gearing arrangements with the capital gains tax discount – have promoted speculative investment in housing while also costing the budget bottom line.

Reducing the capital gains tax discount is the most direct way to reduce the incentive for inefficient investment activity. In addition, **negative gearing** should be **restricted** so that losses from investments cannot be deducted against wage and salary income.

Any changes should apply to all types of passive investments, not just rental properties, so that the tax system does not encourage investors to favour one type of investment over another. Similarly, carve outs for negative gearing changes – exempting new property, capping total deductions or limiting the number of properties that can be negatively geared – produce inferior economic outcomes compared to a blanket restriction against deducting losses on investments from labour income.

Over the longer term, a more fundamental rethink of the taxation of savings income may be warranted. The proposal from the Henry review to align the tax treatment of savings including interest income, net rental income, capital gains and interest expenses would provide a more consistent treatment of household savings and remains a worthy longer-term policy goal.⁵¹⁹ Realistically, however, it is not feasible until budget outcomes markedly improve.

Box 16: Impact of limiting negative gearing and capital gains tax concessions on house prices

We model the impact of our policy proposal detailed in Chapter 5: quarantining rental loss deductions and reducing the CGT discount to 25 per cent. Other reforms would have different effects, although they are likely to be similar order of magnitude.

Two different approaches yield similar results. Firstly we calculate the capitalised value of the revenue foregone from the tax changes as a percentage of total residential property value. Secondly, we calculate the change in return as a proportion of property value, and as a proportion of all property owners.

The proposed changes to negative gearing would reduce tax write-offs for property investment by about \$2 billion in the short run and \$1.6 billion a year over time. Assuming a discount rate of 5 per cent, the present value of these lost tax benefits would be approximately \$33 billion.

The proposed reduction of the capital gains tax discount to 25 per cent would reduce after tax returns by about \$3.7 billion a year, or \$73 billion in perpetuity. Assuming 40 per cent of this relates to gains on real estate (in line with 2013-14 gains realisations) then the expected present value of the lost benefits for would be approximately \$29 billion.

If these lost benefits of \$33 billion and \$29 billion were both fully capitalised into the total value of residential property – currently worth \$5,400 billion – prices would be only **1 per cent** lower than otherwise.

Table 13: Impact of policy changes on after-tax returns

Owner type	Share of property	Return		
		BAU	Proposed	Fall
Negatively geared	18.0%	7.0%	6.5%	6.1%
Positively geared	7.0%	6.4%	6.0%	6.8%
Ungeared	5.0%	5.8%	5.3%	7.8%
Owner-occupied	70.0%	—	—	—

Notes: Negatively geared property had 80% of the property value borrowed; positively geared is 40%.

Alternatively, we can calculate the impact of tax changes on returns as a proportion of asset values for different classes of owners as shown in Table 13.

Weighting these changes in returns by the share of residential property, the average return (and therefore the price) would fall by about **2.2 per cent**. Yet this somewhat overstates the overall price effect because it is based on the change in returns for a representative investor in the top (47 per cent) tax bracket.

Of course, price changes would not be uniform. Prices would fall by more in the segments of the market with more investors (inner city apartments, for example). The drop in returns for investors is the *maximum* rational price change (about 7 per cent). However, this would only occur in locations where every prospective purchaser was an investor, and the fall in prices did not attract any owner-occupiers. Tax changes would be unlikely to drag on property prices in any location by more than 3 to 4 per cent.

5.1 Reducing the capital gains tax discount

The 50 per cent **capital gains tax (CGT) discount** is estimated to provide a tax discount to individuals and trusts worth \$6.2 billion in 2015-16.⁵²⁰

Reducing the capital gains tax discount would make the investment tax regime more efficient and fair (Chapter 2).

Reducing the capital gains tax discount to **25 per cent** for individuals and trusts would make some adjustment for inflation, while moderating the economic and budgetary costs of the discount. The Henry Tax Review nominated a 40 per cent discount for capital gains as a 'more realistic' adjustment for the effects of inflation, given prevailing levels of inflation and asset returns.⁵²¹ The Business Council⁵²² and the Property Council⁵²³ have also supported reducing the CGT discount to this level.

But the Henry Review did not take into account the additional and sizeable tax advantages for capital gains – being taxed only on realisation and at the timing of the investor's choosing. Nor did it take into account the relative efficiency of taxes on savings compared to other options for raising revenue (Section 2.4)

A somewhat lower discount would be fairer and distort investment choices less. Entirely eliminating tax-based distortions in savings choice would require more fundamental changes to align tax treatment across different types of savings (Section 5.5).

Previous Grattan work has suggested that there should be no discount on capital gains.⁵²⁴ The more detailed analysis in this report suggests that a 25 per cent discount would strike a better balance among competing interests. The outcomes should be carefully monitored, and if there is minimal actual change in savings rates as a result, there may be arguments for reducing the discount further.

Reducing the discount to **25 per cent**, could raise about **\$3.7 billion a year** once fully phased in.⁵²⁵ This estimate is slightly higher than that

prepared by the Parliamentary Budget Office (PBO) in response to a request by the Australian Greens to cost a similar policy.⁵²⁶

Our proposed changes may also collect more than estimated. We assume that the most recent 2013-14 taxation statistics are representative of future years. But because capital losses built up from the GFC were still passing through the system in 2014, reducing taxes on net capital gains,⁵²⁷ these statistics probably underestimate the potential future tax revenue from capital gains.

Two factors may result in lower collections. Firstly, the estimate assumes that current asset price growth will continue and investors will not be discouraged from investment following the changes. In reality, higher taxes on capital gains will reduce demand and prices for capital growth assets and therefore revenues collected.⁵²⁸ Secondly, the estimate does not take into account 'asset lock-in' – investors holding their assets for longer to avoid realising the tax. However, this effect is likely to be small: there are already incentives for asset lock-in under the current regime, and in current practice the dominant effect appears to be deferring sale not for a few years, but until retirement (Appendix A).

An alternative proposal, likely to result in somewhat lower average capital gains tax collections than ours, would be to return to taxing inflation adjusted gains. In other words, real gains would be taxed at full marginal rates. The PBO costed such a proposal for the Australian Greens and found it would raise about \$0.5 billion in 2016-17 rising to \$1 billion in 2018-19. However, taxing inflation-adjusted gains proved complex in the past, and was one of the main reasons for moving to the current system of taxing nominal gains with a discount (Box 11 on page 305). And it taxes capital gains too lightly given the considerations outlined in chapter 2.

5.2 Limiting negative gearing

There is also a strong case for quarantining wage and salary income so that losses on investments cannot be deducted from wage and salary income.

5.2.1 In principle, losses on investments should not be deducted from wage and salary income

Quarantining losses so they cannot be written off against wage and salary income would reduce the tax-driven bias towards debt financed and speculative investments.

Obviously that bias will be smaller if the capital gains tax discount is reduced to 25 per cent. Yet even if there were no discount, there would still be good reasons to quarantine losses. Investment decisions would still be distorted even with no capital gains tax discount because losses can be deducted immediately from wage and salary income, but gains are not taxed until realisation.

Quarantining losses reduces the real value of loss write-offs and more closely aligns timing of tax for gains and losses. There is no principled reason to allow any investment losses to be deducted from wage and salary income (Section 3.2).

One concern with quarantining is that it will favour investors with more diversified portfolios. This is because investors with other positive investment income can make use of the loss write offs immediately, whereas those with only one loss making investment will have to wait until the income from that investment is positive. There may arguably be an equity concern if wealthier investors tend to be the ones with more diversified portfolios.

But this will do little to offset the improvement in equality from our proposed change. The impact will be small because most negatively geared investments start to generate positive income – and therefore losses can start to be written off – within five years.⁵²⁹ And those receiving sizeable tax benefits from immediate loss write offs against wage and salary are disproportionately those on high incomes (Section 3.4). And in any case, even if those on somewhat lower incomes are disadvantaged slightly more, policy change should still be pursued. Not every principled policy change will be progressive in every respect.

5.2.2 How should losses be quarantined?

There are different ways to quarantine losses on investments. Taxpayers might be allowed to deduct losses on investments from:

- **any non-wage and salary income**,⁵³⁰ including all forms of investment income, such as interest and rental income;
- investment income from the same **asset class** – for example, losses on a property investment could be written off against gains on another property, but not against dividends from shares (this regime applies in the United Kingdom); or
- income (including future capital gains) from the **same asset**.

There are some economic arguments for the last option. It aligns the timing of tax for gains and losses, minimising the tax driven preference to favour capital gains over recurrent investment income. Yet it may lead to more unproductive tax structuring. It would encourage people to hold their investments through companies or trusts that are allowed to deduct losses on one activity from gains on another.⁵³¹

A more generous tax regime that allows investment losses to be written off against all non-labour income would still be an improvement on the status quo and would be less likely to promote switching to alternative investment vehicles.⁵³²

5.2.3 What losses should be quarantined?

Quarantining of loss write-offs should also apply to negatively geared **share market** investments, although this category is unlikely to be large in practice (Section 3.1). The arguments for limiting negative gearing for these investments – reducing the tax shelter on wages and the tax bias towards speculative investments – are the same as for negatively geared property. And maintaining a consistent tax treatment across housing and share investments also ensures the tax system does not artificially encourage investors to favour one type of investment over another.⁵³³

It is harder to determine whether there should be additional limits on deducting losses on **business activities** from wages and salary income. On balance, these arrangements should be left in place. The losses claimed are relatively small, the activities can be readily distinguished from investment losses, and the policy justification is at least plausible. Nevertheless, some features of these losses suggest that the specific rules could be tightened further as many of the losses being claimed may be funding lifestyle expenses rather than attempts to set up sustainable businesses.

At present there are more restrictions on deducting business losses than there are on deducting losses from investments. Sole traders and participants in a partnership can write off losses from these business activities against unrelated income (including wages) only if they meet a variety of conditions that generally exclude activities that make persistent losses.⁵³⁴ Losses for incorporated businesses cannot be written off against other income.

The losses claimed are relatively small. In 2013-14 only 240,000 taxpayers claimed \$4 billion in business losses (compared to 1.2 million people claiming \$10 billion in losses on property).

Business losses are readily distinguished from investment losses. Tax systems in other countries draw precisely this distinction.⁵³⁵ Other parts of Australia's tax system already apply different tax treatments to active and passive investments – for example, rules governing the availability of capital gains tax concessions for small business.⁵³⁶ These rules are relatively easy to enforce,⁵³⁷ so providing a different tax treatment for active assets should not raise large-scale concerns about avoidance.

Allowing business losses to be deducted from general income recognises that small business owners, particularly in the early stages of a new business, may use their income from employment to fund their business losses. Working part-time may help some new business owners better manage the risks of starting a new business. The argument for retaining loss write-offs is to maintain the incentive for this type of 'toe in the water' entrepreneurship.

However, many of the losses being claimed may not serve this policy purpose. About 40 per cent of business losses claimed are from primary production – animal or crop farming, vineyards or animal breeding, for example. About 53,000 taxpayers claimed \$1.6 billion in primary production losses – about \$30,000 per claimant. In all occupational categories, average salaries for those claiming primary production losses were substantially higher – between 20 and 65 per cent – than the average salaries for their occupation (Figure 102 on page 359). This suggests primary production activity may often be more a lifestyle activity such as a hobby farm, than a sustainable business.

About 190,000 taxpayers claimed an average of \$13,000 of non farm business losses. It is likely that many of these people were individual contractors in fields related to their main job. Some of the losses may simply be taxpayers claiming lifestyle costs where they will be less scrutinised. That is because tax returns require less detail for costs claimed as part of running a business rather than in incurring wage and salary income (for example, travel costs do not need to be separately disclosed).

Nevertheless, given the low costs and potentially meaningful benefits the best approach is probably to leave the current tax treatment for losses from unincorporated businesses in place. In other words, only losses from passive investments would be quarantined so they cannot be written off against wage and salary income. This approach is in place in the United States (Appendix D on page 378).

5.2.4 Budget impact

Restricting negative gearing by quarantining loss deductions for passive investments would raise more tax revenue. How much depends on future housing prices and how long investors hold their assets.

For most investors, the changes will mainly affect the timing, not the amount, of tax deductions. The costs of property and share investments can still be deducted against future investment income, including any capital gains made after the asset is sold.

We estimate that quarantining losses for passive investments would increase income tax collections by **\$2 billion** a year in the short term. Over the medium term, accrued losses – losses not offset against recurrent investment income – will be deducted from capital gains. Assuming no change in investor behaviour, the additional tax revenue would stabilise at about **\$1.6 billion** a year.⁵³⁸

If deductions were limited even more to the particular asset or asset class, income tax collections would rise a little more because investors would wait longer on average until they could realise their losses.

These estimates do not take into account the effects of investors changing their behaviour in response to the policy change. Investments that make income losses are less attractive when the tax benefits are smaller. Negative gearing appeals largely because it can reduce taxes on wage income (Section 3.1). Removing the tax incentive for highly leveraged investment should lead investors to shift toward income-producing assets and could therefore further increase income tax collections. On the other hand, if some investment properties are replaced by owner-occupied properties, less revenue will be collected, because no tax is paid on capital gains on the family home, or on the ‘imputed rent’ – the value of living in occupier-owned housing.

5.3 Alternative policies for limiting negative gearing

Our proposed policy of quarantining investment losses from wage and salary income would apply to losses from all passive investments regardless of the nature or the size of the investment.

Others have proposed less universal changes. For example, Labor’s negative gearing policy would continue to allow unrestricted loss write-offs for new housing.⁵³⁹ It was reported in 2016 that the Coalition contemplated policies to cap loss deductions or limit the number of properties that could be negatively geared.⁵⁴⁰

These ‘halfway house’ policies are not ideal. The economic arguments for limiting negative gearing apply regardless of investment size or type.

By limiting the changes some of the potential budgetary benefits are lost. And introducing differential tax treatments based on the size or type of investment further increases complexity and distorts investment decisions.

Even so, limiting negative gearing to new properties or capping loss deductions at modest levels would only impose modest costs on the budget and the economy. These carve outs may be worthwhile if they make changes to negative gearing more politically palatable.

On the other hand, capping the number of properties that can be negatively geared or setting a high threshold for loss deductions, eliminate almost all the revenue gains from policy change while introducing additional distortions.

5.3.1 Limiting negative gearing only to new properties

It would be possible to quarantine wage and salary income generally, but to allow losses on new properties to be deducted from wages and salaries.

Proponents argue that this exemption will maintain the incentives for the provision of new housing.⁵⁴¹ But in practice it won't make much difference: most of the tax benefits will be reflected in a one-off change in the price of land suitable for development. The supply of such land is not particularly responsive to price changes as Section 4.4 shows. Therefore the value of special tax treatment for new development will mainly flow to landholders.

In any case, the benefits of negative gearing on new properties only are likely to be small relative to the price of property and the cost of development – about 2 per cent of the property value. Even if all of this benefit flowed to developers and purchasers, not to the owners of land suitable for development, there wouldn't be much additional development activity. And of course the impact on overall housing supply would be smaller again because few additional properties are built in any year relative to the stock of existing properties.⁵⁴²

Table 14: Budgetary impact of caps to negative gearing

Threshold	Revenue impact (2015-16 billions)	Landlords affected (%)
\$5,000	\$1.3	20.0%
\$10,000	\$0.8	10.4%
\$15,000	\$0.5	5.8%
\$20,000	\$0.3	3.4%
\$50,000	\$0.04	0.4%

Notes: See page 399.

Source: Grattan analysis of ATO (2016b).

Restricting tax benefits to a subset of investments, such as new housing, creates additional complexity and distorts investment choices. But the costs may not be high. Administrative issues such as how to define ‘new properties’ have already been addressed through government support schemes that target new property investments. These include first homebuyer’s grants and stamp duty concessions.

There are clear political benefits to such an exemption. It appeals to intuitions that tax benefits will produce more new housing, even if theory and history suggest that the effects will be small. As the additional costs are low, it may be a political price worth paying.

5.3.2 Capping loss deductions

Capping the total amount of losses that can be deducted each year for negatively geared properties has been proposed as a way to curb the ‘excesses’ of negative gearing policy.⁵⁴³

Capping losses is politically attractive because fewer landlords will be affected by the policy. And the landlords affected are more likely to be high-income earners because those on high incomes claim much higher losses on average (Figure 100 on page 338).

The budget impact will depend on the level of the cap, as set out in Table 14. A cap on losses of \$20,000 or more would affect very few landlords, but make very little difference to the budget bottom line.

An alternative is to limit deductions. This could apply to all deductions including work-related expenses, interest costs, donations etc.⁵⁴⁴ This is beyond the scope of this report.

5.3.3 Limits on number of properties

An alternative proposal would limit the number of properties on which investors are able to claim losses.⁵⁴⁵ This option is unattractive. It is poorly targeted, would raise little, and would increase distortions in the housing market.

Only 28 per cent of landlords have two or more properties.⁵⁴⁶ A fraction of these would not be taxed as they would be the 'first property' for a landlord. The relatively small number of taxpayers affected substantially reduces the potential budget gains.

In any case, capping property numbers is a crude way to target 'excessive' negative gearing. Taxpayers can increase their deductions by purchasing fewer but more expensive properties. Consequently the policy will distort investment decisions by discouraging investors from buying more affordable properties.

5.4 Summarising impact of proposed negative gearing and CGT changes

Our preferred policy is to reduce the CGT discount to 25 per cent and to limit negative gearing by quarantining all passive investment losses.

As well as raising more than \$6 billion a year, the changes will reduce (though not eliminate) distortions in investment choices toward debt-financing of investment. Effective tax rates will increase a bit more for highly leveraged investors because they lose some of the tax benefits of upfront loss write-offs (Figure 103 on page 361). However, effective tax rates will remain lower for this group because they still eventually write off their losses at a tax rate higher than they pay on gains.

The changes will improve affordability and price stability in property markets, while not unduly affecting the supply of rental properties or incentives to save.

5.5 A longer term reform objective

In an ideal world, as envisaged by the Henry Review, tax rates would be consistent across different types of savings unless there was a good policy reason for the difference (such as lower taxes on superannuation contributions and owner-occupied housing – see Section 2.6.2).

The Henry Review proposed aligning the tax treatment of savings better both by increasing taxes on capital gains, and by reducing taxes on recurrent income and bank deposits. These changes would further reduce distortions in investment choices. They would reduce the difference in returns between geared and ungeared investments, and remove the tax penalty for savings in bank deposits. However, providing these additional tax discounts would strain the budget and is implausible given current fiscal constraints,⁵⁴⁷ even if it remains a longer term reform objective.

Figure 102: Those earning more claim bigger primary production losses ...

CGT-NG-atlas/b5-palatino-atlas/PP-losers-salary-comparison-horiz-bar-1.pdf

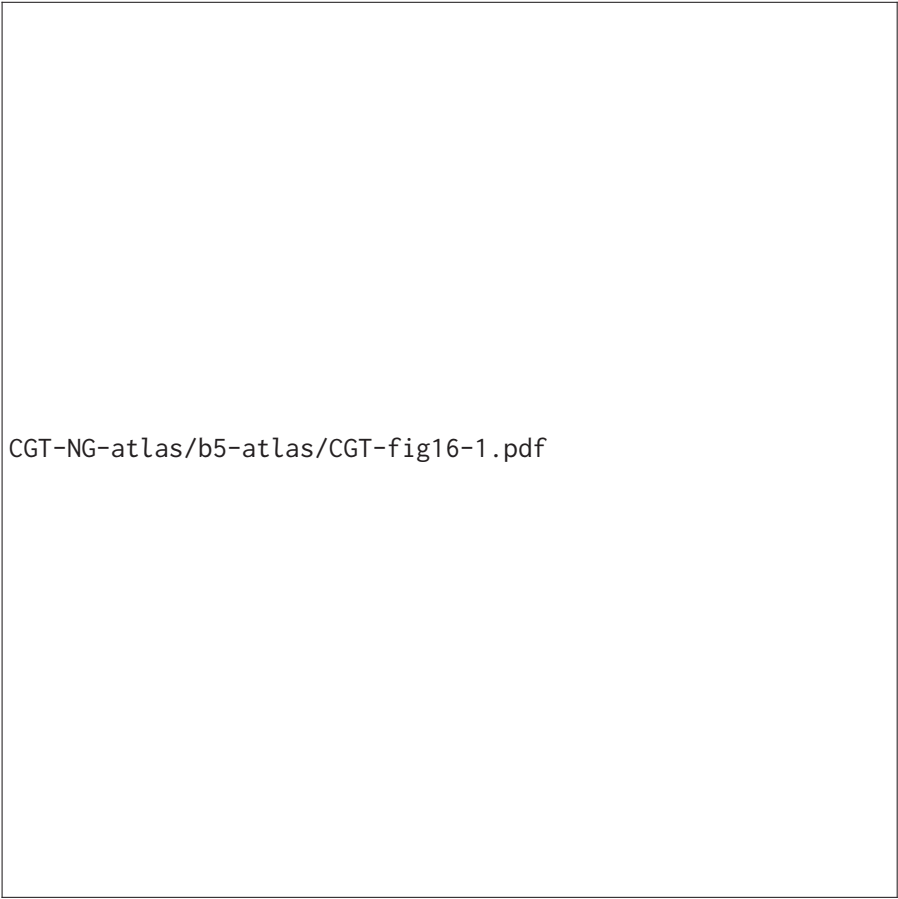
Source: ATO (2016b).

... and claim more often

CGT-NG-atlas/b5-palatino-atlas/Proportions-PP-losses-1.pdf

Figure 103: Proposals increase effective tax rates, particularly for heavily geared properties

Real effective marginal tax rates



*Notes: See page 398.
Source: Grattan analysis.*

6

Transition arrangements

Transition arrangements for changes in the tax treatment of investments could help minimise price shocks in asset markets and make reforms easier to sell.

Changes to both capital gains and negative gearing could be phased-in over time. Grandfathering arrangements for existing investors is an alternative. Grandfathering would raise a host of problems for capital gains tax but has fewer drawbacks for negative gearing.

Phasing-in tax changes and grandfathering would both significantly reduce the revenue from the policy change in the initial years.

6.1 Phase-in reforms

Changes to the current capital gains discount or negative gearing regimes could be phased-in over a number of years, to prevent a rush of investors selling property before the new legislation came into force. For example, under a five-year phase-in, the capital gains discount could be reduced to 45 per cent in the first year, and then reduced by five percentage points each year until 75 per cent of capital gains are taxed.

Changes to negative gearing could also be phased in. For example, taxpayers might be allowed to claim only 80 per cent of their losses against wage and salary income in the first year (the remainder capitalised against any future capital gain), and the twenty percentage points less each year until no losses are claimed against wage and salary income.

In both cases, the phase-in would provide investors with time to reorganise their affairs to adjust to the new regime.

6.2 Grandfathering existing arrangements

Another option would be to grandfather existing arrangements. Those who purchased assets before capital gains tax reform was implemented could still claim the capital gains tax discount, even if they sell the assets several years afterwards. Similarly, those who purchased assets before negative gearing reform, could continue to claim all of their losses against their wage and salary income until the asset was sold.

The most powerful argument for grandfathering is pragmatic: to defuse vociferous opposition from those who benefit from the current arrangements.

But for capital gains tax changes, grandfathering causes a number of problems: it adds to complexity, reduces liquidity, and treats new investors – particularly younger investors – unfairly.

Applying different tax treatments to investments depending on when they were acquired makes the tax system much more complex. Because investors can hold assets for decades, these dual tax arrangements are long-lived. For example, the decision to grandfather the capital gains tax-free status for assets purchased before 1986 still contributes to the complexity of our capital gains tax regime, three decades later.⁵⁴⁸

Grandfathering arrangements reduce liquidity because investors have substantial incentives to retain whichever assets they purchased before the reform was implemented. They will be reluctant to buy and sell because the after-tax returns on the assets bought earlier will be higher. Such a drag on liquidity is economically inefficient because it encourages investors to hold assets even when others could extract a higher return from them.

Grandfathering also exacerbates intergenerational inequality.⁵⁴⁹ Those who own assets before the reforms – more likely those who are older⁵⁵⁰

– earn higher after-tax returns than those who start to build wealth later on.

For negative gearing, grandfathering raises fewer concerns. The fact that properties usually become positively geared over time, normally within five years (Section 5.2.1), provides a natural sunset to any grandfathering arrangements. Any issues around the complexity or unfairness of dual arrangements will inevitably be short-lived.

Nevertheless, given the competing considerations, phase-in would be a better transition than grandfathering. It would be less complex, have less immediate impact on prices, and younger investors would be treated more fairly. Investors should not have too many concerns as the phase-in proposed would give them ample time to reorder their affairs.

A

Capital gains tax and asset lock-in

One reason often provided for lower taxes on capital gains is to reduce “asset lock-in”. If investors are less likely to realise gains when tax rates are higher than increasing taxes on gains could actually reduce tax collections in the short to medium term. But the empirical evidence of lock-in is not settled. In Australia, the primary driver of asset lock-in appears to be people waiting until retirement to sell their assets. This incentive is still strong even with a 50 per cent discount.

A.1 Why does asset lock-in occur?

Asset lock-in occurs because taxes are only paid when gains are realised. This provides an incentive for investors to hold on to assets with large accumulated gains.⁵⁵¹ In effect, the investor seeks to maintain the implicit interest free loan on accrued gains. Crystallising a capital gain is only worthwhile if an investor can achieve a materially higher return elsewhere, or if they want the resources for consumption (Box 17 on the facing page).⁵⁵²

Lock-in can discourage investors from moving their money to the investments with the highest pre-tax returns, so assets do not always go to their highest value use.⁵⁵³ Lock-in effects are most significant from a whole of economy perspective, if they constrain financing of profitable investments.⁵⁵⁴

Australia’s open capital markets and generous capital gains tax regime for non-residents, reduce the danger that worthwhile projects will not get access to capital because of lock-in.⁵⁵⁵

Box 17: Capital gains tax and asset lock-in

The tax treatment of capital gains can deter investors from taking up otherwise profitable investment opportunities.

Suppose Hayley, an investor in the top tax bracket purchases a house for \$700,000 and holds it for 10 years. During that time the market price of the house increases to \$1,000,000. She makes a net rental return of 5 per cent a year, so her final income is \$50,000.

If she were to sell the house she would crystallise the \$300,000 in gains, paying tax on 50 per cent of the gains at her marginal tax rate of 49 per cent (\$73,500). This would leave her with around \$926,500 from the sale: \$226,500 in net gains and her initial investment of \$700,000.

The sale will only be worthwhile if Hayley can find an alternative property that yields more than her current rental income of \$50,000 with the same opportunity for capital gains. With her \$926,500 sale proceeds she would need to find a property with net rental return of more than 5.4 per cent a year.

Properties with rental yields below 5.4 per cent but higher than her current 5 would not be attractive because realising the tax liability on her current property erodes her capital base for investment.

The higher the tax rate on capital gains the less willing she will be to realise gains to pursue new investment opportunities. If capital gains were taxed in full, rather than with a 50 per cent discount, her hurdle rate for the new investment would be 5.9 per cent.

A.2 Impact of lock-in on tax collections

The long-term effect of asset lock-in on capital gains tax receipts has not been settled. The first paper to delineate the effects of tax changes on capital gains realisations over time, estimated that the long run responses to tax changes are significantly smaller than the immediate responses.⁵⁵⁶

More recent research by Dowd et al. (2012) found much higher persistent lock-in effects overall, but also that the size of the effect depends on the entity: mutual funds are almost entirely unresponsive to higher taxes, whereas pass-through entities (such as partnerships, trusts and limited liability companies) were much more likely to hold on to assets.

A key cause of lock-in is investors waiting until they are retired – and their taxable incomes are low – to realise gains. This reduces the average tax rate they pay on gains. The probability of a landlord selling a property increases by over 20 percentage points once they retire.⁵⁵⁷ And we can see the ‘retirement realisation effect’ in the patterns of capital gains realisation by age. Those over 65 have much higher average realisation of gains, regardless of their income level (Figure 90 on page 308).

The other important cause of lock-in is the fact that capital gains are disregarded on death. Passing assets to a beneficiary is not regarded as an ‘event’ that triggers a capital gains tax liability. So by passing on assets to heirs, capital gains taxes can be deferred indefinitely.

Ultimately, the best way to reduce asset lock-in is to tax gains on an accruals basis, with interest charges on the deferred tax.⁵⁵⁸ Requiring tax be paid on notional gains on an annual basis would raise substantial cash flow issues for many investors.

Applying interest charges to the deferred tax would reduce the incentive to hold on to gains to reduce the tax burden. To date, annual asset revaluations have been considered impractical and beset with administrative difficulties. But such valuations can be done easily for shares and to a lesser extent property (which is already revalued in most states

every one or two years for the purposes of levying council rates).^{*} The Henry review flagged that such an accruals approach to capital gains may become more feasible as technology improves.⁵⁵⁹

^{*}See Section 5.2 on page 80.

B

Effective tax rates by investment return and tax bracket

Effective tax rates measure the tax paid on investment returns as a share of the pre-tax returns. Effective tax rates vary by the investor's tax rate and the level of returns. When looking at effective tax rate on real returns (returns adjusted for inflation) or on 'excess returns' (returns above the risk free rate) the level of inflation and the returns will also affect the effective tax rate paid by the investor.

Figure 91 on page 314 presents effective rates for two different return scenarios for an investor in the 47 c tax bracket. Table 15 on the facing page presents calculations for a broader range of return scenarios and investor tax brackets.

Table 15: Effective marginal tax rates for a rental property

MTR	Return type	CGT treatment	Nominal annual capital gain				
			4%	5%	6%	8%	10%
34.5%	real	50% discount	33.9	29.4	26.2	21.7	18.7
		Indexed	34.3	32.6	31.1	28.5	26.2
		25% discount	39.6	35.0	31.7	26.9	23.6
		0% discount	45.5	40.9	37.4	32.4	28.8
	excess	50% discount	61.0	46.2	37.8	28.4	23.1
		Indexed	61.7	51.2	44.9	37.2	32.4
		25% discount	71.3	55.1	45.8	35.2	29.1
		0% discount	82.0	64.3	54.1	42.4	35.5
39.0%	real	50% discount	38.5	33.4	29.8	24.7	21.3
		Indexed	38.8	37.0	35.4	32.5	30.0
		25% discount	45.1	39.9	36.1	30.7	27.0
		0% discount	51.9	46.7	42.8	37.1	33.1
	excess	50% discount	69.2	52.5	43.0	32.3	26.3
		Indexed	69.8	58.1	51.1	42.5	37.1
		25% discount	81.1	62.7	52.2	40.2	33.3
		0% discount	93.5	73.4	61.9	48.6	40.9
47.0%	real	50% discount	46.7	40.6	36.2	30.1	26.0
		Indexed	46.8	44.8	43.1	39.9	37.1
		25% discount	54.9	48.8	44.2	37.7	33.2
		0% discount	63.6	57.4	52.8	46.0	41.1
	excess	50% discount	84.0	63.8	52.3	39.4	32.1
		Indexed	84.2	70.5	62.2	52.2	45.8
		25% discount	98.9	76.6	63.8	49.3	41.0
		0% discount	114.5	90.2	76.2	60.2	50.8

Notes: Inflation 2.5%. Property earns 3% nominal rent in addition to the capital growth and which is reinvested in the property till maturity. Risk free rate 4.5%. Property is held for 15 years then disposed and capital gain realized without losses.

C

International comparisons of capital gains tax

Internationally, there are a range of approaches to taxing capital gains. Most countries offer some form of tax discount for capital income but the amount of the discount and the holding period to qualify vary widely. Contrary to the claims of some, taxes on capital gains are more concessional than in many other OECD countries

Table 16: Tax treatment of capital gains in property, by country

Country	CGT treatment	Holding test	Top MTR	Adj for inflation?
Australia	50% exempt, rest at MTR	1 yr	47	N
Austria	Progressive rise to 50% from 10-35 years, rest at MTR	10-35 yr	50	N
Belgium	Exempt	5-8 yr	45.3	N
Canada	50% exempt, rest at MTR	–	49.5	N
Chile	Exempt	1 yr	40	Y
Czech Rep	Exempt	5 yr	20.1	N
Denmark	MTR	–	55.8	N
Estonia	MTR	–	19.7	N
Finland	MTR on (CG – 20%) of sale price < 10 yrs MTR on (CG – 40%) of sale price < 10 yrs	10 yr	49.1	N
France	Progressive rise to full exemption from 5-30 yrs	5-30 yr	54	N
Germany	Exempt	10 yr	47.5	N
Greece	Exempt unless bought for resale	–	46	N
Hungary	Exempt	15 yr	16	N
Iceland	MTR	–	44.4	N
Ireland	CGT rate 30%, fixed amount deductible	–	47	N
Israel	CGT rate 25%	–	50	Y
Italy	Exempt	5 yr	48.8	N
Japan	CGT rate 20%	5 yr	56.6	N
Korea	30% exempt, rest at MTR	10 yr	39.4	N
Luxembourg	CGT rate 10%	2 yr	43.6	N
Mexico	MTR	–	35	Y
Netherlands	No realisation tax, annual tax @ deemed 30%	–	49.2	N
New Zealand	Exempt unless bought for resale	–	33	N
Norway	MTR	–	39	N
Poland	Exempt	5 yr	20.9	N
Portugal	50% exempt, rest at MTR	2 yr	50.3	Y
Slovak Rep	Exempt	5 yr	21.7	N
Slovenia	Progressive exemption	20 yr	39	N
Spain	MTR	–	46	Y
Sweden	CGT rate 30%	–	56.9	N
Switzerland	Exempt unless bought for resale	–	36.1	N
Turkey	10% exempt, rest at MTR	5 yr	35.8	N
UK	CGT rate 18/28%, fixed amount deductible	–	45	N
US	Improvements (MTR with 25% cap) land value increase (20% CGT) residual (20% CGT)	1 yr	46.3	N

Table 17: Tax treatment of capital gains in shares, by country

Country	CGT treatment	Holding test	Top MTR	Adj for inflation?
Australia	50% exempt, rest at MTR	1 yr	47	N
Austria	25% exempt, rest at MTR	–	50	N
Belgium	Exempt	–	45.3	N
Canada	50% exempt, rest at MTR	–	49.5	N
Chile	Exempt	1 yr	40	Y
Czech Rep	Exempt	0.5 yr	20.1	N
Denmark	MTR	–	55.8	N
Estonia	MTR	–	19.7	N
Finland	MTR, with deductible amounts	10 yr	49.1	N
France	MTR	–	54	N
Germany	26% exempt, rest at MTR	–	47.5	N
Greece	Exempt unless bought for resale	–	46	N
Hungary	Exempt	5 yr	16	N
Iceland	MTR	–	44.4	N
Ireland	MTR	–	47	N
Israel	MTR	–	50	Y
Italy	CGT rate 20%	–	48.8	N
Japan	CGT rate 10%	–	56.6	N
Korea	Exempt	–	39.4	N
Luxembourg	MTR, fixed rate deductible	0.5 yr	43.6	N
Mexico	Exempt	–	35	Y
Netherlands	No realisation tax, annual tax @ deemed 30%	–	49.2	N
New Zealand	Exempt unless bought for resale	–	33	N
Norway	MTR	–	39	N
Poland	CGT rate 19%	–	20.9	N
Portugal	25% exempt, rest at MTR	–	50.3	Y
Slovak Rep	MTR, fixed rate deductible	–	21.7	N
Slovenia	CGT rate 5%	20 yr	39	N
Spain	MTR	–	46	Y
Sweden	CGT rate 30%	–	56.9	N
Switzerland	Exempt unless bought for resale	–	36.1	N
Turkey	10% exempt, rest at MTR	1 yr	35.8	N
UK	CGT rate 18/28%, fixed amount deductible	–	45	N
US	MTR	1 yr	46.3	N

D

International comparisons of tax loss deductibility

Australia’s tax treatment of investment losses is more generous than most comparable countries. Most countries impose some limits on deductibility against wage and salary income (Table 18).

Table 18: Tax treatment of property investments by country

Country	Interest deductions?	Notes	Negative gearing?	Notes
Australia	Yes		Yes	Cash and depreciation expenses can be deducted against any other income
Canada	Yes	For interest expenses that are used to generate income.	Limited	Only cash expenses, not depreciation. Subject to a ‘reasonable expectations of profits test’.
France	Yes		Limited	Allowed up to a set limit and interest costs may not exceed gross rent
Germany	No		Yes	
Netherlands	No		No	Not possible. Taxation of investments based on an assumed yield of 4%.

Country	Interest deductions?	Notes	Negative gearing?	Notes
NZ	Yes	Deductible at marginal tax rate	Yes	All losses deductible against labour income at marginal tax rate
Sweden	Yes		Yes	Only deductible against capital income, not against salary and wage income, due to dual income tax system
Switzerland	Yes	Tax paid on imputed rental income, net of interest and renovation costs	Limited	
UK	Limited	From 2017, the value of tax deductions for interest expenses related to investment properties to be limited, only deductible up to the basic level of income taxation	Limited	Rental losses can only be offset against other rental income, but losses can be carried forward and deducted from future rental income.
US	Limited	Usually deductible, but limited to the amount of investment income generated; interest expenses over this amount can be carried forward to future years.	Limited	Rental property expenses cannot be deducted against unrelated labour income. Deductible from other 'passive' activities only (unless gross income is below \$150 k, in which case a capped amount can be claimed). Excess losses are carried forward.

E

Colophon

The report was originally woven with L^AT_EX2e and R by **knitr**.

L^AT_EX2e is a document preparation system implemented as a macro package for Donald E. Knuth's T_EX typesetting program. L^AT_EX was originally conceived by Leslie Lamport.

R is a language and environment for statistical computing derived from the S programming language of John Chambers. R was created by Ross Ihaka and Robert Gentleman at the University of Auckland.

knitr a general-purpose package for dynamic, literate report generation in R developed from Sweave. Yihui Xie is the author and developer of **knitr**.

The authors are indebted to the creators.

E.1 R session information

The session info (via devtools) is printed *infra*.

Table 19: Platform

version	R version 3.2.5 (2016-04-14)
system	x86_64, mingw32
ui	RTerm
language	(EN)
collate	English_Australia.1252
tz	Australia/Sydney
date	2016-04-24

Table 20: Packages

package	*	version	date	source
acepack		1.3-3.3	2013-05-03	CRAN (R 3.2.3)
assertthat		0.1	2013-12-06	CRAN (R 3.2.5)
bitops		1.0-6	2013-08-17	CRAN (R 3.2.3)
chron		2.3-47	2015-06-24	CRAN (R 3.2.5)
cluster		2.0.3	2015-07-21	CRAN (R 3.2.5)
codetools		0.2-14	2015-07-15	CRAN (R 3.2.5)
colorspace		1.2-6	2015-03-11	CRAN (R 3.2.5)
crayon		1.3.1	2015-07-13	CRAN (R 3.2.5)
curl		0.9.7	2016-04-10	CRAN (R 3.2.5)
data.table	*	1.9.6	2015-09-19	CRAN (R 3.2.5)
DBI		0.3.1	2014-09-24	CRAN (R 3.2.5)
devEMF	*	2.0	2015-01-29	CRAN (R 3.2.3)
devtools	*	1.11.0	2016-04-12	CRAN (R 3.2.5)
digest		0.6.9	2016-01-08	CRAN (R 3.2.5)
directlabels	*	2015.12.16	2015-12-18	CRAN (R 3.2.5)
dplyr	*	0.4.3	2015-09-01	CRAN (R 3.2.5)
evaluate		0.8.3	2016-03-05	CRAN (R 3.2.5)
expm	*	0.999-0	2015-10-07	CRAN (R 3.2.5)
forecast		7.1	2016-04-14	CRAN (R 3.2.5)
foreign	*	0.8-66	2015-08-19	CRAN (R 3.2.5)
formatR		1.3	2016-03-05	CRAN (R 3.2.5)
Formula	*	1.2-1	2015-04-07	CRAN (R 3.2.3)
fracdiff		1.4-2	2012-12-02	CRAN (R 3.2.5)
ggplot2	*	2.1.0	2016-03-01	CRAN (R 3.2.5)
ggrepel	*	0.5	2016-02-08	CRAN (R 3.2.5)
grattan	*	0.3.0.1	2016-04-17	Github (hughparsonage/grattan@854ed3a)
gridExtra	*	2.2.1	2016-02-29	CRAN (R 3.2.5)
gtable		0.2.0	2016-02-26	CRAN (R 3.2.5)
Hmisc	*	3.17-3	2016-04-03	CRAN (R 3.2.5)
httr	*	1.1.0	2016-01-28	CRAN (R 3.2.5)
knitr	*	1.12.3	2016-01-22	CRAN (R 3.2.5)
labeling		0.3	2014-08-23	CRAN (R 3.2.3)
lattice	*	0.20-33	2015-07-14	CRAN (R 3.2.5)
latticeExtra		0.6-28	2016-02-09	CRAN (R 3.2.5)
lazyeval		0.1.10	2015-01-02	CRAN (R 3.2.5)

* attached

Continued on next page

Table 20: Packages

package	*	version	date	source
lubridate		1.5.6	2016-04-06	CRAN (R 3.2.5)
magrittr	*	1.5	2014-11-22	CRAN (R 3.2.5)
Matrix	*	1.2-4	2016-03-02	CRAN (R 3.2.5)
memoise		1.0.0	2016-01-29	CRAN (R 3.2.5)
mgcv		1.8-12	2016-03-03	CRAN (R 3.2.5)
munsell		0.4.3	2016-02-13	CRAN (R 3.2.5)
nlme		3.1-125	2016-02-27	CRAN (R 3.2.5)
nnet		7.3-12	2016-02-02	CRAN (R 3.2.5)
openxlsx	*	3.0.0	2015-07-03	CRAN (R 3.2.5)
plyr		1.8.3	2015-06-12	CRAN (R 3.2.5)
purrr		0.2.1	2016-02-13	CRAN (R 3.2.5)
quadprog		1.5-5	2013-04-17	CRAN (R 3.2.3)
R6		2.1.2	2016-01-26	CRAN (R 3.2.5)
RColorBrewer		1.1-2	2014-12-07	CRAN (R 3.2.3)
Rcpp		0.12.4	2016-03-26	CRAN (R 3.2.5)
RCurl		1.95-4.8	2016-03-01	CRAN (R 3.2.3)
readr	*	0.2.2	2015-10-22	CRAN (R 3.2.5)
readxl	*	0.1.1	2016-03-28	CRAN (R 3.2.5)
reshape2		1.4.1	2014-12-06	CRAN (R 3.2.5)
rpart		4.1-10	2015-06-29	CRAN (R 3.2.5)
rsdmx	*	0.5-3	2016-03-16	CRAN (R 3.2.5)
scales	*	0.4.0	2016-02-26	CRAN (R 3.2.5)
stringi		1.0-1	2015-10-22	CRAN (R 3.2.3)
stringr		1.0.0	2015-04-30	CRAN (R 3.2.5)
survey	*	3.30-3	2014-08-15	CRAN (R 3.2.5)
survival	*	2.38-3	2015-07-02	CRAN (R 3.2.5)
taxstats	*	0.0.2.1314	2016-04-17	Github (hughparsonage/taxstats@accb2ee)
testthat	*	1.0.0	2016-04-14	CRAN (R 3.2.5)
tidyr	*	0.4.1	2016-02-05	CRAN (R 3.2.5)
timeDate		3012.100	2015-01-23	CRAN (R 3.2.3)
tseries		0.10-34	2015-02-20	CRAN (R 3.2.5)
withr		1.0.1	2016-02-04	CRAN (R 3.2.5)
XML		3.98-1.4	2016-03-01	CRAN (R 3.2.3)
xtable	*	1.8-2	2016-02-05	CRAN (R 3.2.5)
zoo	*	1.7-12	2015-03-16	CRAN (R 3.2.5)

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Figure notes

Part I

Figure 2 Revenues and expenses from the general government sector operating statement of the Commonwealth Government financial statements. Difference between revenue and spending is the net operating balance. Commonwealth “own purpose” revenues and expenses (*i.e.* excluding revenues from the GST, and excluding grants to the states) follow a similar pattern.

Figure 10 For 2009 to 2015, the change is the cumulative change over four years from the initial projection to the final outcome. For 2016 to 2018, the change illustrated is the cumulative change from the initial projection to the latest estimate. The change is expressed as a percentage of nominal GDP in the outcome year.

Figure 11 The 2014-15 Budget Papers for many state governments were released prior to the Commonwealth Government budget so forecasts do not include the full impact of reduced Commonwealth funding for health previously agreed under the National Health Reform Agreement. This equates to around \$1.2 billion in revenue (0.06% of GDP) in 2017-18.

Figure 12 Debt forecasts in NSW, Queensland, South Australia and ACT were revised downwards between the 2013-14 Budget and the 2014-15 Budgets and Mid-Year forecasts. This accounts for the lower combined debt forecasts compared to those presented in our 2014 Budget Pressures report Daley, McGannon and Hunter (2014, p. 41). The improvement in the forecast debt position was particularly significant in NSW because of the sale of Macquarie Generation in September 2014.

Figure 13 Less reliance ought to be placed on figures for 80+, as sample sizes are small and data categories change across surveys. Spending figures are adjusted to constant prices using the GDP implicit price deflator. Since health prices grew somewhat faster than average price levels, a small proportion of the increase across all categories will reflect this faster price growth.

Part II

Figure 16 Immobile property includes both land and buildings; recurrent taxes on immovable property includes taxes levied regularly in respect to use or ownership of immovable property, and excludes transaction taxes on property such as stamp duty.

- Figure 18** ‘Property levy’ shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place since 1990-91; GST is for the period since its introduction in 2000-01 to 2013-14.
- Figure 19** ‘Property levy’ shows the revenues that would have been raised with a broad-based property levy of 0.2 per cent applied to unimproved land values had it been in place since 1990-91; GST is for the period 2000-01 to 2013-14 only, but displays similar volatility compared to state taxes assessed over this shorter period.
- Figure 20** Property levy revenue forecasts are for 2015-16, whereas land tax, council rates, and stamp duty revenues reflect 2013-14 collections. ABS land values for each state in the national accounts may differ, albeit not materially, from state Valuer-General figures due to different approaches, especially for residential land: see ABS (2014e, p. 419).
- Figure 25** Simulated impact of applying a 0.2 per cent levy to unimproved land values; average rates and levy costs are calculated based only on those households within the disposable income decile that would pay the levy; households reporting negative household disposable income and negative net wealth are excluded from the analysis; council rates include all charges, net of rebates, but exclude water charges; deciles are grouped by equivalised disposable (*i.e.* post tax) income of each household.

Part III

- Figure 35** Home is net of related mortgage liabilities; other assets are net of other liabilities; superannuation excludes at least some defined benefit schemes. Net present value of Age Pension based on average annual pension payments received by households in each age group in 2011-12, inflated forward to 2013-14. The annual average Age Pension payment is converted into a capital value using a discount rate equal to the Age Pension indexation rate of 4 per cent and an average life expectancy for those aged 65 now of 89 years for women and 86 years for men. The net present value of lifetime Age Pension payment assumes that the average real pension currently received by households in each age group continues to life expectancy. Does not account for future expected increases in private retirement saving before retirement, especially for households aged 45 to 54 years and 55 to 64 years where the bulk of households are not yet retired.
- Figure 37** As explained in Appendix C, we define the real effective marginal tax rate on saving as the income foregone due to tax, as a proportion of the pre-tax return (net of inflation). Effective marginal tax rates are presented relative to a pre-paid expenditure tax (*i.e.* TEE) benchmark. This approach is consistent with the approach to calculating real effective marginal tax rate rates adopted in the Henry Tax Review.

Assumes superannuation earnings are taxed at an average effective rate of 8 per cent in the fund, reflecting the concessional treatment of capital gains (10 per cent tax rate) and dividend imputation for investments in domestic equities. Assumes 6 per cent nominal return; 2.5 per cent inflation; all investments are held for 25 years; for property and equities capital gains tax is only crystallised and paid at the end of 25 years; for property and equities, 50 per cent of the return is attributable to capital gain, 50 per cent to rental or dividend income; dividends on domestic equities are fully franked. Ignores impacts on qualifying for welfare payments.

Figure 39 Dates are financial year ending. Revenue cost of superannuation tax breaks are estimated relative to an income tax benchmark – they compare tax actually paid with the tax that would be paid if the same contributions and earnings were taxed at each individual’s marginal tax rates, including relevant tax offsets where available. The estimates are based on Treasury’s ‘revenue gain’ approach to estimating tax expenditures and account for behavioural change. See endnote 199.

Figure 43 ‘Super’ assets include any interests in both APRA regulated and self-managed superannuation funds. May exclude interests in some defined benefit schemes. ‘All other wealth’ includes other non-financial assets such as the value of vehicles and home contents.

Figure 44 Expenditure of elderly single households (60-79) and working age (25-59) single household expenditure, by expenditure percentile. Expenditure variables have been inflated forward to 2015 levels using the change in final household consumption expenditure between June 2009 and March 2015. Left pane shows expenditure for elderly singles who own their own home outright, and who will probably have higher expenditure on average than households that do not own their own home outright.

Figure 47 Net present value of lifetime cost to government includes Age Pension payments and net tax expenditures of those aged 30 in 2010; assumes life expectancies of 88 years for males, 90 years for females; pre-tax investment returns of 6.5 per cent, annual wages growth 4.14 per cent; all income groups except the 99th percentile are assumed to fully draw down their superannuation balances by death; excludes Division 293 tax.

This calculation may substantially understate the lifetime cost of super tax breaks for those in the top 20 per cent of income earners. They tend to make large post-tax contributions close to retirement (Figures 58 to 59 on pages 195–196). Consequently, in retirement their total super balances, and the value of the earnings tax breaks, are much higher than would be expected from analysing the distribution of pre-tax contributions (Figure 60 on page 203), which appear to underlie Treasury’s estimates for the lifetime cost of tax breaks.

- Figure 48** Compulsory pre-tax contributions are total employer contributions reported by APRA, including defined benefit contributions, less reportable employer (*i.e.* salary sacrificed) contributions reported by the ATO; voluntary pre-tax contributions are the sum of reportable employer contributions and reportable personal contributions reported by the ATO; voluntary post-tax contributions are total member contributions reported by APRA, less reportable personal contributions reported by the ATO; other contributions include spouse contributions and government co-contributions, and are drawn from APRA figures.
- Figure 49** Does not include the Medicare Levy, Low Income Tax Offset or the Temporary Budget Repair Levy. Division 293 tax applies to all contributions where the sum of taxable income and pre-tax super contributions exceeds \$300,000.
- Figure 50** The statistics for the 2012-13 income year were sourced from 2013 individual income tax returns processed by 31 October 2014 and member contributions statements received before 8 July 2015; Post-tax personal contributions are sourced from member contribution statements. Generally this represents contributions made to super from after personal tax income; Pre-tax personal contributions are sourced from individual income tax returns.
- Figure 53** Compulsory Super Guarantee contributions estimated from salary and wage income; includes reportable salary sacrifice contributions and contributions from post-tax income for which the taxpayer has claimed a tax deduction. There were 1.27 million people in each taxable income decile in 2012-13.
- Figure 55** For proposals to change tax rates on contributions, we assume a concessional contributions cap of \$30,000 remains in place (\$35,000 for over 50s); \$11,000 cap proposal assumes Division 293 tax remains in place for those earning more than \$300,000; a taxpayer earning more than \$115,000 is assumed to make pre- and post-tax total contributions of 9.5 per cent of their taxable income. Estimates of tax concessions do not include tax savings of avoiding the Medicare Levy or Temporary Budget Repair Levy.
- Figure 58** Excludes those taxpayers and post-tax contributions where the ATO is unable to identify their account balances. The statistics for the 2012-13 income year were sourced from 2013 individual income tax returns processed by 31 October 2014 and member contributions statements received before 29 October 2015. The super fund balance is the sum of all member account balance values reported for a single individual where the Member Contributions Statement had a Tax File Number. Age is as at 30 June 2013 and is based on the date of birth reported by the individual on their income tax return. Where this date of birth is not populated ATO registration information is used.

Figure 60 Total income includes estimated earnings on super account balances but excludes withdrawals; around 70 per cent of those with super balances aged over 60 are in the drawdown phase, and therefore benefit from tax-free super earnings. The value of tax-free superannuation earnings in the benefits phase is calculated on the basis that taxing earnings would lead to a net increase in the effective tax rate on super earnings of 14 per cent, from a small negative effective tax rate (given refundable imputation credits and the capital gains tax discount), to an effective tax rate of between 8 and 10 per cent.

Figure 61 Additional tax is only paid by those in pension phase. Total income includes taxable income and estimated earnings on super account balances, but not drawdowns from superannuation. Effective tax rate on fund earnings as per Figure 60 on page 203; account balances inflated forward to 2015-16. Income deciles based on all people over 60. Average super balances are reported only for retirees in benefits phase. There are 415,000 people in each income decile.

Figure 62 Based on nominal investment return of 5 per cent and an effective super earnings tax rate of 14 per cent after accounting for the 33 per cent capital gains tax discount for super fund investments and investment preferences of retirees; account balances inflated forward to 2015-16; behaviour change assumes that taxpayers withdraw assets from superannuation and reinvest in the same underlying assets elsewhere if this would reduce the tax rate on the earnings, such as if they have unused tax-free income entitlements arising from the tax free threshold, LITO or SAPTO entitlements.

Figure 63 The statistics for the 2012-13 income year were sourced from 2013 individual income tax returns processed by 31 October 2014 and member contributions statements received before 8 July 2015; Concessional employer contributions includes both SG contributions and other compulsory contributions made by the employer, as well as any salary sacrificed contributions made voluntarily by the employee; Non-concessional personal contributions are taken from member contribution statements. Concessional personal contributions are taken from individual income tax returns.

Figure 75 Assumes individuals receive SG contributions from their employer at the 9.5 per cent SG rate and make additional voluntary concessional contributions up to the \$35,000 concessional contributions cap for over 50s; includes Medicare Levy and Low Income Tax Offset but excludes Temporary Budget Repair Levy; over 65s are also eligible for the Senior Australian and Pensioners Tax Offset; includes 15 per cent tax on concessional super contributions; super benefits withdrawn are not included in taxable income; assumes no other taxable income sources apart from wage and salary income. Source: ATO (2015f), ATO (2015e) and ATO (2015c); Grattan analysis.

Table 21: Assumptions for Figure 91 on page 314

return type	scenario	capital gains	risk free rate	inflation
excess	historic	7.3%	5.6%	2.8%
excess	lower	5.0%	4.5%	2.5%
nominal	historic	7.3%	5.6%	2.8%
nominal	lower	5.0%	4.5%	2.5%
real	historic	7.3%	5.6%	2.8%
real	lower	5.0%	4.5%	2.5%

Part IV

Figure 81 Investment income includes other income not otherwise classified. Own business income is for unincorporated businesses owned by one or more household members. Welfare includes all government payments such as pensions, unemployment benefits and family allowances. Source: ABS (2015c); Grattan analysis.

Figure 82 Age Pension includes Age and Veteran's Affairs Pensions. Family payments include Family Tax Benefits and Parenting Payments.

Figure 83 Assumes that 30 per cent of the additional revenue from increasing the GST to 15 per cent is spent on higher welfare payments. The HES understates the GST burden on households because it understates household spending. A comparison of HES with the Australian System of National Accounts (ABS (2011, Appendix 3)), shows the difference in some spending categories – for example, tobacco, alcohol and gambling and health – exceeds 30 per cent. We inflate the HES numbers to reflect the total GST collections, assuming the downward bias in reporting is uniform across income quintiles.

Figure 84 Assumes that 30 per cent of the additional revenue from increasing the GST to 15 per cent is spent on higher welfare payments and an additional 30 per cent is spent on tax cuts. Tax cuts applied to the 2009-10 survey respondents. Magnitude of the cuts to the marginal rates calibrated to result in a change in revenue of approximately 30 per cent of the contemporaneous GST revenue. See also note to Figure 83.

Part V

Figure 91 Assumes: marginal tax rate of 47%, property held for 15 years, nominal rent at 3% of the property value.

Figure 103 See Table 21.

Table notes

Part III

Table 4 Assumes that person contributes \$11,000 each year, growing with nominal wages at 4%; funds returns of 6.5%; inflation is 2.5%; contributions are taxed at 15% and earnings at an average effective rate of 8%. ASFA standard reports super balance required at retirement to generate the income needed for a comfortable lifestyle, which is \$42,861 for a single person who is healthy and owns their home outright, under the new Age Pension asset test rules that will apply from 1 January 2017.

Table 5 All figures in 2015 dollars. Couples are treated as two singles if they are separated due to ill health. ASFA lump sums assume investment earnings of 7% and CPI deflator of 3.75%. Assets thresholds are projected based on legislated changes from 1 July 2017, assuming that pension payments grow by 3.75% annually due to indexation arrangements.

Table 6 Retirees that do not own their own home may also be eligible for rent assistance. Tax assumes that all income is taxable, and includes Medicare Levy, SAPTO and LITO. Couple calculation assumes one partner earns two thirds of the taxable income.

Table 7 Under 35s could only contribute \$15,260, while those aged 35 to 49 could contribute \$42,385, and those aged 50 and over could contribute up to \$105,113. The former Labor government sought to increase the pre-tax contributions cap for over 50s to \$50,000 in the 2010-11 Budget for those with superannuation balances below \$500,000, but this measure was dropped following industry consultation.

Part V

Table 14 Assumes that all net rental losses above the cap in a year cannot be written off against wage and salary income. That is, if the investor does not make other (positive) investment income in that year then the loss in excess of the cap cannot be claimed.

Notes

1. Daley, D. Wood, Weidmann et al. (2014, p. 9).
2. Ibid. (p. 9).
3. In the 2013 election, just over 47 per cent of voters were 50 and over at the Close of Rolls on 27 August 2013. See: **AEC2013**.
4. Treasury (2015a, pp. 3–9).
5. Net debt was 18.1 per cent of GDP in 1995-96. See Treasury (2014a, p. 273).
6. Daley, D. Wood, Weidmann et al. (2014).
7. **Treasury2013-PEFO**.
8. **ProductivityCommission2015-Childcare; DaleyMcGannonGinnivan2012**.
9. **PBO2013**; and Daley, D. Wood, Weidmann et al. (2014, pp. 20–23).
10. Treasury (2015a, BP No. 2, p. 47).
11. **PBO2015f**.
12. Grattan estimates based on major measures that have been reversed including proposal to index social security benefits to CPI, Medicare co-payments and the 6 month waiting period for Newstart Allowance.
13. Grattan analysis of **Treasury2014-Budget-Papers-2014-15**.
14. Treasury (2010, p. vii).
15. **Carmody2013**. National living standards are often measured by reference to Gross Domestic Product (GDP), which measures the volume of goods and services produced in the Australian economy. Gross National Income (GNI) measures the income earned by Australian residents. GNI differs from GDP principally because GNI captures changes in the price of exports compared to the price of imports. In periods when there are large changes in the terms of trade, GNI is arguably a more accurate reflection of living standards.
16. **Stevens2013**; and Minifie et al. (2013).

17. Treasury (2015a, pp. 2–5).
18. **Treasury2014-Budget-Papers-2014-15.**
19. Hockey (2015, pp. ix, xi).
20. **Borland2014.**
21. **Commission2014.**
22. **Gordon2012Cowen2011.** See Daley, D. Wood, Weidmann et al. (2014)**Dolamore2015** for a more detailed discussion of this literature.
23. **Parkinson2014.**
24. Hockey (2015).
25. Grattan estimates based on the forecast spending on the NDIS (**Commission2014**) and the forecast growth in childcare and defence spending above the growth in nominal GDP (**NationalCommissionAudit2014**). This does not include the cost of the Direct Action Policy because no spending estimates are available beyond the forward estimates.
26. **PBO2015.**
27. Minifie et al. (2013, pp. 34–35).
28. Treasury (2015a, pp. 1–7).
29. **RBA2015a.**
30. **Treasury2014h.** More precisely, the projections assume that economic activity increases to close the output gap, so if growth has been below trend, then economic growth is projected to be higher than the long run average.
31. Grattan analysis of **OECD2015a.**
32. **IMF2015b.**
33. **IMF2015.**
34. **BailyBosworth2013; RoxburghLundWimmerEtAl2011.**
35. **RoxburghLundWimmerEtAl2011.**
36. **PBO2014TrendsAustralianGovtReceipts1982to2013.**
37. **RBA2015a.**
38. Ibid. (pp. 5–11).

39. **PBO2015.**
40. Ibid. (pp. 3–9).
41. **Daley2014.**
42. Ibid. (BP No. 1, pp. 5-11).
43. See: **Defence2014.**
44. The depreciation on this capital spending affects net operating balances in subsequent budget years. Non-cash depreciation already built into state operating budgets will erode this debt if state capital spending falls, as their most recent budgets forecast.
45. Daley, D. Wood, Weidmann et al. (2014, p. 41).
46. Daley, McGannon and Hunter (2014, p. 4).
47. Daley, D. Wood, Weidmann et al. (2014, p. 26).
48. **gruen2007conceptual.**
49. **ProductivityCommission2013AgeingAustralia.**
50. Ibid. (p. 26).
51. These estimates based on engineering work done are consistent with ABS statistics based on government budget papers **PBO2015a.**
52. **KellyDonegan2015; InfrastructureAustralia2015-InfrastructureAudit.**
53. **ProductivityCommission2013PublicInfrastructure.**
54. **Treasury2014-Budget-Papers-2014-15.**
55. Estimates in 2013-14 dollars. Schools estimate calculated from nominal value of transfer provided in **Treasury2014-Budget-Papers-2014-15.** Health estimates based on Hockey (2015).
56. Daley, D. Wood, Weidmann et al. (2014, p. 34).
57. **PBO2015a.**
58. State royalties are typically value-based; they are not simply charges based on volume.
59. The 2014-15 Budget cut proposed spending for official development assistance (ODA) by \$7.6 billion over five years (**Treasury2014-Budget-Papers-2014-15**). Another \$3.7 billion in savings over four years was announced in MYEFO 2014-15 (Treasury (2014a, p. 47)).
60. **Treasury2014-Budget-Papers-2014-15.**

61. **Loughnane2013.**

62. Very few state governments have engaged in serious debate about tax reform in recent years. Indeed, the trend in election campaigns has been to rule out any changes to taxation. In the recent Victorian election campaign, the Labor Opposition committed to no new taxes or tax increases if they won power (**Savage2014**). The LNP made similar commitments in the Queensland Election campaign (**Eaton2015**). One exception is South Australia that has recently released a comprehensive discussion paper on State Tax Reform (**GovernmentSouthAustralia2015-State-Tax-Review-Discussion-Paper**).

63. State royalties are typically value-based; they are not simply charges based on volume.

64. While South Australia has announced the abolition of stamp duties on commercial property following the release of a comprehensive discussion paper on State Tax Reform (**DTF2015-State-Budget-Papers-201516**), it hopes to fund this largely through an increased share of GST revenues (**GovernmentSouthAustralia2015-State-Tax-Review-Discussion-Paper**).

65. Treasury (2015a).

66. **ABS2015h.**

67. **ACT-Treasury2012-13-Budget-Papers; ACT-Treasury2014-15-Budget-Papers.**

68. **GovernmentSouthAustralia2015-Govt-response-to-State-Tax-Review; DTF2015-State-Budget-Papers-**

69. **RBA2014SubmissionAffordableHousingInquiry.**

70. Capital improvements on land are investments made which increase the value of the property, particularly buildings, as well as drainage and other works. In this report, the term 'improved value' is used to refer to any land value definition that includes the value of improvements when assessing the value of a property.

71. **ABS2015h.**

72. Grattan analysis of ABS (2013b)**ATOMultipleyears** and ABS (2014g).

73. Commonwealth Grants Commission (2015a, p. 1).

74. For example, hospital services are used more intensively by some age groups and by indigenous people.

75. Commonwealth Grants Commission (2015b, p. 23).

76. Treasury (2010, p. 247).

77. Grattan analysis of KPMG Econotech (2011)**ABS2015h.**

78. In this working paper, the term **unimproved value** is used to capture a range of land value definitions, such as unimproved value, and site value, among others. Although there are

differences in the definitions, they all capture the value of land separate from the value of major capital improvements, such as buildings. For example, see **HefferanBoyd2010**.

79. Land use restrictions tend to reduce land values where they prevent land being used for its' first and best use. For example, **KulishRichardsGillitzer2011** find that residential building height restrictions result in lower land prices closer to the CBD where the height restriction is binding **KulishRichardsGillitzer2011**. However land use restrictions also tend to increase land values for land approved for certain uses by increasing the scarcity of that type of land. See **Brueckner2007** for a theoretical overview of the impact of land usage policies on land prices.
80. Land taxes are capitalised into land values (Treasury (2010, pp. 247–248)).
81. **KulishRichardsGillitzer2011**.
82. **KellyDonegan2015**.
83. **JohanssonHeadyArnoldEtAl2008**.
84. KPMG Econotech (2011, p. 18).
85. Assuming an average nominal pre-tax rate of return on capital of 12 per cent. The tax rate on capital improvements would rise to 1.4 per cent for an investment with a pre-tax rate of return on capital of only 7 per cent.
86. This figure is independent of the rental return rate adopted.
87. The weighted average of U.S. state property taxes in the year 2000 investigated by these studies is equivalent to an annual tax rate of 1.56 per cent of property values.
88. Land taxes also usually exempt much Commonwealth and State-owned land, and land used by public hospitals, libraries, cemeteries, charities, religious organisations, universities, schools and foreign embassies. See Productivity Commission (2008, p. 105).
89. **ABS2015h**.
90. Treasury (2010, p. 261)**KellyMaresHarrisonEtAl2013**. Even though owner-occupied housing accounts for 75 per cent of all residential land, imposing land tax on it would only raise \$5 billion as it would be taxed at comparatively low rates under the highly progressive rates of land tax currently in force.
91. Treasury (2010, p. 260).
92. NSW Treasury (2014, pp. 31–33).
93. **Berry2000**; **WoodOngStewart2010**; and Treasury (2010, p. 261).
94. NSW Treasury (2014, pp. 31–33).
95. Treasury (2010, p. 261).

96. **GabbitasEldridge1998.**
97. **KellyMaresHarrisonEtAl2013.**
98. Productivity Commission (2008, p. 198).
99. For example, the City of Gosnells estimated the value of the rates revenue foregone by WA councils from exemptions to charities in WA at \$6.5 million, or 0.7 per cent of total state-wide council rates revenue for 2005-06. See Productivity Commission (2008, p. 107).
100. In Victoria, for example, most councils determine rates on the basis of the assessed capital value of the property. See **HefferanBoyd2010.**
101. Productivity Commission (ibid., p. 139) notes that 'other things equal, imposing a minimum (or fixed) charge makes rates regressive (or less progressive) than otherwise'.
102. Treasury (2010, p. 265); **GovernmentSouthAustralia2015-State-Tax-Review-Discussion-Paper.**
103. **WoodOngCigdemEtAl2012.**
104. For example, see **SlackBird2014.**
105. Based on a property levy 0.2 per cent of unimproved land value, and median residential land values supplied by NSW Treasury.
106. Councils in all states except WA currently have the option to levy rates based on land values (Table 1 on page 79).
107. **Ombudsman2005; HefferanBoyd2010.**
108. In most cases, states provide a fixed rebate on council rates, and reimburse councils for the foregone rates revenues. Many councils also offer an additional fixed rebate on municipal rates for pensioners and concession card holders. In most cases, property-owning pensioners still have some residual rates liability after these concessions are applied.
109. Daley, McGannon, Savage and Hunter (2013, p. 37).
110. **Brownfield2014.**
111. Under a non-recourse loan, the creditor cannot claim any other assets of the borrower if the borrower defaults and the collateral is insufficient to repay the debt.
112. A 0.1 per cent levy on property value, with payment deferred for 30 years would result in a deferred charge equivalent to 4 per cent of the property value, including deferred interest. This assumes a 7 per cent nominal interest rate and 3 per cent annual growth in nominal house prices. With a 10 per cent nominal interest rate, the deferred charge would be equivalent to 7 per cent of the property value.

113. State governments typically reimburse councils for the rate revenue foregone under council rate deferral programs.
114. There is considerable literature documenting the capitalisation of property taxes into land values. For example see **Oates1969****oates2009****simple**. **WoodOngCigdemEtAl2012** adopt a similar approach to estimate the impact of the Henry Review recommendations on land values in Victoria.
115. The impact of the tax on land values depends upon the discount rate adopted. For example, a property levy would lower land values by 6 per cent with a discount rate of 2 per cent, but by only 3 per cent if a 6 per cent discount rate is adopted. This analysis assumes a levy of 0.2 per cent on land values only.
116. Rents would rise by 1.3 per cent for a real rental yield (excluding any capital gains) of 4 per cent. For a rental yield of 7 per cent, the percentage increase in rents drops to 0.7 per cent. Both examples reflect a property levy of 0.1 per cent of capital improved property values.
117. This analysis assumes a levy of 0.2 per cent on land values only. The results would be broadly similar for a levy on capital improved property values of around 0.1 per cent.
118. Ibid. (p. 21).
119. **OECD2013d**.
120. The ABS adopts the concept of household net worth, rather than household wealth, in the Survey of Income and Housing. See **ABS2014f** for a detailed discussion on this issue.
121. The equivalent net worth figure for a two adult household in the top income net worth quintile would be \$960,000. For a two adult family with two children aged under 15, this rises to \$1.34 million. Grattan analysis of ABS (2013b) and ABS (2014d).
122. Grattan analysis of ABS (2013b) and ABS (2014d).
123. For earlier commentary on this issue see **HardingWarren1999** and Productivity Commission (2008, pp. 156–158).
124. **CGC2009a**.
125. **ABS2015ResidentialPropertyIndex**.
126. **TreasuryTradeQld2012**.
127. Grattan analysis of ABS (2014d).
128. **CGC2010b**.
129. **Treasury2007a**.
130. **Treasury2008a**.

131. Daley, McGannon and Savage (2013, p. 29).
132. Daley, McGannon and Hunter (2014, p. 25).
133. Daley, D. Wood, Weidmann et al. (2014, p. 22).
134. Ibid. (p. 29).
135. Grattan analysis of ABS (2015c) **ABS2006HES0304**.
136. Australia had an EET system for pre-tax superannuation contributions until 1988 when the Hawke Government introduced taxes on super contributions and earnings, and reduced taxes on super withdrawals, creating a 'TTT' system. The Howard Government abolished taxes on super withdrawals in 2007, creating our present tte system, **Treasury2008RetirementIncomeConsultPaper**.
137. **Mercer2015SubmissionToReThink**. For example, the Commonwealth Government expects to collect \$6.1 billion in superannuation taxes in 2014-15. **Treasury2015FinalBudgetOutcome1415**.
138. As proposed by **MaddockKing2015Freebairn2015a**.
139. Daley, D. Wood, Weidmann et al. (2014, p. 2).
140. **Davidson2015**.
141. Some authors identify three pillars in the retirement income system, either by combining all superannuation savings into one pillar, or separating out compulsory and voluntary superannuation savings but ignoring voluntary savings beyond superannuation such as housing assets (see **Treasury2009aftsRetirementIncomeStrategicIssues**). More recent approaches distinguish between compulsory and voluntary superannuation savings, and note the importance of voluntary savings outside the superannuation system (**Derby2015**).
142. **Mercer2015**.
143. Grattan analysis of ABS (2015c) and ABS (2013b)
144. The Superannuation Guarantee was only introduced in 1992-93, with compulsory contributions rising from 3 per cent of wages in that year to 9 per cent from 2002-03, before reaching the current 9.5 per cent in 2013-14. The Super Guarantee rate will remain fixed at 9.5 per cent until 2021. It will then increase by half a percentage point each year until it reaches 12 per cent.
145. For a more detailed analysis of trends in asset holdings by age, see Daley, D. Wood, Weidmann et al. (2014, p. 14).
146. This is consistent with estimates by the **ActuariesInstitute2015RetirementIncomes**, which estimates the value of the full rate Age Pension for a people retiring today at the age of 65 at \$816,000 for couples, \$419,000 for a single man and \$482,000 for a single woman – far more than expected average super balances.

147. The self-employed can make contributions directly to their super fund and claim a tax deduction for the tax already paid on that income on their tax returns.
148. The maximum SG contributions an employer is required to make is determined by the maximum super contributions base, currently set at \$203,240 per year, and indexed annually to average weekly ordinary time earnings, **ATO2015MaxSuperContrBase**.
149. This is only possible for people whose employers offer salary sacrifice arrangements, or for self-employed individual who are eligible to claim a tax deduction on their post-tax super contributions. Otherwise, contributions not made through employers are made out of employees' post-tax income.
150. Those earning over \$300,000 pay 30 per cent tax on their concessional super contributions. The \$30,000 concessional cap for under 50s is indexed to wages; the \$35,000 concessional cap for over 50s is not indexed (**ATO2015ConcessionalContrCap**).
151. **ATO2015SuperCoContrATO2015IncomeThresholdTest** Those earning less than \$35,454 benefit from the full government co-contribution, while those earning between \$35,454 and \$50,454 are eligible for a reduced co-contribution.
152. For example, **Mercer2015GlobalPensionIndex** suggests that the net effective tax rate for many super funds in the accumulation phase is around 8 per cent.
153. **ATO2015RefundingImputationCredits**; and Financial System Inquiry (2015, Appendix B).
154. Treasury (2010).
155. Some commentators have argued that tax-free earnings support encourages people to take their super benefit as an income stream, rather than as a lump sum. However, recent evidence suggests that people already draw down on their assets in an orderly fashion **ProductivityCommission2015SuperPolicyPostRetirement**.
156. The preservation age is set to rise from 55 today to 60 by 2024. Some benefits can be accessed prior to preservation age, such as those that accrued prior to 1999, **ATO2015WhenYouCanAccessYourSuper**.
157. Some superannuation benefits are not tax-free on retirement for over 60s, such as some defined benefit superannuation schemes. In these schemes benefits withdrawn may still be taxable where taxes liable on contributions and fund earnings have not already been paid in the fund. For more detail on the different tax treatment of super fund benefits when withdrawn, see **ATO2015HowTaxAppliesToSuper** and **Mercer2015SubmissionToReThink**.
158. **APRA2015JuneSuperPerformance**.
159. **MinifieSavageCameron2015**.
160. Financial System Inquiry (2015, p. 95).
161. **Greenwood2010**.
162. **Henry2009; RBA2014FinancialSystemInquirySubmission**.

163. Ibid. (p. 98).
164. Only 4 per cent of funds managed by APRA-regulated superannuation funds are invested in infrastructure **APRA2015a**.
165. **ProductivityCommission2013PublicInfrastructure**.
166. **ProductivityCommission2013PublicInfrastructure**.
167. **ElaurantMcDougall2015**.
168. **MirrleesAdamBesleyEtAl2011**.
169. The superannuation system also aims in pension phase to encourage people to manage financial risks in retirement (**MaddockKing2015**), an issue beyond this report's scope.
170. Ibid. (p. 4).
171. Gruen and Soding (2011); **Connolly2007**.
172. Of course, some of those that retire without qualifying for the Age Pension may qualify later in retirement as they draw down on their savings. The level of super savings required for a reasonable retirement, and where taxpayer support might be justified, is discussion in Section 3.3.
173. **Keating2015**.
174. Hockey (2015).
175. There is good evidence that higher ability (*i.e.* higher earning) people are more patient and tend to save more (**BanksDiamond2010**).
176. Figure 37 presents the effective marginal tax rates on savings compared to a pre-paid expenditure tax (or TEE) approach, where tax is paid on the income used to finance savings, but earnings and withdrawals are tax free. Comparing effective tax rates to a TEE approach shows the degree to which taxes on savings result in a bias for or against future consumption. A positive effective tax rate compared to a TEE approach implies a bias against future consumption, whereas a negative effective tax rate implies a bias towards future consumption. This approach is consistent with analysis of effective tax rates on savings contained in the Henry Tax Review and the UK's Mirrlees Review. See Treasury (2010), Wakefield (2009)**MirrleesAdamBesleyEtAl2011**.
177. Treasury (2010, p. 32); Treasury (2015a, p. 58); **MirrleesAdamBesleyEtAl2011**.
178. **MirrleesAdamBesleyEtAl2011**.
179. Treasury (2010, p. 12).
180. **CarlingCowanErgas2015**.

181. Of course, this logic would only apply to superannuation if it were a full TEE system, with no concessional tax rates on any contributions.
182. Ibid. (p. 12).
183. **MirrleesAdamBesleyEtAl2011** However, the authors also acknowledged that some taxation of the normal risk-free return from financial capital investment may be desirable to limit distortions between investments in physical and human capital (p. 311).
184. **BanksDiamond2010**. The authors point to evidence of a positive correlation between individuals' earnings capacity and their willingness and ability to smooth consumption over their lifetime by savings, as well as greater uncertainty about lifetime earnings for those with low earning capacity.
185. **Leigh2013; Piketty2013**; and Ingles (2015, p. 23).
186. **Teles2013**.
187. **DynanSkinnerZeldes2004**.
188. In contrast, Poterba et al. (1996) summarizing various studies from Venti and Wise (1985; 1986; 1987; 1990; 1991) find a larger 'new savings' effect. However, there are a range of data and methodological problems with these studies, particularly, the failure to fully control for difference preferences between participants and non-participants in tax-advantaged savings programs or within these groups over time **EngenGaleScholz1996** More recent studies in Benjamin (2003) and Engen and Gale (2000) have attempted to overcome these issues by using improved data and techniques, and found very little new savings.
189. OECD (2007) A review of the experience of tax-preferred savings accounts in 11 OECD member countries suggests that that high-income people are most likely to participate in tax preferred savings plans but tax preferred accounts only create new savings when people of moderate incomes participate in them.
190. **DynanSkinnerZeldes2004**.
191. For example, see **BlundellEmmersonWafefield2006**. The Age Pension does not discourage many high-income earners from saving, as their assets and income are likely to exclude them from accessing the Age Pension anyway.
192. Chetty et al. (2014) is a particularly compelling study because of the quality and size of the data (41 million observations on savings for people from Denmark). Other studies drawing similar conclusions include Engen and Gale (2000) and Benjamin (2003).
193. **Feng2014** consistent with Figure 67.
194. ABS (2013b) The proportion of employees making salary sacrifice contributions has fallen sharply, from 50 per cent in 1993, as the Super Guarantee has expanded to cover most workers.

195. By definition, superannuation tax breaks boost the post-tax value of compulsory superannuation savings. However, the value of the tax breaks only account for a small portion of the estimated impact of compulsory superannuation on overall household savings.
196. **Connolly2007**. That is, there was only a small offsetting fall in other savings in response to the introduction of the compulsory Superannuation Guarantee.
197. **Connolly2007**. Possible drivers of the increase in voluntary savings include greater awareness of the importance of retirement savings due to compulsory super, and the added convenience of making voluntary contributions into accounts already set up to receive compulsory contributions.
198. Ingles (2015, p. 21).
199. Grattan analysis of APRA (2014)**APRA2015JuneSuperPerformance** and Treasury (2015c). The combined value of tax expenditures on superannuation contributions and fund earnings using the Treasury's 'revenue gain' approach exceeded \$27 billion in 2014-15, and is expected to rise to \$40 billion by 2017-18 Treasury (2015c). It is often cautioned that one cannot simply add together the Treasury's 'revenue foregone' tax expenditure estimates for contributions and earnings tax breaks into one figure. However, we estimate the degree of 'double counting' in combining the 'revenue gain' tax expenditure estimates from abolishing each of these tax breaks at less than \$1 billion a year over that period. Alternatively, **ASFA2015TreasurySubmission** puts the combined annual revenue cost of contributions and earnings tax breaks at \$23 billion in 2014-15.
200. Treasury (2015a, pp. 4-14).
201. See endnote 199.
202. Ibid. (pp. 4-14).
203. APRA (2014, Table 7).
204. **RiceWarner2015SubmissionTaxWhitePaper** projects that the share of superannuation assets held in (tax-free) retirement pensions will rise from 32 per cent in 2014 to 38 per cent in 2029.
205. For example, Treasury analysis undertaken for the **CooperReview2013** estimated that the revenue foregone from superannuation tax breaks as a result of moving to a 12 per cent Superannuation Guarantee would exceed the budgetary savings from lower Age Pension spending by close to 0.5 per cent of GDP a year in the short-term, with the net budget cost only falling to 0.2 per cent of GDP a year by 2050. Based on these figures, the cumulative increase in Commonwealth public debt from increasing the Superannuation Guarantee to 12 per cent would exceed 10 per cent of GDP by 2050.
206. **Clare2015; ASFA2015TreasurySubmission; Mercer2013a; Carling2015**.
207. Treasury (2015c, p. 124). Treasury's 'revenue gain' estimate from abolishing contributions tax concessions assumes that all voluntary super contributions are directed towards other alternative tax-preferred investments, which are typically funded out of post-tax income. The estimate for earnings tax breaks accounts for lower contributions to super as it becomes

a less attractive savings vehicle, and greater voluntary withdrawals from super in order to take advantage of tax-free thresholds and offsets available elsewhere in the personal income tax system.

208. **Carling2015; Sloan2015.**
209. **MaddockKing2015; Freebairn2015.**
210. **Mercer2013a; FSC2015; Clare2015.**
211. Half the value of super earnings tax breaks go to those in top 20 per cent of income earners (vide Section 6.2 infra). Figure 47 on page 161 shows that people in the top 10 per cent of income earners are unlikely to receive much Age Pension over their lifetimes, particularly compared to the value of tax breaks they will receive.
212. Combined couple rate of Age Pension, including Maximum Pension Supplement and Energy Supplement (**DHS2015IncomeTestForPensions.**
213. Grattan analysis of ATO (2015i)**ABS2013AWE.**
214. Just under 20 per cent of retirees currently aged 80 and over remain self-funded (*i.e.* don't draw any Age Pension), compared to 35 per cent of those aged 65 years **ActuariesInstitute2015RetirementIncomes.**
215. ASFA's use of an inflation rate of 3.75 per cent (to reflect growth in nominal wages) in projecting forward the superannuation balance required at retirement to achieve its comfortable retirement standards overstates the balance required, since the nominal cost of maintaining the ASFA retirement standard is likely to only grow at around CPI: **RothmanBingham2004.**
216. **Morrison2015TheBestFormOfWelfare.** Around 45 per cent of pensioners were net savers in the first five years of receiving the Age Pension, and 43 per cent drew down on their savings. In the final five years of receiving the pension, 43 per cent of pensioners were still net savers, while just a third drew down on their savings.
217. **WuAsherMeyrickeEtAl2015** find that younger, wealthier pensioners tend to draw down on their savings but most pensioners are net savers later in life.
218. **SpicerStavrunovaThorp2015.**
219. **Cooper2015.**
220. Grattan analysis of **APRA2015JuneSuperPerformance.**
221. **ActuariesInstitute2015RetirementIncomes; Blayney2015.**
222. **ASFA2015b.**
223. Daley, D. Wood, Weidmann et al. (2014, pp. 18, 19, 49–50).

224. **LevellRoantreeShaw2015.**

225. For example, **ProductivityCommission2015-Tax-and-transfer-incidence** finds that average income taxes for a given lifetime income align closely with the annual income taxes paid by someone with that same income in 2014-15, suggesting that people's annual and lifetime incomes are closely related.

226. **Karahan2015** also finds that a large shock to income becomes less likely as workers age, and then becomes more likely again after age 50.

227. **Clare2012.**

228. For example, **Blayney2015** estimates that 75 per cent of the accumulated lifetime value of investment returns occurs beyond the age of 60 years.

229. For single men retiring to 2055. The projected lifetime cost of super tax breaks for single women in the top 5 per cent of income earners is \$1.6 million.

230. **ASFA2015TreasurySubmission.**

231. Grattan analysis of **TreasurymultipleyearsBudgetPapers200809to201516.**

232. Treasury (2012a, p. 41).

233. **Treasury2013MYEFO1314.**

234. **ATO2015LISC.**

235. **Treasury2009BudgetPapers0910.** The super co-contribution was first introduced by the former Coalition government in 2003. The government originally provided a matching co-contribution of 150 per cent on the first \$1,000 of post-tax contributions made by low-income taxpayers.

236. **Treasury2010Budget1011no2.**

237. **Treasury2011MYEFO1112.**

238. Grattan analysis of ATO (2015i).

239. APRA (2014), ATO (2015i) **ATO2015MaxSuperContrBase.** 'Compulsory' contributions also includes employer contributions beyond the 9.5 per cent super guarantee rate that are negotiated as part of collective agreements. These additional contributions beyond the SG rate are estimated to account for around 7 per cent of 'compulsory' contributions, and cover almost 1 million workers **Kelly2013.**

240. Income earners that do not have an employer making super contributions on their behalf, such as the self-employed, can access contributions tax concessions by claiming a tax deduction on super contributions they make directly to their super fund out of post-tax income.

241. **Kelly2013.**
242. Individuals aged 65 and over are also eligible for the Senior Australian and Pensioners Tax Offset (SAPTO), which can reduce their tax liability even further when recycling wage income through superannuation. ATO (2015c)
243. **ASIC2015TransitionToRetirement.**
244. Of the estimated 5 per cent of eligible Australians (workers aged between 55 and 65) who received transition to retirement pensions in 2011-12, the majority were working full time and were relatively wealthy (**ProductivityCommission2015SuperPolicyPostRetirement**). However, data on self-managed super funds suggest the transition to retirement pensions are used by around half of eligible SMSF members. This probably reflects how SMSF members tend to have more wealth and manage their superannuation more actively. **ProductivityCommission2015SuperPolicyPostRetirement**
245. A worker with annual earnings of \$115,000 would receive SG contributions from their employer of \$10,925, at the current 9.5 per cent SG rate.
246. Under the maximum superannuation contributions base, employers are obligated to make SG contributions on the first \$203,240 of employees' wages. This equates to a maximum level of compulsory SG contributions of \$19,308 in 2015-16. The maximum super contributions base would be indexed to the same level each year as the concessional contributions cap.
247. Daley, McGannon, Savage and Hunter (2013, p. 32).
248. 'Division 293 tax' imposes a 30 per cent tax rate on concessional super contributions from those whose earnings and super contributions exceed \$300,000 (**ATO2015HowisDiv293calculated**). It was introduced in 2012 (**Shorten2012**).
249. **ALP2015FairerSuper.**
250. At the time of the Henry Review, the cap was of \$25,000 or \$50,000 for people aged 50 or older (Treasury (2010, p. 100)).
251. Analysis for the Henry Review found that such a proposal would have a budget cost of \$4 billion a year by 2017-18, but this assumed a simultaneous change that allowed an income earner to make two pre-tax contributions of up to \$30,000 each year, one to their own account and another to that of their partner. This costing also anticipated a higher cap of \$50,000 on the pre-tax contributions of those aged over 50: see **Treasury2010SuperAdditionalMaterial** and Treasury (2010, p. 95).
252. **Treasury2010IGR.**
253. Deloitte (2015).
254. **Treasury2013PortfolioBudgetStatement1314.**
255. **SuperContrTaxRegs1997ATO2003ATO2008ATO2014gATO2014h**

256. Tax planning opportunities with a lifetime cap would be worth less if all taxpayers received the same value tax break per dollar contributed to super, as would occur under the model put forward by the Henry Tax Review considered in Section 4.6.
257. **Deloitte2015DynamicsofAusSuper** argued that after taking into account the timing of voluntary contributions, this would be sufficient to produce a retirement income from age 65 to the 75th percentile of life expectancy.
258. **ASFA2015TreasurySubmission**. ASFA also proposes this lifetime cap would be accompanied by a (higher) annual cap on pre-tax contributions of \$45,000.
259. **Mercer2015SubmissionToReThink**.
260. The value of the contributions tax break would fall more than shown in Figure 55 for some workers whose employers contribute more than the 9.5 per cent Super Guarantee rate under awards or agreements, so that their total contributions are more than the \$11,000 cap. Government would need to consider whether to raise the \$11,000 cap if the Superannuation Guarantee rises from 9.5 per cent to 12 per cent, as currently legislated.
261. Individuals with taxable incomes of below \$37,500 face marginal tax rates of up to 19 per cent, plus the Medicare Levy of up to 2 per cent.
262. This is consistent with Treasury (2015c), which suggests behavioural change will be limited: the difference between Treasury's 'revenue foregone' and 'revenue gain' estimates of the cost of contributions tax breaks is just 5 per cent.
263. **DaleyCoates2015PropertyTaxes**.
264. Daley, McGannon and Savage (2013)**DaleyWood2016NG**.
265. The Henry proposal could be combined with a tighter cap on concessional contributions to reduce the tax breaks available to high-income earners. However, this would still entail the administrative challenges detailed below.
266. Defined benefit superannuation schemes are already required to report the notional taxed contributions for each fund member in order to administer the annual cap on pre-tax super contributions (**ATO2015DefinedBenefitFundsNotionalTaxedContributions**). Such notional contributions are subject to Division 293 tax where the taxpayer meets the income test (**ATO2015AssessingYourDiv293TaxDebt**).
267. **Sloan2015a**.
268. Super funds pay 15 per cent tax on all super contributions financed from the pre-tax income of the super fund member. However, super funds do not pay tax on any contributions financed from post-tax income, as this income has already been subject to full rates of personal income tax.
269. For employees with multiple employers, these would be based on the schedules in place for PAYG tax collections. **ATO2015WhenYouHaveIncomeFromTwoPayers**.
270. The administrative issues are discussed further in **Mercer2015SubmissionToReThink**.

271. Daley, D. Wood, Weidmann et al. (2014).
272. About 30 per cent of those aged between 60 and 70 make post-tax contributions, contributing an average of \$40,000 each (Figure 72). If these contributions are from earnings, then they would be in addition to \$35,000 of pre-tax contributions. Average taxable incomes for this group are around \$50,000 (ATO (2015i)), and less than half are still in paid work (**ProductivityCommission2013AgeingAustralia**).
273. Individuals can 'bring forward' three years of their pre-tax cap entitlement to make pre-tax contributions of up to \$540,000 in a single year (**ATO2015SuperContr-too-much-super-can-mean-extra-tax**).
274. **RiceWarner2015SubmissionFSI**.
275. The tax on death benefit for superannuation funds is intended to restrict the use of superannuation tax concessions for estate planning purposes. Tax is liable on benefits transferred to dependents if taken as an income stream (if neither the deceased or the beneficiary is aged 60 years or over), but not on lump sums. Tax is liable on benefits paid either as lump sums or income streams if both the deceased and the dependent are less than 60 years of age. Higher taxes also apply on death benefits transferred to non-dependents. The precise tax payable on death benefits also depends upon whether the super fund has already paid taxes on contributions and fund earnings; **ATO2015DeathBenefits**.
276. **IndustrySuperAustralia2015-Nearly-half-Australians-not-have-comfortable-retirement**.
277. The lifetime cap would be fixed in nominal terms. Alternatively, the cap could be indexed to wages growth, in \$25,000 increments.
278. For example **RiceWarner2015SubmissionTaxWhitePaper** have suggested a lifetime cap set at \$500,000, while **ASFA2015TreasurySubmission** have proposed a \$1 million.
279. The optimal level of the lifetime cap that balanced flexibility against creating tax-planning opportunities for high income earners would depend upon contributions behavior of those that make large post-tax contributions over their lifetimes. However, there is no publicly available data on this issue.
280. For example, women returning to work after the birth of a child tend to work part-time, which limits the disposable income available to be contributed to super **ProductivityCommission2009PaidParenta**
281. The CGT cap amount is indexed in line with AWOTE, in increments of \$5,000 (rounded down). The new indexed amount is generally available each February **ATO2015CGT-cap-amount**.
282. Transferring assets into a superannuation fund typically triggers a 'CGT event', requiring individuals to pay tax on any capital gains up to that point. However, no CGT is payable on small business assets up to the lifetime CGT cap owned for at least 15 years, or on assets owned for less than 15 years, up to a lifetime limit of \$500,000 (**ATO2015-Small-business-entity-concessions**).
283. For example, **PBO2015-Super-for-retirement-not-tax-minimisation** estimate that a lifetime cap of \$500,000 would raise \$165 million over the four years of the forward estimates. By contrast, a cap of \$800,000 would cost the budget \$335 million over the same period.

284. For example, the **ActuariesInstitute2012-Australias-Longevity-Tsunami** estimate that retirees aged 65 in 2010 will live on average until 86 for men and 89 for women.

285. The requirements for reporting member contributions to the ATO vary across different types of superannuation funds. Funds regulated by the Australian Prudential Regulation Authority (APRA) must report contributions and allocations by 31 October if they received contributions in the financial year. Self-managed super funds report any contributions received when lodging annual SMSF income tax returns with the ATO, which are due any time from 31 October to 5 June of the financial year after the contributions are received (**ATO2015l**).

The ATO aggregates all contributions data from superannuation funds and examines deductions claimed on each taxpayers' income tax return to determine whether the taxpayer exceeded either the concessional or non-concessional contributions cap (**InspectorGeneralTaxation2014-Review-into-super-excess-contr-tax**).

286. As noted earlier, the average effective tax rate on super fund earnings in the investment phase is typically lower – ranging from 7 to 10 per cent depending on the mix of fund investments – since superannuation funds receive refundable dividend imputation credits for investments in Australian equities. **Mercer2013**.

287. Capital gains would be taxed at 10 per cent, as occurs presently for those aged below 60.

288. The Financial System Inquiry (2015, p. 140) Financial System Inquiry (2015) noted the benefits of aligning the tax rate on super fund earnings in the accumulation and drawdown phases. Different tax rates on earnings across these phases 'can act as a barrier to funds offering 'whole-of-life' superannuation products and increases costs in the superannuation system' Financial System Inquiry (ibid., p. 140).

289. This analysis is based on the ABS Survey of Income and Housing (**ABS2015-Survey-of-income-and-housing**). It is broadly consistent with analysis based on total superannuation balances. In 2015, Australian's superannuation assets were valued at \$2 trillion (**APRA2015JuneSuperPerformanceMinifieSavage**). As of June 2013, those aged 60 or over owned 33 per cent (\$409 billion) of super assets held in APRA monitored super funds – up from 23 per cent in 2005. Those over 60 owned around 42 per cent of the assets (\$321 billion) in SMSFs (Grattan analysis of **ATO2014e**). This implies that today those aged over 60 hold about \$730 billion in super, assuming that the proportion of the assets held by those over 60 has remained constant since 2013 – it has probably in fact increased. About 70 per cent of the assets owned by those over 60 are in drawdown phase where they pay no tax. **RiceWarner2015SubmissionTaxWhitePaper** projects that the share of all superannuation assets held in (tax-free) retirement pensions will rise from 32 per cent in 2014 to 38 per cent in 2029. Each year, assets in superannuation accounts earn an average of around 6 per cent – around \$120 billion in income. On this basis, assets held by those over 60 in the drawdown phase earn around \$26 billion a year.

290. **ASFA2015TreasurySubmission**. Before 2007, there were no restrictions on the amount of post-tax super contributions that people could make. However, the abolition of reasonable benefit limits – which restricted how much someone could withdraw tax-free from their super – allowed those that had already accumulated very large super balances to enjoy tax-free earnings in retirement.

291. Capital gains on investment assets held in super funds are taxed at 10 per cent during the accumulation phase. However capital gains are tax free if sold when in pension phase (Treasury (2015b, p. 69)).
292. **Mercer2015SubmissionToReThink.**
293. See section 5.2 on page 198.
294. The tax on earnings would apply to all defined contribution superannuation funds and funded defined benefit schemes. Reducing the 10 per cent tax offset for defined benefit income would ensure that similar tax breaks are removed for beneficiaries of unfunded defined benefit superannuation schemes (**ALP2015FairerSuper**).
295. The effective tax-free threshold (including the Low Income Tax Offset) for taxpayers below 60 is \$20,542.
296. The precise value of the tax-free threshold would depend upon the mix of capital gains (taxed at 10 per cent) and other earnings from super fund balances.
297. 2015-16 saving is based on Grattan analysis of ABS (2013b). The ALP suggested that in conjunction with reducing the threshold for Division 293 tax on contributions from \$300,000 to \$250,000, this policy would raise \$1.9 billion over three years of the forward estimates (from 2016-17) and \$14.3 billion over the ten years to 2026-27 (**ALP2015FairerSuper**).
298. **Clare2015b.**
299. For a home owning couple. A cap of \$2.5 million is almost five times the assets test that will apply for a home owning single from 2017.
300. Grattan Institute calculation for 2015-16, based on **Treasury2010SuperAdditionalMaterial**.
301. Treasury (2010, p. 36).
302. ATO (2015c).
303. Includes the value of the Senior Australians and Pensioners Tax Offset.
304. Grattan analysis of ABS (2013b).
305. Grattan analysis of **NationalCommissionAudit2014**.
306. This estimate is based on the conservative assumption that 75 per cent of people 60 or older are in the benefits phase (Grattan analysis of ABS (ibid.)).
307. Senior Australians of Age Pension age are eligible for the Senior Australian and Pensioners Tax Offset (SAPTO), which increases the effective tax-free threshold for single retirees to \$32,280, and \$57,948 for couples.
308. As noted in Section 2.7, Treasury estimates of the revenue gain from abolishing superannuation earnings tax breaks outright suggest that the impact of behaviour change is small,

and would reduce the boost to revenues by just 12 per cent (including the effect of lower super contributions on fund balances and taxable earnings).

309. This may help to explain why capital gains tax receipts have consistently fallen well short of Treasury forecasts over the last few years (Treasury (2012b, p. 51)).
310. As noted in Section 3.5, the top 10 per cent of income earners receive little or no Age Pension payments over their lifetime. Therefore reducing the value of superannuation tax breaks to this group will have little impact on future Age Pension expenditure, particularly compared to the additional revenue collected.
311. Financial System Inquiry (2015, p. 44).
312. **RiceWarner2015SubmissionTaxWhitePaper.**
313. Ibid. (p. 139).
314. Ibid. (p. 141).
315. For example, changes in super fund unit values due to unrealised capital gains and deferred tax assets (*i.e.* previous losses carried forward to offset future tax) are captured in unit values, but fall outside the definition of ‘earnings’. See Financial System Inquiry (ibid., p. 26).
316. **ASFA2015TreasurySubmission.**
317. **MinifieSavageCameron2015.**
318. Grattan analysis of ABS (2013b).
319. **ASFA2015TreasurySubmission** have suggested a similar mechanism in their submission to the tax reform white paper, albeit with different thresholds.
320. Daley, D. Wood, Weidmann et al. (2014, p. 47).
321. **Teles2013.**
322. Daley, McGannon, Savage and Hunter (2013, p. 29).
323. Ibid. (p. 37).
324. **ACOSS2015–Sub-to-Govt-Retirement-Incomes-Review.**
325. This analysis is consistent with **FengGerransClark2014**, which reported that over 30 per cent of those aged over 50 made voluntary contributions from post-tax income in 2007, compared to around 10 per cent of those aged below 40.
326. Most people can only access their superannuation once they are retired, or aged 65 years and over. Workers aged 60-64 can access their super tax-free under ‘transition to retirement’ rules, and still make concessional contributions, provided that workers withdraw between

4 and 10 per cent of their superannuation balances each year as an income stream (**ProductivityCommission2015SuperPolicyPostRetirementATO2015a**).

327. Individuals aged 65 and over are also eligible for the Senior Australian and Pensioners Tax Offset (SAPTO), which can reduce their tax liability even further when recycling wage income into superannuation.

328. **ASIC2015TransitionToRetirement**.

329. For example, of the estimated 5 per cent of eligible Australians (workers aged between 55 and 65) who received transition to retirement pensions in 2011-12, the majority were working full time and were relatively wealthy **ProductivityCommission2015SuperPolicyPostRetirement**.

330. **MirrleesAdamBesleyEtAl2011**.

331. Ingles (2015, p. 16).

332. Treasury (2010, p. 97).

333. **Mercer2013a**.

334. Wakefield (2009, p. 7).

335. A similar approach appears to have been adopted in the Henry Tax Review (see: Treasury (2010, Figure A1-19)) where the effective tax rate on individual equity holders is very low, and in fact becomes negative for those facing low effective marginal tax rates, compared to a pre-paid expenditure tax (TEE) benchmark (Treasury (ibid., p. 67)).

336. **DaleyCoates2015PropertyTaxes**.

337. Commonwealth Grants Commission (2015a, p. 12).

338. **Treasury2015FinalBudgetOutcome1415**.

339. The OECD average was 19.5 per cent in 2012. See **OECD2014**. Australia's GST collections were 3.3 per cent of GDP, compared to the OECD average for value added taxes as a percentage of GDP of 6.6 per cent. Collectively, taxes in Australia in 2012 were a lower proportion of GDP (27.3 per cent) than the OECD average (33.7 per cent). See: OECD (2015). The exceptions are Japan and the United States (which does not have a broad based consumption tax) **OECD2014**.

340. **OECD2014**. The OECD calculates its consumption tax coverage ratio based on the difference between consumption tax revenue actually collected and what would theoretically be raised if consumption tax were applied at the standard rate to the potential tax base in a 'pure' consumption tax regime.

One reason that New Zealand has such high coverage is that it applies GST to *government-provided* services such as health and education. Beyond the question of whether this is worthwhile, this would be more difficult under Australia's federal system because it would require state governments to impose and collect the tax on behalf of the Commonwealth

Government. See: **Millar2015**. But even discounting this, New Zealand's GST is still substantially broader than Australia's.

341. See **Treasury2014-Budget-Papers-2014-15PBO2014TrendsAustralianGovtReceipts1982to2013** 41 for a more detailed discussion of these trends.
342. The decline in the household savings ratio coincided with a period in which household wealth and debt levels grew strongly (**PBO2014TrendsAustralianGovtReceipts1982to2013**).
343. Daley, D. Wood, Weidmann et al. (2014, p. 28).
344. Ultimately future housing prices will depend on population growth, household size and whether supply of new properties keeps pace with the growth in demand. See: **RBA2014SubmissionAffordableHousingInquiry**.
345. **CostelloBudgetSpeech2000-01**.
346. In theory, broad-based payroll taxes and consumption taxes are equivalent, but the range of exceptions and thresholds provided by state governments for payroll taxes have considerably reduced their efficiency.
347. Treasury (2010, p. 274).
348. Under an income tax system, individuals pay tax on their labour income (regardless of how much they save) and then again on any returns to saving that income. See: Treasury (2010)
349. Daley, D. Wood, Weidmann et al. (2014, p. 27).
350. For a summary, see: **McCaffry2008**.
351. **BlumkinRuffleGanun2012SausgruberTyran2005**. This is because of the 'money illusion': individuals tend to think in nominal rather than real terms.
352. Treasury estimates that the 'marginal excess burden' – the loss of economic activity for each dollar of tax levied – is 21 c for a flat labour income tax and 17 c for a broad-based GST. See: Treasury (2015b, p. 25).
353. **ProductivityCommission2015-Tax-and-transfer-incidenceHardingNguVuPayneEtAl2009Reference-G** which recommended mechanisms to improve these incentives. **Apps2015** argues that GST could exacerbate this problem because the unit of taxation is the household – *i.e.*, all household consumption is taxed at a flat rate. In contrast, the progressive nature of labour income allows a lower tax rate for the second earner on the lower wage. Our proposed compensation package that targets income tax cuts at the low and middle brackets (Chapter 3) will help mitigate this concern.
354. The OECD draws a distinction between goods and services taxed at reduced rates, including a zero rate, and goods that are exempt (input-taxed). Under this classification, in Australia, health, education, fresh food, water and childcare are taxed at a reduced (zero) rate and financial services and housing are exempt.

355. All costings in this paper are for 2014-15. Using historical data allows more robust modelling of the distributional impacts of changes in the GST and proposed compensation packages. As GST revenues are forecast to grow, the revenues to government from increasing or broadening the GST will be higher in future years.
356. Financial services exemptions include supplies by charitable organisations and administrative exemptions for very small businesses. See Treasury (2014b, p. 169).
357. **Freebairn2013**; and Treasury (2010, p. 52).
358. The invoice basis on which GST is determined for most other goods and services is very difficult in circumstances where there is an implicit fee or margin arising from financial transactions entered into over a period of time with a number of customers. See: **Evans2015Davis2015** for more discussion.
359. **OECD2014**. The Treasury potential revenue gain estimates in Figure 79 on page 254 assume away this difficulty.
360. **Evans2015; Weatherill2015**.
361. **Davis2015**.
362. In other words, the value threshold will be set at zero. The measure to include GST on cross-border supplies of digital goods and services was included in the May 2015 Budget, Treasury (2015a, p. 20). The government announced a policy to charge GST on cross-border supplies of physical goods under \$1000 following agreement with the state and territory treasurers at a meeting in August 2015. **Hockey2015–GST-import-threshold**.
363. Netflix indicated they will continue to comply with local tax obligations. Apple already charges GST on its digital downloads in Australia. See: **Coorey2015-Netflix**.
364. The Low-Value Parcel Processing Taskforce that explored this issue in 2012 said that GST obligations imposed directly on international suppliers would 'likely be non-enforceable, and hence rely on voluntary cooperation by suppliers'. **Treasury2012c**
365. **Hockey2015–GST-import-threshold**.
366. **OECDKoreaInstitutePublicFinance2014-Distributional-Effects-Consumption-Taxes**.
367. KPMG Econotech (2011).
368. **AtkinsonStiglitz1976**.
369. **GST-Act-1999**.
370. Currently private schools and hospitals are classed as charities (see **ACNC2015**) so there would need to be some amendments to the charities exemption to apply the GST to these services.
371. **Freebairn2015**.

372. For example, the recent proposal to remove GST from feminine hygiene products. However, the proposal failed because it did not receive unanimous support from State and Territory governments. See: **Hockey2015-Federal-Finance-Relations**.
373. Recent poll of the 49 senior economists on the National Economic Panel, **NationalEconomicSocietyAustralia**.
374. **MirrleesAdamBesleyEtAl2011**.
375. In these examples the purpose of the taxes is to change relative prices and therefore behaviour rather than to simply raise money. **MirrleesAdamBesleyEtAl2011** and Treasury (2010).
376. For example, the Australian Government's Preventative Health Taskforce recommended a review to consider increasing taxes on energy dense foods. **Preventative-Taskforce2008-Australia-Health**.
377. A recent study using MySchool data to adjust for relative disadvantage suggests that Catholic private schools receive only slightly less (and in some cases more) government funding per student for a given range of student disadvantage. Other independent schools receive somewhat less but the gap is decreasing over time. **BonnerSheperd2015**.
378. **Megalogenis2010**.
379. **Megalogenis2010; Henry2015**.
380. See, for example, **Morrison2015-QnA-Melbourne-Institute**.
381. For example, Labor Minister Tony Burke cited in **Hutchens2015-ALP-not-support-GST**.
382. See **Daley2013** for further discussion.
383. For the claim that GST collects more from high-income households, see **OECDKoreaInstitutePublicFinance** and Treasury (2010). Fresh food amounts based on Grattan estimates using Treasury (2015c) **ABS2011HES0910curf**.
384. The bottom quintile of households by income spend around 40 per cent more than they earn before taxes and transfers, while the top quintile saves the equivalent of 20 per cent of their gross income.
- At first glance, analysis by the Productivity Commission (PC) casts doubt that the GST is regressive – it shows that poorer households pay only slightly more GST as a proportion of their income than richer households. However, this is because the PC presents GST burden as a share of disposable income but ranks households based on income levels before tax and transfers. See: **ProductivityCommission2015-Tax-and-transfer-incidence**. Using the same measure of income to assess the GST burden and rank household incomes – either both gross or both disposable – we find that poorer households pay substantially more GST as a proportion of income.
385. Treasury (2010, p. 275) **OECDKoreaInstitutePublicFinance2014-Distributional-Effects-Consumption-Ta**
If a household saves in net terms over their lifetime (*i.e.*, they pass on some assets) then some of the tax burden will be deferred until the money is spent by the next generation.

386. **OECDKoreaInstitutePublicFinance2014-Distributional-Effects-Consumption-Taxes.**
387. ABS (2015c).
388. We allocate compensation based on the proportion of welfare payments received by each gross income quintile. For example, 33 per cent of welfare spending goes to the second income quintile and therefore 33 per cent of new welfare spending is allocated to households on welfare in this quintile. We assume no change in the taper rates for existing payments (Section 3.3).
389. Daley, McGannon, Savage and Hunter (2013, pp. 18–19).
390. **BCA2012.**
391. Newstart and family payments are indexed to the CPI, which means they increase to keep pace with movements in prices but not community living standards. In contrast, pensions (including age, disability *etc*) are indexed to Male Total Average Weekly Earnings (MTAWE) or CPI/the Pensioner and Beneficiary Living Costs Index (an alternative price index), whichever is highest. **DSS2015.**
392. The spending pattern of these households more closely resembles that of the second income quintile than the lowest.
393. Grattan analysis of ABS (2013a).
394. Deloitte (2015, p. 14).
395. Daley, D. Wood, Weidmann et al. (2014, p. 20).
396. We assume that the additional welfare in our package (totalling approximately 5 per cent of current welfare spending) increases all payment categories by an equal percentage. The number of additional individuals who would receive the Newstart allowance is given by the number of individuals without welfare payments whose taxable income is between 100 per cent and 105 per cent of the current maximum income for Newstart recipients.
397. For example, Graeme Bradley, former Business Council of Australia president, cited in: **BaloghHepworth2015.** See also: **Hockey2015d.**
398. Exemptions from capital gains tax for small business owners include: exemptions for the sale of active assets (needs to be paid into a super fund for people under 55); and an exemption for people over 55 who are retiring and selling business assets held for more than 15 years. A lifetime cap of \$1.4 million applies to these exemptions. See: ATO (2014a) as well as Part III at 198.
399. \$63,000 was the maximum income for a household in the bottom 40 per cent of household incomes in 2013-14. See: ABS (2015c).
400. Grattan analysis of ABS (2013a).
401. This is based on compensating 80 per cent of households in the third income quintile (and more with lower incomes). The income of the 60th percentile household was approximately

\$100,000 in 2013-14. See: ABS (2015c). The analysis assumes household income is earned by a single income earner. Households earning up to \$100,000 split between more than one income earner would require even larger tax cuts for equal compensation.

402. **GST-Act-Bonuses-for-Older-Australians-1999.**

403. Self-funded retirees pay no tax on any earnings within their superannuation accounts or on any draw-downs from these accounts. See: Part III.

404. Daley, D. Wood, Weidmann et al. (2014, pp. 25–27); and Daley, McGannon and Hunter (2014, p. 17).

405. **DuckettBreadonGinnivanEtAl2013; DuckettBreadonRomanesEtAl2015.**

406. **Daley2015.**

407. **COAG2011.**

408. **Treasury2014-Budget-Papers-2014-15.**

409. **SenateEconomicsLegislationCommittee2014.**

410. **SenateEconomicsLegislationCommittee2014.**

411. **GST-Act-Rate-Base-1999.**

412. **Twomey2003.**

413. See Chapter 2 on page 15, also Martin Parkinson cited in **Uren2015-Parkinson-tackle-spending-revenue.**

414. Commonwealth deficit for 2015-16 estimated at \$35.1 billion. **Treasury2015FinalBudgetOutcome1415.**

415. Scott Morrison as quoted in **Coorey2015a.**

416. **FinancialServicesCouncil2015-Tax-white-paper-submission.**

417. **PropertyCouncil2015-Tax-reform.**

418. A full one percentage point cut to all brackets would cost around \$6.2 billion, see: Table 12 on page 281 on the budgetary costs of income tax rate changes.

419. Approximate figure based on the tax rate that would reduce the \$68 billion in company tax collections in 2014-15 by approximately \$5 billion. The **BusinessTaxWorkingGroup2012** released a discussion paper that estimated a \$5 billion cost to revenue (before dynamic changes such as increased activity) from a 3 percentage point cut to company tax. Company tax receipts are at a similar magnitude currently to what they were at the time of that estimate. See: Treasury (2015a, Statement 4).

420. It would be possible to phase in this transition over time – with additional funding initially tied based on the existing profile of tied grants but converting to untied funding.

421. The Issues Paper for the White Paper on Reform to the Federation points to accountability for performance as one of the key issues to be considered in reforming the federation **PrimeMinisterCabinet2014a**.
422. This assumes that the states receive a net increase in funding from the package of \$5 billion a year to offset the historic reduction in Commonwealth tied funding for health.
423. A number of concerns have been raised about the way tied funding allows the Commonwealth to exert a degree of control over state service delivery. First, tied funding undermines the benefits of subsidiarity – the greater flexibility provided when the lowest level of government possible provides the service. Second, it reduces democratic accountability of state governments and encourages ‘blame shifting’ across levels of government. Third, it can reduce efficiency when state governments focus on meeting the set of performance indicators for tied funding rather than delivering the best outcome.
424. **Treasury2015MYEFO201516**.
425. Treasury reports Australian Government net debt since 1970-71 Treasury (2014a, p. 273). Projected debt of 18.5 per cent of GDP is higher than any year reported in the Treasury series, exceeding the previous peak of 18.1 per cent of GDP in 1995-96.
426. The IMF Article IV report on Australia in September 2015 concluded that: ‘Medium-term potential growth is likely to be around 2½ percent rather than the 3¼ percent of the past, bringing per capita GDP growth back to the advanced economy average of around 1 percent’. See: **IMF2015b**.
427. Daley, D. Wood, Weidmann et al. (2014, p. 9).
428. **Daley2013**.
429. 2015-16 Budget Paper 1. Table 5 memoranda. http://www.budget.gov.au/2015-16/content/bp1/html/bp1_bs4-03.htm
430. **ReinhardtSteel2006**.
431. **Evans2005; Kenny2005**.
432. **AustralianGovernment1985**.
433. **RalphReview1999**.
434. The CGT exemption for the family home is a significant cost to the budget. Changing this policy would have many social and political implications beyond the scope of this report. See: Daley, McGannon, Savage and Hunter (2013), pp.43-45.
435. They simply offset the loss of purchasing power as price levels increase. See: Treasury (2015b, p. 58).
436. **ABS2015HousingFinance**.

437. ABS (Various years[a]).
438. **Finance2015**.
439. **Haldane2015**.
440. This chapter discusses the nominal risk-free rate, which compensates for both inflation and waiting. In Australia the 5 year government bond rate – a proxy for the risk-free rate – has averaged around 2.8 percentage points above the inflation rate over the past 25 years. **RBA2015CapitalMarketYields**.
441. Treasury (2010, p. 32); Treasury (2015b, p. 58); **MirrleesAdamBesleyEtAl2011**.
442. Treasury (2010, p. 12).
443. **MirrleesAdamBesleyEtAl2011**. See also the sources cited Ingles (2015, p. 2). Others such as **Carling2015** suggest the optimal tax rate on capital gains may be zero.
444. This is because Banks and Diamond (2008) also consider progressivity: they point out that those with higher earning capacity (generally higher levels of education) tend to have greater ability and willingness to smooth consumption over their lifetime, while those with lower earning capacity tend to be more uncertain about their future lifetime earnings.
445. Excess returns are defined broadly to include the investment risk premium (required to compensate the investor for uncertain returns), economic profits (returns due to unique skill, idea or patent) and supernormal returns (higher returns from good luck). See: **PresidentsAdvisoryPanelTaxReform2005Proposals**.
446. **GreenMyersonLichtmanEtAl1996** demonstrate older low income adults have much higher discount rates (*i.e.* they put more value on consumption today rather than in the future) than higher income adults of all ages. Others have also identified that those on lower incomes have higher discount rates: **ReimersMaylorStewartEtAl2009HarrisonLauWilliams2002**.
447. **ClemensLammamLo2014**. If capital gains were taxed on an accrual basis and capital losses were fully tax refundable, then taxing gains in full would be neutral with respect to risk. However, since losses are only deductible against gains, investors risk making a loss they will not be able to deduct. It is not clear whether deferral of taxes on gains until realisation, itself a significant tax advantage (Section 2.2), is itself enough to compensate investors for this risk. **Burman2009ProductivityCommission2004FirstHomeOwnership**.
448. **Burman1999**.
449. Optimal taxation requires that commodities should be taxed at rates inversely related to their demand elasticities. So if demand for future consumption is relatively inelastic, an efficient tax system would more heavily tax saving activity. Ingles (See: 2015, pp. 21–22).
450. **DaleyMcGannonGinnivan2012**.
451. Bank deposits comprise 20 per cent of the assets of the households in the lowest income decile compared with around 5 per cent for the top two income deciles (HILDA (2015)).

452. **Ingles2009TaxEquity**; and Ingles (2015, p. 22).
453. Daley, McGannon, Savage and Hunter (2013, pp. 43–45).
454. Owner-occupied housing (net of property loans) is almost 40 per cent of the net worth of Australian households. **ABS2015HousingFinance**.
455. The tax-free status of the family home is so entrenched that a recent inquiry into the Tax Expenditure Statement recommended it be removed as a tax expenditure, arguing that it now so unquestioned it is in effect the benchmark tax treatment for this asset. **HouseOfRepresentativesStandingCommitteeonTaxRevenue2015TES**.
456. The Henry Tax Review recommended that long term lifetime savings through owner-occupier housing continue to remain exempt from tax because of these benefits Treasury (2010, Part A, p. 4)).
457. **ABS2015HousingFinance**.
458. **Evans2005; MinasLim2013**.
459. **OECD2006TaxationOfCapitalGains**.
460. **Ingles2009TaxEquity**.
461. **MinasLim2013**.
462. The top 20 per cent of households by disposable income save on average 35 per cent of their disposable income. This compares to dissavings of 25 per cent for the lowest income quintile and savings rates of less than 10 per cent for the second and third quintiles. **ABS2014DistributionHouseholdIncome**.
463. That is, less than \$10,000.
464. Most 30-45 year olds with no other taxable income receive very small capital gains. However, around 2.6% of this group receive capital gains in excess of \$10,000 that make up more than 95% of their total income. This small group pushes up the average capital gain for the bottom decile.
465. **Piketty2013** highlights how returns on private capital have grown faster than the economy for much of history for a number of major economies. If this continues, wealth will become increasingly concentrated. **Leigh2013**.
466. **Rognlie2014OnPiketty**.
467. **Rognlie2014OnPiketty**.
468. **TheEconomist2015NIMBYs**.
469. A sufficiently high tax on nominal gains amounts to a tax on wealth because it can eat into the real value of a person's assets over time: **Cowen2013**.

470. **Harding2013**. Although in some countries – including Denmark, Estonia, Iceland, Norway and Spain – property investments other than the family home are taxed as ordinary income.
471. For example, holding periods to receive maximum concession on investment property are ten years in Germany and Korea, 20 years in Slovenia, 30 years in France and 35 in Austria. **Harding2013**. In New Zealand, where capital gains are notionally tax free, capital gains on property purchased with the intent to sell is taxed as ordinary income. **InlandRevenueNewZealand2015MistakingPropertyDealingForPropertyInvestment**.
472. Returns on property over the last 15 years may well have been usually high, driven by the fall in interest rates.
473. Ingles (2015, p. 21).
474. Of course, owner-occupied housing also receives highly favourable tax treatment – it is exempt from capital gains tax and (net) imputed rents are not taxed. But as discussed on page 318, this reflects a deliberate policy choice to encourage people to purchase their own home. Overly generous tax breaks for investor housing undermine this objective.
475. Of course a negatively geared investment is generally not making a real loss, but is accruing capital gain, which is not included in the definition of taxable income until it is realised: **ACOSS2015NGCGTHousingCarling2015**.
476. Half of the costs of *all* investors, including those who do not borrow, or who are positively geared.
477. See for example: **Brown2012**. There is some evidence from the US of taxpayers placing disproportionate weight on tax deductions for investments. For example, taxpayers are far more likely to contribute to a tax deductible retirement saving account if they owe money to the Internal Revenue Service in excess of taxes withheld, see: **HubbardSkinner1996**. The psychic pay-off is also reflected in the popularity of managed investment schemes for agriculture in Australia that allowed investors to claim the entirety of their investment as a deduction against their wages, although many of those schemes did not make attractive investment returns. See: **LaceyWaston2004**.
478. Individuals claimed \$1.1 billion in deductions for interest costs in 2013-14 (ATO (2016a, Table 12)), which excludes interest costs for rental properties. Assuming an average interest rate of 6 per cent, the amount lent would be about \$19 billion. This is plausible: margin lending in 2013-14 was around \$11 billion (**RBA2015StatsMarginLending**), although not all of this would have been lent to individuals for share investing as some of this would have been lent to companies, and some would have been lent for managed funds. In addition to margin lending, individuals can borrow against housing to invest in shares.
479. **RBA2015StatsMarginLending**.
480. Most margin lending customers dislike margin calls, and so they tend to maintain a buffer of at least 10 per cent less than the maximum permitted leverage.
481. Ibid.

482. **FaneRichardson2004.**

483. If interest expenses were adjusted for inflation, and real gains were taxed annually as they accrue, this would present the strongest case for full deductibility of losses. But this is not the world we are in, and it is difficult to see a move to taxing accrued but unrealised gains given the issues this could cause for cashflow (Appendix A). Beyond the 'in principle' question of what income should be available for loss write-offs, quarantining losses from wage and salary income will reduce distortions by more closely aligning the timing of gains and losses.

A counter argument is that true symmetry in gains and losses would allow investors to claim back losses against previous tax paid on gains – effectively lifetime smoothing of investment income. However, this is a largely theoretical concern with little impact on behaviour: few investors aim to make losses in perpetuity.

484. If the business is a primary production business or a professional arts business, losses can only be deducted if other income (such as wages and salaries) is less than \$40,000 a year; for other businesses, losses can only be deducted if wage and salary income is less than \$250,000, and if the business has top-line income of at least \$20,000, made a profit in three of the previous four years, owns property worth at least \$500,000 used for a business activity, or uses other assets worth at least \$100,000: see **ATO2015OffsettingCurrentYearLosses**

485. **DHS2015AdjustedTaxableIncome.**

486. Passive income is more technically defined as income from rental properties or businesses in which the taxpayer does not materially participate. It is distinct from active income (wage, salary and income from business in which the person is actively involved) and portfolio income (income from interest, dividends etc). **IRS2015.**

487. International regimes are summarised in **RBA2014SubmissionAffordableHousingInquiryProductivityCommis**

488. Treasury (2010, p. 69).

489. **RBA2015SubmissionHomeOwnershipInquiry.**

490. **RBA2014SubmissionAffordableHousingInquiry.**

491. A clear majority considered capital gains as more important than rental income over a five and ten year time horizon. Seelig et al. (2009, p. 63).

492. Ibid. (p. 63).

493. Treasury (2015b, p. 65).

494. **Eslake2013**; and ATO (2016a).

495. 13.1 per cent of negatively geared investors repurchase, compared to 11.2 per cent of positively geared investors. G. Wood and Ong (2010, p. 28).

496. **ABS2016a.**

497. **KellyMaresHarrisonEtAl2013.**
498. **RBA2014FinancialSystemInquirySubmission; RBA2014SubmissionAffordableHousingInquiry; ProductivityCommission2004FirstHomeOwnership;** Treasury (2010, pp. 70 & 418); and Financial System Inquiry (2015, p. 278).
499. Financial System Inquiry (2015); **Grudnoff2015.**
500. An **RBA2015SubmissionHomeOwnershipInquiry** analysis of HILDA (2015) also suggests that higher income earners are more likely to negatively gear property. It shows that the top 20 per cent of income earners are almost ten times more likely to have a debt-financed investment property than those in the bottom 20 per cent of earners.
501. **PropertyCouncilAustralia2015WhoReallyUsesNG.**
502. **ABS2010MeasuresOfAustraliasProgress.**
503. This estimate is similar to that made by **AbelsonJoyeux2007.** They suggest the tax subsidy associated with the asymmetric treatment of gains and losses by housing investors (i.e., the interaction of negative gearing and the capital gains tax discount) is about 1.6 per cent of annual housing value (p.154). This paper also models the effect of a 10 per cent increase in tax on rental incomes – larger than effective changes from our policy (Box 16 on page 346) – it estimates a 3 per cent decrease in house prices.
504. **ABS2015ResidentialPropertyIndex; Yates2011.**
505. For the December quarter of 2015, 9.7 per cent of new residential property loans had a loan to value ratio of greater than 90 per cent, and almost a quarter have a loan to value ratio above 80 per cent. See: **APRA2016PropertyExposures.**
506. **APRA2014a.** See **Schlesinger2015** for a discussion of the impact on bank lending practices and LVRs.
507. The leverage on many existing loans has fallen because property prices rose, and a material proportion of investors chose to get ahead on their mortgage repayment schedule. See: **RBA2015StatsMarginLending.**
508. **McKellInstitute2015SwitchingGears** The measures only applied to real estate purchased after 17 July 1985.
509. **BadcockBrowett1991;** and Daley, McGannon, Savage and Hunter (2013, pp. 47–48).
510. **DiPasqualeWheaton1992.**
511. **BlackleyFollain1996** show that only a fraction of higher investment costs are ultimately reflected in higher rents, and even then, there is very limited discernible effect for a decade after any tax changes. Even **Poterba1992** who argues that changes in the tax treatment of investor housing should be reflected in higher rents, failed to find any short term impact. Real rents grew more slowly in the United States after 1986 when negative gearing was restricted and depreciation allowances were made less generous.

512. **CapozzaGreenHendershott StapledonRoberts2016** highlight that in the long run the relative shares of the cost of development versus land value (locational premium) determine the relative impact on rents and prices. Closer to the cities where land value is a larger component of property value, changes in tax will mainly change prices. For apartments and properties on the outer edges where structure is a larger share of the value, the effect on rent may be somewhat larger (and the effect on land prices smaller). However, given the size of the tax concession in the context of the overall market (Box 16), any impacts on rents for these properties are still likely to be modest.
513. This assumption is the basis for claims in some papers that tax changes for investment housing will have much larger impacts on rents than we estimate. For example, **AbelsonJoyeux2007** estimate a 10 per cent increase in tax on rental incomes would lead to a 7 per cent increase in rents and a 3 per cent decrease in property values (p.160). However, they assume that markets return quickly to an equilibrium at which returns equal the returns on other assets in the same risk group. As the empirical evidence summarised at section 6.2 shows, in reality any impact on rents is likely to be smaller and slower to take effect.
514. **Poterba1984; AlmFollain1994.**
515. **BISShrapnel2016** cited in **Daley2016onBIS.**
516. **KellyHarrisonHunterEtAl2013; KellyDonegan2015.**
517. Treasury (2010).
518. The most recent ABS lending data suggests that only 8 per cent of recent lending to investors is for construction of new dwellings **ABS2016**. As **StapledonRoberts2016** note, in addition some investors purchase dwellings that have just been constructed. Assuming the share of lending to investors for these purchases is the same as for owner-occupiers, then 14 per cent of all lending to investors would be for new dwellings.
519. Ibid. (pp. 62–75).
520. This is Treasury’s estimate of the revenue forgone from the discounted tax treatment of capital gains for individuals and trusts. That is, compared to taxing gains at full marginal rates. Treasury estimates suggest this will increase substantially over the forward estimates to \$8.6 billion in 2018-19. **Treasury2016TES.**
521. Based on the history of real risk-free returns and the Reserve Bank of Australia’s objective of keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle. See: Treasury (ibid., p. 72).
522. **BCA2016.**
523. **Vickery2016.**
524. Daley, McGannon, Savage and Hunter (2013, pp. 40–43).
525. Treasury estimates that revenue foregone from the capital gains discount for individuals and trusts will be \$6.2 billion in 2015-16, which would suggest our proposal would raise

less than \$3.1 billion. Our higher estimate is a projection from the subsequently released 2013-14 sample file. Possible reasons for the discrepancy with Treasury estimates include: different forecast methods for growth in non-capital gains income, differences in the assumptions surrounding the future incidence of the discount (i.e., what proportion of individuals will be entitled to it) and differences in estimates about capital gains in trusts (information in the sample file on trusts is limited). Whatever the reason, capital gains are highly volatile and capital gains tax collections are a source of considerable forecasting error in general. As John Clark of the Treasury notes, despite capital gains tax accounting for only around 3 per cent of receipts since 2001, 'CGT forecasts have been responsible for over 20 per cent of the forecasting error' in budget estimates, see: **Clark2014**.

526. An independent costing by the Parliamentary Budget Office in 2015 on behalf of the Australian Greens of a similar policy – a 25 percentage point reduction in the CGT discount – was forecast to increase revenue by \$3.2 billion in 2017-18, accounting for reductions in asset investment due to discouraged investor behaviour (but not changes in asset prices). Our methodology forecasts \$3.3 billion for the same policy change using data contemporaneous to that report (2012-13). Our estimate from the 2013-14 sample file is higher (\$3.7 billion) for the same policy change, due to recent real estate price growth. See: **PBO2015GreensReformingNGandCGT**.
527. CGT revenues are yet to recover following the GFC. Receipts were 0.46 per cent of GDP in 2012-13, down from a peak of 1.56 per cent of GDP in 2007-08. Even as asset prices have improved, capital losses carried forward have limited taxable gains. **PBO2014TrendsAustralianGovtReceipts1982to2013StewartMooreWhitefordEtAl2015**.
528. We estimate that this could reduce the additional tax collected per year by about \$0.2 billion.
529. The five year figure is based on estimated number of years a property owner will incur rental losses based on interest rates and returns from the lower potential return scenario in Figure 91 and Figure 94. It is also consistent with Grattan analysis of HILDA (2015) data which suggests that at least 50 per cent of negatively geared landlords are no longer negatively geared after five years.
530. Wage and salary income should include other forms of employee remuneration such as fringe benefits, allowances, and employee termination payments.
531. Tax losses from investments held in companies and trusts are carried forward and written off against future income generated within that company or trust. These loss write-offs are not restricted to any particular investment. **ATO2015OffsettingCurrentYearLosses**. Of course, investors restructuring their affairs would have to weigh up the benefits and costs of these alternative structures, including the fact that assets held within a company would not be entitled to the capital gains tax discount.
532. Alternative tax structures offer no advantage under these rules because tax losses from trusts and companies are quarantined within the structure and cannot be distributed to the beneficiaries or owners to write off against their other income. Losses must be quarantined in a trust to be carried forward by the trust indefinitely until offset against future net income. **ATO2015OffsettingCurrentYearLosses**.
533. **Commission2004a**.

534. If the business is a primary production business or a professional arts business, losses can only be deducted if other income (such as wages and salaries) is less than \$40,000 a year; for other businesses, losses can only be deducted if wage and salary income is less than \$250,000, and if the business has top-line income of at least \$20,000, made a profit in three of the previous 4 years, owns property worth at least \$500,000 used for a business activity, or uses other assets worth at least \$100,000: see **ATO2015OffsettingCurrentYearLosses**.
535. See section 6.2 on page 431.
536. Under the active asset test, small business can only claim CGT concessions for those assets used or held ready to use in the course of carrying on a business. See: **ATO2015ActiveAssetTest**.
537. **Mather2016**.
538. The short-term costing is the amount of money that would be raised in year one of the policy change, assuming taxpayers had no other investment income in that year against which to offset losses. The longer term or steady state estimate reflects the fact that losses carried forward will be written off against positive investment income as it accrues for investors
539. **ALP2016PositivePlanHousing**.
540. **Coorey2016**.
541. **McKellInstitute2015SwitchingGears**.
542. Because a second purchaser will not be eligible to negatively gear the property, the total tax benefit will be the value of negative gearing for the average period that properties are held by their first purchaser. The annual benefit is around 0.4 per cent of the property value. Properties tend to stay negatively geared for around five years (see Section 6.2 on the facing page).
543. This was reported one of the policy alternatives considered by Treasurer Scott Morrison when he raised concerns about the ‘excesses’ of negative gearing. See: **Coorey2016**.
544. A universal cap on all deductions would ultimately impose a minimum effective rate of tax for high-income earners. See: **BCA2016**.
545. According to reports, this policy option was also considered by the Treasurer in 2016. See: **Coorey2016**.
546. **ABS2015-Survey-of-income-and-housing-2013-14** and HILDA (2015) Not all of these will be negatively geared, but it is reasonable to assume that the proportion of negatively geared landlords who own multiple properties is no higher than for other landlords.
547. **Daley2015**.
548. Treasury (2010, p. 75).
549. Daley, D. Wood, Weidmann et al. (2014).

550. Ibid. (p. 14).
551. **Burman2009**.
552. **Ingles2009a**.
553. **Lindsey1987**.
554. **OECD2006TaxationOfCapitalGains; Johnson2008**.
555. Non-resident investors in Australian shares are generally not subject to Australian capital gains tax (see: *Income Tax Assessment Act 1936* (Cth), s 136-25).
556. **BurmanRandolph1994** This finding helped reconcile the high estimated elasticities from cross-sectional studies (which measure transitory effects) and the low estimates from time series studies (which measure permanent effects).
557. G. Wood and Ong (2010).
558. **Burman2009; Ingles2009a**.
559. Treasury (2010, p. 64).

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