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Defaulting into a world without growth

Satyajit Das

Economic growth is the central assumption underlying our political and economic systems. It is the mechanism relied upon for improving living standards, reducing poverty to now solving the problems of over indebted individuals, businesses and nations. All brands of politics and economics assume sustainable, strong economic growth, combined with the belief that governments and central bankers control the economy to bring this about. Like F. Scott Fitzgerald's Gatsby:

"[they believe in] *the orgiastic future that year by year recedes before us. It eluded us then, but that's no matter – tomorrow we will run faster, stretch out our arms farther*."

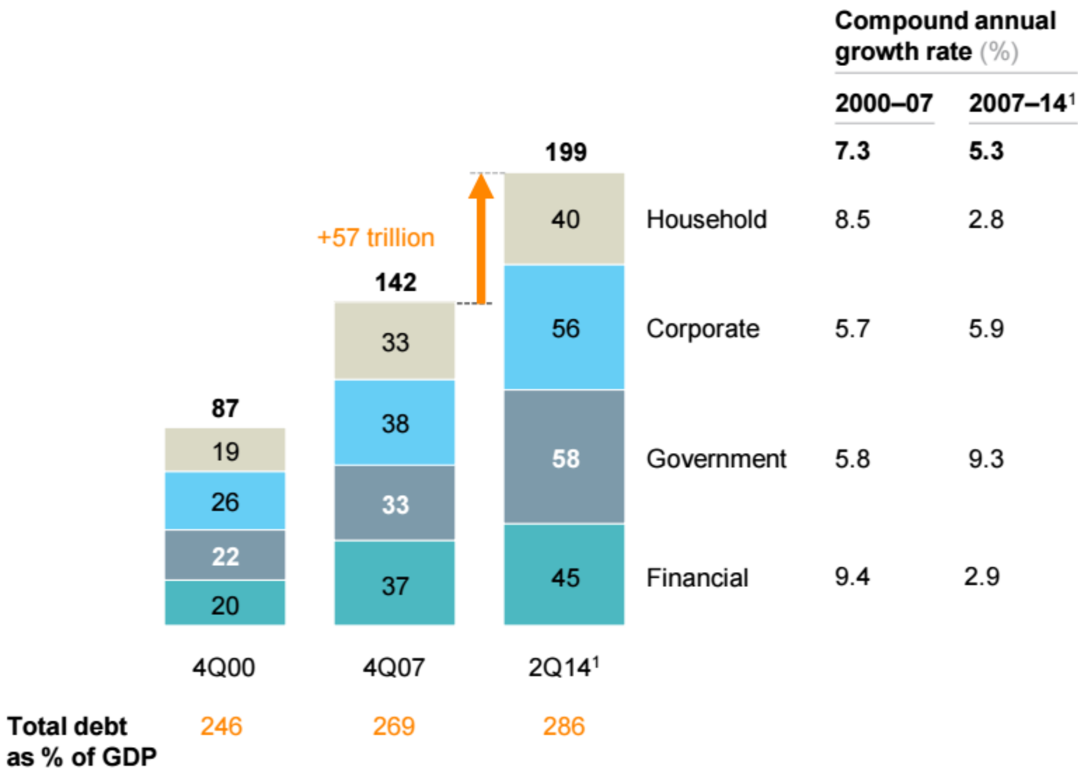
Growth fuelled by debt

But strong growth is not normal, being a relatively recent phenomenon in human history. Moreover, recent economic activity and the wealth created relied on borrowed money and speculation. It was based upon the profligate use of mispriced natural resources such as oil, water and soil. It relied on allowing unsustainable degradation of the environment. In 1954 German economist E.F. Schumacher identified the trajectory:

"Mankind has existed for many thousands of years and has always lived off income. Only in the last hundred years has man forcibly broken into nature's larder and is now emptying it out at breathtaking speed which increases from year to year."

Central to the problem is the level of indebtedness. Debt accelerates consumption, as borrowed funds are used to purchase something today against the promise of paying back the money in the future. Spending that would have taken place normally over a period of years is squeezed into a relatively short period because of the availability of cheap borrowing. Business over invests misreading demand, assuming that the exaggerated growth will continue indefinitely, increasing real asset prices and building significant over-capacity. Around 85% of the debt incurred over the last 30-35 years funded the purchase of existing assets or consumption rather than being used for creating new businesses or productive purposes which build wealth.

The problem of debt remains unaddressed. As a recent analysis by McKinsey Global Institute shows (see Table below), deleveraging has not even commenced.



Source: Richard Dobbs, Susan Lund, Jonathan Woetzel and Mina Mutafchieva (2015) Debt and (not much) deleveraging, McKinsey Global Institute.

Elegant financial engineering and 'hopium' economics cannot mask the problem of excessive leverage forever. The debt will have to be repaid out of future income or proceeds of asset sales, diminishing growth or savaging investment values. If as is likely this debt cannot be repaid, then it will be written off, resulting in an unprecedented loss of wealth for savers.

Pushing problems to the future

Compounding the problems of debt, resources and environment are challenges of slowing rates of meaningful innovation, lower improvements in productivity, demographics, inequality and exclusion.

The trade-offs are complex. Lower growth reduces environmental damage and conserves resources. But it lowers living standards and increases debt repayment problems. Faster growth lifts living standards. If the expansion is mainly debt driven, it adds to already high borrowing levels and increases environmental and resource pressures.

Lower commodity prices help boost consumption and growth. But it encourages greater use of non-renewable resources and accelerates environmental damage. Inflation reduces debt levels but penalises savers and adversely affects the vulnerable in poorer nations. Reducing free movement of goods and capital or currency devaluation assists an individual country, but the resulting economic wars between nations impoverishes everyone.

The approach to dealing with the challenges is flawed. In a Faustian bargain, policy makers sold the future originally for present prosperity and are now re-selling it for a precarious and short lived stability. There is a striking similarity between the problems of the financial system, irreversible climate change and shortages of vital resources like oil, food and water. In each area, society borrowed from and pushed problems into the future. Short-term profits

were pursued at the expense of risks which were not evident immediately and that would emerge later.

Kicking the can down the road only shifts the responsibility onto others, especially future generations. By postponing the inevitable, the adjustment becomes larger and more painful. A slow, controlled correction of the financial, economic, resource and environmental excesses now may be serious but manageable. If changes are not made, then the forced correction will be dramatic and violent, with unknown consequences.

Less room to move

The world is remarkably sanguine about a new major crisis. During the last half-century each successive crisis has increased in severity, requiring progressively larger measures to ameliorate its effects. Over time, the policies have distorted the economy. The effectiveness of instruments has diminished. With public finances weakened and interest rates at historic lows, there is now little room for manoeuvre. Resource constraints and environmental problems are increasingly pressing. A new crisis will be like a virulent infection attacking a body whose immune system is already compromised.

Economic problems feed social and political discontent, opening the way for extremism. In the Great Depression the fear and disaffection of ordinary people who had lost their jobs and savings gave rise to fascism. Writing of the period, historian A.J.P. Taylor noted:

"[the] *middle class, everywhere the pillar of stability and respectability . . . was now utterly destroyed . . . they became resentful . . . violent and irresponsible . . . ready to follow the first demagogic saviour . . .*"

In 130 AD, Claudius Ptolemaeus, known as Ptolemy, a mathematician, astronomer, geographer and astrologer, developed an astronomical system. The system fitted the accepted view of philosophers and the church that the earth was at the centre of the universe and all stellar bodies moved with perfect uniform circular motion. When Galileo observed the actual movements of heavenly objects and tested Ptolemy's theories against the evidence, the system collapsed. Economic and political processes increasingly resemble the Ptolemaic system where the possibility of lower growth, reduced wealth, reduced living standards, and constrained economic sovereignty do not feature in the policy debate.

The world generally and financial investors are remarkably unprepared for the events that are unfolding. Humanity faces this, its greatest crisis, with, in the words of Biologist E.O. Wilson, "*Palaeolithic emotions*", "*medieval institutions*" and delusions about its "*god-like technology*". Like Fitzgerald's tragic hero Gatsby, the battle cry is: "*Can't repeat the past? Why of course you can!*"

Satyajit Das is a former banker and now a world-renowned author and consultant. His latest book is A Banquet of Consequences. © *2015 Satyajit Das, All Rights reserved.*

CIPRs are coming and that's exciting

David Bell

It appears that CIPRs (Comprehensive Income Product for Retirement) will soon eventuate. The Government has finally released its response to the Financial System Inquiry (FSI). Among many recommendations across different segments of the finance industry, the Government supported the FSI's recommendation for CIPRs to be created by all institutional super funds for their non-defined benefit default members. This is a really good thing – a sound recommendation, sensibly endorsed by the Government. If the regulators (in terms of developing policy) and industry (in terms of design and implementation) get this right, then the vast majority of Australians should experience a better financial retirement outcome.

Bring it on!

I can't remember ever being so excited about a new piece of policy! Any super industry professional who is begrudging this change should self-reflect and consider a career change. Compared to other changes of the last decade or two, this one will have the greatest positive impact on the retirement outcomes of average Australians. The Wallis Inquiry (also a financial system inquiry) focused on regulation, competition and disclosure, and the outcome was arguably a collection of disclosure documents and a multitude of products that the

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average Australian doesn't understand, especially given our low national levels of financial literacy (see *Do clients understand what advisers are saying?*). The Cooper (Super System) Review created MySuper products which generated some efficiency gains but also, in my view, sowed the seeds of an unhelpful focus on fees to the possible detriment of net returns to members.

While much of the emphasis has been on efficiency during accumulation, the post-retirement solution has been left unaddressed. Here it is important to acknowledge history: Cooper's vision for MySuper was as a whole-of-life product: *"MySuper products must include one type of income stream product, either through the fund or in conjunction with another provider, so that members can remain in the fund and regard MySuper as a whole of life product".* However this was not supported by the Labor Government at the time, potentially because MySuper already represented significant change. Murray's vision for CIPR is broader than Cooper's. It is a clean sheet of paper to research, innovate and create a default retirement solution for default members. At a minimum it focuses the industry on retirement outcomes in the presence of investment risk and uncertain lifetimes, and super funds will now be required to consider mortality outcomes.

The design of future retirement solutions

Currently the industry relies predominantly on account-based pensions and an age pension system which guarantees a level of income close to ASFA's definition of Modest Retirement Outcome. Who knows what future retirement solutions will look like? While not writing off the account-based pension, we may see greater use of both life products and mortality-pooling solutions. A post-retirement solution could incorporate basic financial advice. The best CIPRs will include multiple components blended together.

I have concerns that the concept of CIPR and even Murray's proposed (and endorsed by Government) objective of superannuation (*"To provide income in retirement to substitute or supplement the Age Pension"*) are not fully formed. Perhaps it has been deliberately left this way as a concept which is then thrown to the industry and regulators to work through and devise the best solution.

It is the process which will drive numerous beneficial outcomes. I believe that at the heart it needs a retirement outcome engine (see *'Outcome engines' should be the heart of your business*). This could be mandated and reviewed by APRA: for instance, it could be a requirement that every super fund must have an internal engine capable of modelling the distribution of retirement outcomes of their default members. The development of such an engine will ensure appropriately designed products, form the basis for trustee education, and could be used as the framework for member education and engagement.

Implications across the finance industry

The implementation of CIPR will have many flow-on effects across the industry. Those who think this is an issue solely for institutional super funds risk missing opportunities and facing threats. Consider the following possibilities:

- Actuaries will be in much greater demand across the industry, particularly within super funds. It is surprising how few actuaries are employed by super funds. We could now be entering 'the age of the actuary' as their skills in risk, mortality and modelling become more highly valued.

- Fund managers have the opportunity to design products and services that assist super funds implement successful CIPRs. Meanwhile some of their products and services may prove less relevant in a CIPR environment.

- Annuity products are likely to be more actively assessed and used by super funds as a component of their CIPR. Is the current market structure of the annuity industry in Australia in appropriate shape to support the potential demand? Effectively we have one dominant player, Challenger Life, and a couple of other large groups playing a small part. Is this deep enough to ensure price competition and the opportunity to diversify exposure? Perhaps we will see other new entrants or super funds negotiating solutions directly with offshore life companies.

- Asset consultants could play a pivotal role or could lose out, depending on how they have shaped their business. Some asset consultants, those with an actuarial practice (especially if the practice has a strong interaction with the investment practice) are well-placed to perform an integral role in assisting super funds to design their CIPRs. Those whose retirement

practices are embryonic and based on simple solutions which do not account for mortality risk are at risk of losing business.

- Financial advice may be more heavily scrutinised. Most financial planning software fails to consider the range of mortality outcomes; financial plans are developed for a certain age (albeit some buffer can be built in). It would feel like a strange system if default funds have the systems and explicitly manage for mortality risk while financial planners do not.

Exciting change is upon us! Grasp the opportunity to develop better retirement outcomes for the average Australian. It is the biggest change the industry has experienced, and if we do it well, we will improve one of the best pension systems in the world.

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Choosing managers should not ignore tax impact

Raewyn Williams

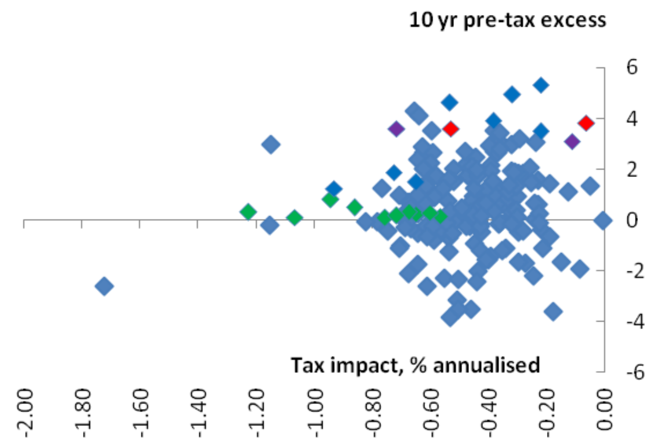
For large superannuation funds and other investors with institutional-sized portfolios, a common practice is to spread the allocation to a particular asset class among a number of managers within a 'multi-manager' structure. This provides the well-known benefits of diversification not only across asset classes, but within key allocations like Australian equities and global equities. The aim of good manager selection is to construct an optimal style blend and beat the index, noting that no one style is likely to perform well in all market conditions.

Vital information missing when selecting managers

Manager research and selection is a specialist skill which requires a comparison of alternative managers across an array of attributes, especially performance 'track record'. It is recognised that 'past performance is no predictor of future performance', so other attributes considered typically include each manager's credentials and experience, fees, structures offered, technology, research pedigree, operational support and trading efficiency. Large superannuation funds will typically engage an asset consulting firm to assist them with manager research and may also subscribe to surveys and publications which report and rank manager performance.

But much attention is paid to performance track record, and the way that performance is measured and compared by funds and advisers is very important. Yet there is a vital piece of the picture missing. Superannuation funds, like most investors, are subject to tax on investment performance and what really matters is 'what members and investors eat' in the form of after-tax returns. In the ideal world, it would be reasonable to assume that manager performance is, as standard practice, measured and compared on an after-tax basis. Unfortunately, this assumption is wrong.

How does this misdirect superannuation funds and other investors? Let's take a look at the 10 year excess returns ('alpha') of 198 U.S. mutual fund managers ending 31 December 2013 from the perspective of an Australian complying superannuation fund. We will explain the coloured data points later.



Source: Parametric (2015). Analysis is of Morningstar database of 198 mutual funds' month end performance over the period 1 January 2004 – 31 December 2013. Benchmark return is iShares MSCI EAFE ETF month end performance over same period, unhedged. Performance is gross fees. Tax impact is calculated using the tax rates and rules applicable to Australian complying superannuation funds.

Any data points above 0% on the y-axis (plotted between -6% and 6%) denote funds which appear to have outperformed by generating returns in

excess of the 4.84% per annum benchmark return we have used over a 10 year period. The data points high on the y-axis indicate the most outstanding strategies based on performance track record. The y-axis is typically the only kind of performance information considered when evaluating strategies and choosing between alternative managers.

Missing the tax impact

That approach misses a significant point. What is important to also consider is the x-axis which shows the tax cost of achieving the managers' pre-tax excess returns. It is concerning to think that many institutional investors and advisors take a 'one-dimensional view'. By fixating on the y-axis which focuses only on pre-tax performance, they do not consider the important dimension of tax (the x-axis) which can give these decision-makers a much more complete picture of each manager's performance after taxes. A few forward-thinking institutions have the ability to focus solely on pre-tax manager returns, because they employ a sophisticated overlay approach to tax management (Centralised Portfolio Management), but most do not have that luxury.

Without using the 'two-dimensional' after-tax view of manager performance, it is hard to see that:

- *strategies and managers that look very similar pre-tax can look very different on an after-tax basis* – this is illustrated by comparing the two funds highlighted in red in the above chart
- *strategies and managers that look like they are adding value can actually erode wealth on an after-tax basis* – this is illustrated by the funds highlighted in green in the above chart
- *a strategy or manager that looks superior to another strategy pre-tax can actually be inferior when compared after-tax* – this is illustrated by comparing the two funds highlighted in purple in the above chart. The fund which generated an annual pre-tax excess return of 3.60% (compared to its competitor who returned 3.09%) in fact returned only 2.88% after-tax, less than the 2.98% after-tax return of its competitor.

The simplistic one-dimensional analysis of the performance histories of the complete set of funds shows that 132 of the 198 funds outperformed the broader market; that is, generated positive pre-tax 'alpha'. This looks like good news. However, the two-dimensional analysis, factoring in tax, shows that only 99 (about half of the funds) actually added value above market. So, in fact, the news is not quite so good, and is certainly not good for a superannuation fund invested in one or more of the 33 managers whose performance looked healthy pre-tax but who did no better or actually worse than the market on an after-tax basis.

Analyse with tax profile in mind

This analysis should act as a cautionary message for superannuation funds and advisors engaging in the important task of choosing investment managers to achieve the right multi-manager and strategy mix. The message is to always check that performance is evaluated with the investor's tax profile in mind and beware of traditional pre-tax analyses and their potential to mislead.

Raewyn Williams is Director of Research & After-Tax Solutions at Parametric, a US-based investment advisor. Parametric is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) (the "Act") in respect of the provision of financial services to wholesale clients as defined in the Act and is regulated by the SEC under US laws, which may differ from Australian laws. This information is not intended for retail clients, as defined in the Act. Parametric is not a licensed tax agent or advisor in Australia and this does not represent tax advice. Additional information is available at www.parametricportfolio.com/au.

Providing financial assistance to parents

Alex Denham

A Cuffelinks reader has asked about the options and opportunities for the younger generation to financially assist their parents. He says:

"People in my situation would be curious about tax-effective ways of giving money to parents:

- *Any tax schemes (such as spouse contributions) applicable between parents and their adult children*
- *Centrelink implications of any strategies*
- *Ensuring that in the event of early death/TPD of an adult child, that parents receive some or all of the insurance/inheritance/estate payouts regardless of the marital status of the child.*

Using myself as an example, let's say I die – my understanding is that my wife would receive all of my assets and any insurance payouts as she is my spouse. However, my wish is that my mother, father and wife each receive an equal share of my wealth if I die early. How do I ensure this?"

This question is not addressed much in Australia as it's usually the other way around with parents helping out or passing on wealth to their adult children. However, this reader is Asian where the younger, working generation is pulling out of poverty and gaining affluence, so more people will want or need to assist financially-strained parents. Please note, I only refer to Australian laws for the purposes of this article.

There are no specific strategies or tax-effective schemes that I can think of to gift money to your parents. Tax is not payable on gifts either by the receiver (the parent) or the giver (you). Of course, if you need to sell assets to make the gift, then capital gains tax could apply.

It is probably the estate planning and Centrelink effects that are more important than the tax issues in most cases.

An important starting point would be to determine the reason for the gift. Is it to help with everyday expenses, to give them a roof over their head, to buy a specific item such as a car or a holiday, to provide an income stream or to pay for aged care?

Next, ask what should happen with the money or gift if or when they die? If you want to ensure that it flows back to you or to your beneficiaries such as your spouse and children, then this should be provided for in your parents' will.

Money into superannuation

If they meet the required age and work test criteria, superannuation is a tax effective way to give money to your parents. It can be used to provide a tax-free income stream in an 'account-based' pension.

However, super comes with two major problems:

1) Once the money is in your parents' superannuation account, you lose control over it. Your parents nominate where the money goes on their death, and they can change this nomination any time. Even if you hold an Enduring Power of Attorney for your parents, if they still have capacity, you must act in accordance with their wishes, so this does not give you the power to make or change a nomination without their consent.

2) If your parents are over age 65 OR start an income stream with the superannuation balance, it will be counted in in Income and Assets tests and could affect their age or other pensions.

Since a parent must satisfy the work test to make contributions if they are over 65, it may be better to help with super before this time.

Buying your parents a home

Joint Tenants

If you buy your parents a home and want to retain some control, one option is to buy it in joint names with you as one of the owners. This means it is held by each of you jointly and equally and does not form part of your parent(s) estate*, so long as they predecease you*. On the death of one joint tenant, the surviving joint tenant(s) split the shares equally. If there's only one other tenant, they inherit the whole share.

In theory this means that you will own the asset entirely upon the death of your parents. However, if you predecease one or both of them, your share goes to them and you have lost control. There is no guarantee that it will end up back in your estate.

From a Centrelink point of view, your parents will be treated as 'homeowners' and the property will be exempt from the Income and Assets test.

Owning the property yourself

Buying a home in your own name and allowing your parents to live there rent free would provide more certainty in terms of where the asset ends up.

Centrelink would treat your parents as 'non-homeowners' which imposes a higher Asset Test threshold than homeowners. The property is not assessed as an asset of theirs.

On balance, from both an estate planning and Centrelink point of view, it may be best to own the house yourself rather than buy it in their name, however be aware that if you have borrowed to buy the house, negative gearing benefits may not be available as you are not receiving market rate rental income from the property.

Gifts and paying expenses

A simpler way to help out may be to give occasional gifts or pay their ad hoc expenses from time to time. From the "Guide to Social Security Law":

If the gift is ...	Then it...
a one-off payment,	IS NOT treated as income.
received regularly from an immediate family member, *(Example: brother, sister, mother, father, son or daughter)*	IS reduced to a fortnightly equivalent, AND: • treated as income for benefit purposes, and • NOT treated as income for pension purposes.

Buying a gift such as a car in your parent's name will be treated as an asset by Centrelink/DVA.

Paying for aged care

It is not unusual for family members such as adult children to pay for their parents' accommodation costs in an aged care facility. These facilities charge an upfront amount called a Refundable Accommodation Deposit (RAD) often amounting in the hundreds of thousands. Whilst paying this RAD for a parent won't affect their age pension, it may result in them paying higher ongoing fees in the facility known as 'means-tested' fees as the RAD is counted for the calculation of this fee, so take that into account.

Your early death

Now to briefly address the final question of distributing wealth to parents in the event of your early death. The first step is to make sure you have an up to date will. If you have a will and then get married, the will may be invalid so make sure it is updated after marriage.

Take care here. If your wife and family have not been adequately provided for, there may be grounds for a Family Provision claim. In the drafting of your will, make sure your wishes and the reasons for them are very clear, and ideally you should explain the context to your spouse and children.

Insurance and superannuation payouts are generally dealt with by beneficiary nomination forms rather than the will. Unless your parents are considered your 'dependants' under both the superannuation and tax laws, it is generally more tax effective for your spouse to receive your super balances.

It's best to seek advice if looking to provide substantial financial assistance to your parents. There are other important issues which we will explore in a subsequent article.

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Fixed rate loan break costs – the need for transparency

Peter Cooper and Keith Ward

If interest rates fall and borrowers decide to repay a fixed rate loan, the bank will require the customer to pay a 'break funding fee' (sometimes called an 'early termination interest adjustment'). Banks manage the interest rate risk on their fixed rate loan book by locking in similar term liabilities. If the customer discharges the loan prior to maturity after interest rates fall, the bank will be left with no asset matching the higher cost of funds. The break funding fee compensates the bank for this cost.

The role of break funding costs

Break funding costs first came to prominence in the early 1990's when interest rates fell rapidly. Borrowers sought to refinance themselves at progressively lower interest rates. The ability of banks to charge break funding costs was crucial in

preserving margins or covering costs. One mortgage securitiser at the time, FANMAC, wrote fixed rate mortgages with no break fees and experienced significant refinancing from customers switching into lower rate loans. The increased repayments flowed through to bond holders who found the duration of their investments reduced markedly. Significantly for FANMAC, the borrowers remaining were those who had difficulty refinancing and were of a lower credit quality, adversely affecting the performance of their book.

When explained to the borrower, most understand the need for a break fee, however they are often surprised at the size of the compensation sought by the bank. It also should be pointed out if rates were to rise, allowing the banks to replace the loan with one at a higher rate, it is usual for the customer to receive a payment.

Transparency of calculation method

Over the years there has been greater emphasis on disclosure of fees and charges so a borrower can make an informed decision when comparing loan products. This trend to greater transparency does not appear to apply to banks disclosing break funding calculations.

Recently, a client of one of the authors repaid over $2 million dollars in fixed rate loans. The loans were taken when interest rates were higher and the bank, as was its right, charged the customer a break fee exceeding $80,000. This is abnormally large and the client, while understanding why the fee was charged, justifiably requested the basis on which the fee was calculated.

In order to calculate the break fee only a few bits of information are required:

- The remaining term of the loan
- The balance outstanding
- The funding cost when the loan was written
- The funding cost when the loan was discharged.

Obviously, the bank must have access to the above information to calculate the fee, yet banks are very reluctant to disclose how the break fee is calculated. Numerous requests for this information to satisfy the client have fallen on deaf ears. If a particular bank consistently charges higher break fees due to the way it locks in funding, this is important information to be taken into consideration when taking out a fixed rate loan.

Even if the bank has made an honest mistake, there is no way of checking and the client is left feeling as though the bank is concealing something. Since the size of the discharge fees often surprises borrowers, it strengthens the case for greater transparency.

Calculation based on wholesale not retail rates

A borrower known to one of the authors took out a fixed rate loan and understood the bank would pass on any economic cost if the loan was discharged prior to the fixed rate maturity. The client decided to sell her property and entered into an unconditional contract to sell, however on discharge discovered that the bank had calculated a $13,000 break cost. The client believed that there would be no economic cost as retail rates had not moved since the time she took out the loan. This is not to suggest the bank was wrong. It does though make the point that many borrowers, whilst believing they understand the terms of their loan, do not understand the way break costs are calculated. The rates used are also too much at the discretion of the banks.

Given interest rates are currently relatively low, if funding rates on fixed rates were to rise, then a mortgage discharge allows the Bank to replace the loan at a higher rate and accordingly the customer should receive the benefit. Understanding how this benefit is calculated is very important. When interest rates rise a borrower with a low fixed rate loan views their loan favorably and they may be reluctant to discharge their loan. If they are confident they will receive an accurate economic benefit on discharge this may influence their behaviour.

Banks should be more transparent in how they calculate break fund costs and disclose the basis of those calculations to their clients. If the banks were obliged on loan settlement to disclose the funding rate, it would assist in estimating future break funding costs or benefits. Mortgage brokers should also properly explain break fees to potential clients, and quantify what these costs may be depending on different rate outlooks. Borrowers are then able to make a more informed decision.

Peter Cooper is Managing Director at Cooper Financial Connections and Keith Ward is the former Head of Retail Banking St George Bank.

Busting tax myths for better reform

Deloitte

Australia's tax reform debate is in desperate need of a circuit breaker, and our report *Mythbusting tax reform #2* aims to achieve exactly that. It slices through the myths that clog clear thinking on super, negative gearing and capital gains, and recommends reforms that return simplicity, fairness and sustainability to the way Australia taxes superannuation contributions and capital gains.

This is the second of Deloitte's mythbusting tax reform reports. The first focussed on issues that are central to Australian prosperity – bracket creep, GST and company tax. This second report covers matters at the heart of Australian fairness – super, negative gearing and capital gains.

Myth 1: Superannuation concessions cost more than the age pension

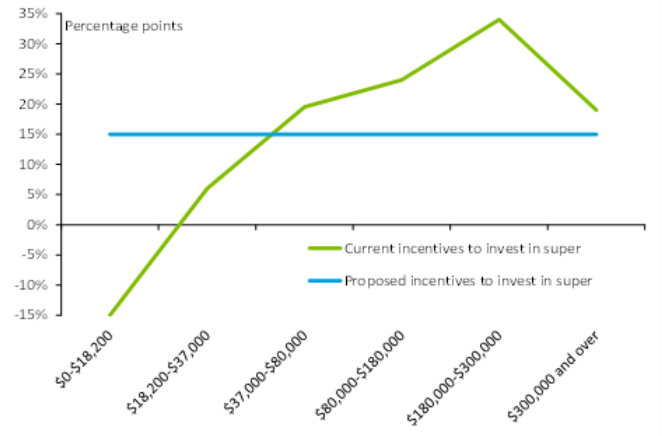
Super concessions do cost a lot – but nothing like the pension does.

The Treasury estimate of the dollars 'lost' to super tax concessions uses a particularly tough benchmark: the biggest possible tax bill that could be levied if super was treated as wage income. It also doesn't allow for offsetting benefits via future pension savings, or any offsetting behavioural changes. Better measures of super concession costs are still huge, but rather less than the pension.

Myth 2: We can't change super rules now, because the system needs stability to win back trust

So super concessions don't cost more than the pension. Yet the costs are still pretty big. And that's what puts the lie to this second myth. If our super concessions cost lots but achieve relatively little, then Australians are spending a fortune on 'stability and trust' in super settings while actually achieving neither. Governments can only truly promise stability if the cost to taxpayers of our superannuation system is sustainable.

Proposed reform of the tax benefit (loss) of diverting a dollar from wages to super



As the chart above shows, there's a Heartbreak Hill at the centre of Australia's taxation system: low income earners actually pay more tax when a dollar of their earnings shows up in superannuation rather than wages, whereas middle and high income earners get big marginal benefits. So one example of a better super tax system would be an updated and simplified version of the contributions tax changes proposed in the Henry Review – where everyone gets the same tax advantage out of a dollar going into super, with a concession of 15 cents in the dollar for both princes and paupers.

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

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

And because the incentives are simpler and fairer, the current caps on concessional (pre-tax) contributions can also be simpler and fairer. They could be abolished completely for everyone under 50, and the cap could be raised for everyone else (subject only to a safety net of a lifetime cap). That would put super on a simpler, fairer and more sustainable basis.

And, depending on how the super savings are used (to cut taxes that really hurt our economy, or to

fund social spending, or to help close the Budget deficit), the resultant package could appropriately help Australians to work, invest and save. For example, this reform alone would pay for shifting the company tax rate down to 26% from the current 30%.

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

The blackest hat in Australia's tax reform debate is worn by negative gearing. Yet negative gearing isn't evil, and it isn't a loophole in the tax system. It simply allows taxpayers to claim a cost of earning their income. That's a feature of most tax systems around the world, and a longstanding element of ours too.

Yes, negative gearing is over-used, but that's due to (1) record low interest rates and easy access to credit, (2) heated property markets and (3) problems in taxing Australia's capital gains. Sure, the rich use negative gearing a lot, but that's because they own lots of assets, and gearing is a cost related to owning assets: no smoking gun there.

Myth 4: Negative gearing drives property prices up, but ditching it would send rents soaring

And those who argue the toss on negative gearing raise conflicting arguments on its impact on housing.

Let's start with a key perspective: interest rates have a far larger impact on house prices than taxes. The main reason why housing prices are through the roof is because mortgage rates have never been lower. And, among tax factors, it is the favourable treatment of capital gains that is the key culprit – not negative gearing.

Equally, while negative gearing isn't evil, nor would ditching it have a big impact on rents. By lowering the effective cost of buying, negative gearing long since raised the demand for buying homes that are then rented out. Yet the impact on housing prices of negative gearing isn't large, meaning that the impact of it (or its removal) on rents similarly wouldn't be large.

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

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

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

So the capital gains discount is no longer meeting its policy objectives. That not only comes at a cost to taxpayers, but to the economy as well. One possible option would be to reduce the current 50% discount for individuals to 33.33%.

Deloitte's report 'Mythbusting tax reform #2' was prepared by tax and superannuation specialists from Deloitte in conjunction with economists from Deloitte Access Economics. See full report for disclaimers.

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