The Policy Pitch - *Negative gearing and capital gains tax reform: what's in the public interest?* **- Melbourne 22 March 2016**

Negative gearing and capital gains tax have been much debated over the last few months. In this event, John Daley, CEO of the Grattan Institute, and Simon Cowan, Research Manager of the Centre for Independent Studies work through the issues.

What are the economic effects of taxes on investment? Do current taxes unduly favour some investments over others? Will changes to negative gearing and capital gains tax have big impacts on rents, property prices, construction activity, or home ownership? What are the relative merits of different models for reform? And who will lose – and who will win – from reform?

Speakers: John Daley, CEO, Grattan Institute
Simon Cowan, Research Manager at the Centre for Independent Studies & Director of the CIS TARGET30

PETER MCMAHON: Good evening and welcome to tonight's *Policy Pitch*. My name is Peter McMahon and I'm the Director of Digital Marketing & Comms here at the Library. Tonight's event is held on the traditional lands of the Kulin nation. I'd like to acknowledge them as the traditional owners and pay my respects to any of their Elders or the Elders of any other communities who may be with us this evening. It's my great pleasure to welcome you to tonight's *Policy Pitch* presented by Grattan Institute and the State Library of Victoria. I'd like to start by welcoming tonight's speakers, John Daley and Simon Cowan. I'd also like to extend a warm welcome to Grattan Institute members and staff and also to our own corporate members and our many Friends of the Library.

Now in its third year, the *Policy Pitch* brings together leading thinkers to discuss the critical topics in key public policy. The *Policy Pitch* is a key part of the Library's regular program of events, the details of which you can find in our "*What's On"* brochure or on our website. Tonight's topic poses a question that continues to attract robust debate, *Negative gearing and capital gains tax reform: what's in the public interest?* To explore the topic further I'd like to introduce tonight's speakers. Simon Cowan is the Research Manager at the Centre for Independent Studies and Director of the CIS TARGET. He's a leading media commentator on policy and politics, frequently appearing on Sky network, ABC and commercial radio. He's written and presented extensively on retirement incomes, government industry policy, defence and regulation. John Daley is the CEO at Grattan Institute. As well as frequently participating in this seminar series, he appears regularly in the media to comment on public policy issues. John is one of Australia's leading public policy thinkers with 25 years' experience in private, public and university sectors.

Please join me in welcoming Simon and John.

JOHN DALEY: Good evening and welcome from me as well, our thanks again to the State Library for this magnificent venue and this series. Welcome Simon, it's great to have you here.

SIMON COWAN: Absolutely, thank you very much for the invitation. It's fantastic to be in sunny Melbourne and fantastic to see so many people who are engaged and interested in policy debate. One of the things that we see a lot of is interest in politics and I think the policy is probably more important, so thank you very much for coming.

JOHN DALEY: So you'll have noticed tonight's a little bit different. We have a conversation between two people, unlike an awful lot of our policy it's not mediated, and part of this is about how we should talk about policy some of the time.

One thing I would observe is that it's all too often very uncivil, all too often it's seen as a game about victory, and one of the things that I've always liked about the Centre for Independent Studies, despite the fact that I disagree with Simon, as you'll discover, on pretty much all topics, is that nevertheless it's a search for truth rather than for victory. I think that's really important to our civil society. We have a very large country which is obviously very important to Australia and which is currently going through a political process which is perhaps rather less civil and where the idea that you might talk in a thoughtful considered debating way about policy doesn't really seem to be part of what's going on. So I thought it was really quite important to see tonight whether civilised debate is still possible in Australia, and I'm sure it is.

As I said, Simon and I disagree about almost everything apart from that fact that owner-occupied housing ought to be included in the age pension assets test, so we're a unity ticket on that one. But, I regret to say, we're not going to go there tonight - although if anyone wants to argue we'll both give you our reasons why we think that's an excellent idea. Instead, we're going to talk about tax. There's been a lot of talk about tax. Simon, I think six weeks ago was superannuation week, is that right, and the week after?

SIMON COWAN: We've gone through the full gamut I think. We started off with the whole income tax debate and is it progressive enough, then we went through is bracket creep a real thing? Well the government said yes, then the government said no, and now the government says maybe it is. Now we've moved onto taxes on savings, which I think is probably the more interesting debate to be having here. We've run through the gamut there from capital gains tax to negative gearing and through superannuation again.

JOHN DALEY: I am slightly worried that this is actually a slightly last week event because in fact this week appears to be company tax, but I'm guessing that capital gains tax and negative gearing are coming back. It's clearly an important debate, we're not going to talk tonight about the size of government, that's another topic on which Simon and I disagree, but I think we can probably agree that some tax has to be collected.

SIMON COWAN: Yes, I'm willing to accept that some tax is necessary. There needs to be a government, although I have been involved in a few forums where people studiously and earnestly debated what would happen if you got rid of the police force and how you could contract your way out of that, so if you want to talk about that we can.

JOHN DALEY: Yes, but for tonight we're going to talk about capital gains tax and negative gearing. It's an interesting reflection that the topic that's taken all of the attention in public is around negative gearing. On the other hand, the one that's got the most money is capital gains tax and in many ways is probably the more theoretically interesting I suspect. So bad news for anyone who desperately wants to talk about negative gearing, we will get to the raw red meat in due course but you have to eat your greens first. You will see as this conversation evolves that you have to think about both negative gearing and capital gains tax as part of the same set of issues because they overlap so strongly.

The first issue is should we be taxing capital gains at all?

SIMON COWAN: Until 1985 Australia didn't tax capital gains. New Zealand still doesn't tax capital gains and a number of countries have a much lower rate of tax on capital gains than Australia does. So in a sense there is no actual capital gains tax per se, what there is is a capital gain income which is then taxed at income rates with a potential deduction attached to it for certain types of investment. So we talk about capital gains tax as if it's a distinct and single thing. It's actually an element of the overall income tax system I think.

JOHN DALEY: Yes and presumably the thing that lies behind it at a really crude level, I think the crudest way it gets put is a dollar is a dollar is a dollar, that every dollar that comes into your pocket ought to be taxed at your marginal rate of income tax, whatever that might be. Is that right or what are the arguments for saying that capital gains are different from income?

SIMON COWAN: So there are probably two streams of argument here where you could say this was different.

The first is the distinction between consumption, so income that's use for consumption, then income that's saved, which in this context is also income that's used for investment. So encouraging people to save money and to invest that money is an activity that generates additional wealth, additional income, jobs and growth. So we really want to have a system that's set up not to encourage people to consume straight away, but to save both for their own retirement, for example, and in order to create a pool of investment to generate additional income for other people. So you've got that first stream which says that taxing savings, taxing capital, that something is going to diminish the overall income.

Then you've got a second stream approach which says that in order to generate savings income you first had to have been taxed on that income as wages. So if you put your money into a home or into a bank account or into your super account you've been taxed on that income already at your full marginal rate. You then receive income from that saving or that investment and that is again taxed, in some cases, at your marginal rate. So the effective rate of taxation on that income is not your marginal rate, it's actually much higher than that and in some cases very, very high, particularly for things like bank accounts.

So you've got the stream that says you should have lower taxes on capital because it's good for the country and then you'll have a stream that says you should have lower taxes on savings because you've already been taxed on it.

JOHN DALEY: So if we just take that first argument, one way that it's often put is that the system should be indifferent between consumption today versus consumption tomorrow and the argument of course is that there's no reason why the system should be encouraging you to consume more tomorrow, on the other hand it shouldn't be encouraging you to consume less tomorrow.

So I think one of the questions then that arises is in that very pure world, and we'll get to why the world is less pure in a minute, how big does the discount have to be? Clearly it has to be more than simply your nominal rate of tax. If I tax your capital gain at the nominal rate then by definition you are losing the value of inflation. So if you've got $100 in your pocket you could spend it today or you could put it in the bank, it might earn, say, $2.50 worth of interest these days, not a lot, but of course the value of the investment would effectively fall by about $2.50, more or less the inflation rate, so you'd in effect have less in your pocket than when you started. So clearly you want not to tax that so-called inflationary gain, that's the first argument.

The second argument as I understand it is one that says yes, but we also need to compensate you for waiting. Most people would rather do something today than tomorrow, most of us have implicitly discount rates and therefore we shouldn't be taxing the so-called risk-free rate, roughly speaking whatever the government bond rate is, whatever the government can borrow at. That's indeed where the Report wound up in the UK, saying essentially that there should be no tax at all on the inflationary part and the so-called risk-free part, by and large in Australia that's inflation currently about 2.5%, on top of that the risk-free rate may be about 1.5%, 2%. But then the Report said you should be taxing the gains over and above the risk-free rate.

What do you think about that? Should we tax it over and above the risk-free rate?

SIMON COWAN: Certainly at a minimum the inflation rate needs to be acknowledged and you often see in this debate people saying a nominal capital gain of a million dollars should be taxed as if that's all income. If you bought a house in 1980 you probably paid $15,000, $20,000, $30,000, maybe $100,000. That house might now be worth a million dollars, but there's no way that your gain over that 30 year period is $900,000, it's much, much smaller than that. So we need to acknowledge the difference between real and nominal returns, but ultimately there's a difficulty in trying to capture this preference between consumption now and savings for later because it's different for everyone. When you are a young person on a relatively low income there's a good incentive for you to consume now. If you're older and looking at retirement there's an incentive for you to save naturally.

So there's a difference in the preference over time and it makes it very difficult to come up with a policy that works for everyone. This is an area that's quite complicated when you get down into the nitty-gritty of it.

JOHN DALEY: Interestingly, that would in fact suggest that our current tax policy is completely the wrong way around because what it does is it provides, in essence, very, very high concessions for people who are older who are probably going to save anyway and, relatively speaking, much weaker concessions for people that are young. Is it the wrong way around?

SIMON COWAN: Think about superannuation as a relatively tax-efficient form of saving. It's a very inefficient form of saving as a whole. So we compel people in their 20s and their 30s, when they need money for a house, when they've got a young family, to take 10% of their salary and put it into superannuation where they can't touch it for any of those expenses, and in some cases we provide them with government assistance to be able to do that. We then lock those people out of putting additional money into their superannuation when they're in their 50s and they could afford to do more so because we have the wrong incentive structure set up within our super system. So having that flexibility is actually important in that specific case and it's something I think is missed a lot in the current debate.

JOHN DALEY: Let's drag ourselves back to capital gains tax. If that's the theoretical argument, that we want it to be essentially indifferent between consumption and savings, and I take your point that we're never going to be perfect but that's the nature of the tax system, it will never be perfect given the differences in people, I'd like to suggest that that's the absolute minimum tax rate. Because there are at least three reasons why we might want the tax rate to be higher than that theoretical minimum at which we are indifferent between consumption today and saving to consume tomorrow.

The first is that although it may lead to inefficiencies, all taxes lead to inefficiencies one way or another except maybe land taxes, and we're unlikely to get a land tax big enough to compensate for the entirety of the income tax system. So the question is not whether or not a capital gains tax drags on the ideal system, the question is whether it drags more than other taxes that we're going to raise somewhere if we're not raising money through a capital gains tax. So that's question one. Then as part of that we have to look at the actual drag of capital gains taxes, and here I'd like to suggest if you look at the behaviour of people both in Australia and around the world in terms of their savings behaviour there's a stylised pattern. If anything, people on relatively low incomes tend not to save as much as might be "rational", in other words they tend to consume a bit more today and they consume a bit less tomorrow. On the other hand, people on higher incomes tend to save a lot more and indeed tend to save almost irrespective of the tax rate.

So although there's this theoretical argument that capital gains tax leads to people consuming more today and saving less for tomorrow, in practice people on higher incomes, who are those who do the bulk of the savings at least by dollar numbers, actually are probably going to save about the same amount. Normally when we find things where taxes don't change people's behaviour very much those are the kind of things we like taxing precisely because it doesn't have that much of an economic impact in practice. So that's one reason I'd like to suggest that we might well want to have a capital gains tax higher than the theoretical level.

Is that a plausible argument?

SIMON COWAN: I think the impact of inefficiency is particularly at the margin. So what you find is some people will save no matter what, some people will not save no matter what. The issue is what do they save in, how do they save, and what happens at the margins? At the moment our system directs people towards particular types of savings. The most tax efficient form of saving is probably owner-occupied housing and it's not a surprise that people are significantly overinvesting in owner-occupied housing. The other probably most tax advantaged vehicle is superannuation and so we see a significant amount of savings invested in superannuation. So the overall impact might be relatively small. The impact at the margins, where people put their money and how people save their money actually is probably more affected by some of these issues than others.

JOHN DALEY: I think one of the questions there is which distortion do we care about most here? So if we increase the capital gains tax rate maybe we'll get a little bit more in the way of savings in owner-occupied housing, effective savings there. On the other hand, we might also get more in the way of savings in bank deposits, which at the moment are particularly disadvantaged, and at least an increase in capital gains will bring investing in, for example, investor housing a little bit closer to the returns or lack of after-tax returns you get on a bank deposit.

SIMON COWAN: Sure. Australia's had two different capital gains tax regimes. The first regime from 1985 until 1999 applied indexation which is to say that you're only taxed on your real returns; the value of the inflation component of your return was taken off the capital gains tax. Since then that indexation has been converted to a 50% discount. That's created I think a misconception about what that discount is in the sense that this is somehow a bonus or an advantage. Mostly that discount simply reflects the value of inflation.

JOHN DALEY: Except that over the last 15 years it's done a lot more than that because returns have been very -

SIMON COWAN: Well, for some asset classes it has and for others it hasn't.

JOHN DALEY: Yes.

SIMON COWAN: You've got that issue that, again, you don't have neutrality between types of savings, but when we talk about it it's not a discount, it's not a bonus, it's not a tax shelter, it's supposed to reflect inflation. If it doesn't reflect inflation appropriately then we can look at changing that, but I think if you ignore that inflation component and just say, "This is a capital gain, it accrues mostly to people on high incomes, therefore it should be taxed more" I think you're missing the essential element of inflation in that calculation.

JOHN DALEY: I think the argument that I'm putting is one that says okay, I concede as a matter of theory that you should get inflation, I even concede as a matter of theory that you should get risk-free gains, but then you've got a bunch of counterarguments that all essentially push in the opposite directions.

So argument one is sure, it's distortionary but I've got to weigh that against the distortions of whatever other taxes I might raise. Whether that's company tax, which discourages investment through companies, whether it's income tax which discourages working, whether it's other forms of tax like stamp duties which discourage transactions, one way or another most of these taxes are going to distort behaviour to some extent. The second argument is one we've already talked about, that it's going to distort people away from investing in, say, bank deposits. Then the third one is around an income tax integrity argument, which I think was one of the things that did lead to the Wallis Reforms, which essentially runs like this: some people, to be blunt particularly those on higher incomes, can often manage to re-characterise what most people would think of as basically returns to working, they can get it re-characterised as capital gains and, hey presto, they're paying much less in the way of income tax.

The one I've heard about more recently is you're running a professional services firm, life is sweet, you've made lots of income this year. "But," you say to your accountant, "I don't know how much work I'm going to have next year but I've got all of these people I've got on staff and I can't let them go that fast. Consequently, I need to take a provision against this year's income in case there's no work next year, therefore rather than recording an income of $2 million I'm only going to record an income of $1 million, I'm going to take a provision of $1 million against this possibility that maybe everything will go to custard next year". Then at the end of a year, after I've had that provision on the balance sheet for more than a year, I turn around and say, “Oh good news, the work has held up so that provision can be released”. But from an accounting point of view that provision is classified as a capital gain, so simply by waiting for 12 months I’ve turned that income into something where I think most people would say you ran a professional services firms, you got paid for doing work, you got money in and suddenly that is not being characterised as income, it’s being characterised as capital gains.

SIMON COWAN: Yes, sure. There are specific situations within the tax code where you’re going to have a problem in that respect, but there’s an important element of taxation which is simplicity. So having a tax system that is designed to deal with every possible way that very clever accountants can come up with to find their edges, it creates something that’s impossible for people to understand. So to an extent you end up accepting that there’s going to be some leakages from the system to have a system that is relatively simple and that’s easy for people to use.

JOHN DALEY: Simon, is that an argument for saying keep it really simple, a dollar is a dollar?

SIMON COWAN: Well a flat tax would be very simple and you’d probably find some sympathy for that.

JOHN DALEY: No, but I’m saying you would say any money that comes into your pocket, whether it’s a capital gain, whether it’s income, keep it really simple, you tax the whole lot as a dollar.

SIMON COWAN: But you’ve got the element of fairness that has to be overlaid on that. When we talk about fairness a lot of people only talk about it in the context of ability to pay, so vertical equity, but there’s also an important element of fairness which basically says that the government should treat people roughly equally and that there is a need for the government not to create arbitrary rules that just hurt some people and hurt some people because they’ve got money. When you get to negative gearing there’s a good example of this where income is pooled but people are talking about expenses not being pooled. What’s the logic behind not applying the same rules to income and expenses? They’re two sides of the same balance sheet.

JOHN DALEY: That might be a good time to move on to negative gearing because I can see the slavering for the red meat of negative gearing which, as I said, seems to get people so much more excited that capital gains tax. Is it a natural tax deduction? Is it natural to deduct my losses on my property against my wage income?

SIMON COWAN: There are two different elements here and when people talk about negative gearing they talk about them interchangeably.

The first is the concept that expenses incurred in the generation of income should be able to be offset against income and if you’ve got pooled income on one side and you’ve got pooled expenses on the other you can offset your expenses against your income. That applies in pretty well every situation you can think of. There’s a second element to negative gearing though, and people mean the second element when they actually talk about this, which is a strategy of buying property that you know will make a rental loss in order to minimise your tax income and then achieve a capital gain at the end of it.

So there’s the investment strategy of negative gearing and there’s the concept of offsetting your expenses against your income. The concept of offsetting expenses against income I think is fairly uncontroversial. The investment strategy of negative gearing is quite unpopular. Well, popular but not publically popular.

JOHN DALEY: One of the questions I've got about whether you are really offsetting expenses is the reality is you are taking the expenses when you purchase a property and when you're making a loss primarily they will be the interest costs. The reality is that the only reason you're making a loss this year is that you're hoping to make a capital gain at the point that you sell the property, but here's the rub: you are planning to claim a capital gains tax rate of tax when you finally get around to selling the property. So whereas you are claiming the expense today at your marginal rate of tax, if you're a top marginal tax rate payer that's 49c in the dollar but you are planning to only pay 24c in the dollar on the revenue that you get from that in due course.

One of the questions is, is that mismatch fair? Does it lead to distortions in behaviour?

SIMON COWAN: It's an interesting question and there's actually a lot of work been done as to is there actually a distortion in the property market caused by negative gearing and then, even more simple than that, who is it that is actually negatively gearing property? Some reports suggest that two-thirds of the individuals who negatively gear have an income of $80,000 or less. The sense that negative gearing is how the super-rich avoid paying tax, I don't think that's right. I think it's actually the upper middle class who's mostly doing the negative gearing.

JOHN DALEY: Let's get to the distributional thing in a minute, but first what about that question, is it ultimately a distortion of rational investment behaviour that I know through negative gearing that I can essentially be deducting the costs of the investment at, say, 49c in the dollar but I'm intending to only pay tax on the returns from the investment at 24c in the dollar?

SIMON COWAN: You are paying tax on the real returns at 49c. Again, you have to take that inflation into account there. If you assume that you only are supposed to pay tax on the real returns and the returns roughly equal inflation, so the nominal return is roughly half inflation and half capital gain, then you would actually be paying the capital gain at 49c in the dollar. The real return, not the inflation unadjusted return.

JOHN DALEY: If that is my return is roughly double inflation, and in practice my return tends to be a great deal more than inflation, at least for the last 15 years. One of the reasons I certainly come to this issue is in my past life I was head of marginal lending at the ANZ and I sat there writing brochures for my clients saying, "Because of this mismatch between the rate at which you are deducting the expenses and the rate at which you are paying tax on the capital gains, essentially the risk return curve is not what it would normally be". So it shifts the risk return curve and it made it very, very attractive. You didn't have to believe in very much, certainly back then, in order to believe that it was a good idea to leverage at least if you got a normal return.

Now, of course, returns go up, returns go down, so whether it turned out to be a good idea depended on your timing, but at least in the long run you would expect to do better than a normal risk return curve precisely because of that mismatch between the rate at which you were claiming the deduction and the rate at which you were paying tax. Because I think the argument would be, and this is I guess where the Henry Review came from, if you are ultimately only going to pay tax on the returns at 25c, and yes, that does take into account inflation, well you should also be only claiming the deductions at 25c.

SIMON COWAN: I think we've got to separate out a lot of the impacts that we've had on property prices over the last 20 years and one of the reasons why negative gearing has become such a valuable strategy, and it wasn't really that valuable a strategy initially. It's become a very valuable strategy because of the massive one-off increase in property prices as a result of significantly falling interest rates.

So you go back 20, 30 years when interest rates were sitting at 12%, 10%, they've come down into 2.5%, 3% now. That has led to a significant one-off increase in the price of property, it's made it so much easier to borrow more and it's lifted the capital gains, and over the time that that's happened we've seen an increase in negative gearing. Now that those rates are sitting at that lower level there is at least an argument to suggest that in the future negative gearing will be a lot less attractive strategy because the big capital gains will no longer be there. So we've got a period of abnormal returns that has skewed investment in a particular direction, but the underlying theory and the underlying principles of the tax system which led to that I think are at least arguably sound.

JOHN DALEY: Let's move onto impacts. Let's assume that the ALP has their way, they materially reduce the discount on capital gains and they materially restrict your ability to negatively gear property. What do you think will be the impact on the economy, on house prices and on rents?

SIMON COWAN: The big three. We saw a report two weeks ago from BIS Shrapnel that predicted absolute doom and gloom, and you, I noticed, rubbished that report as fanciful in the AFR. I think the impacts will vary significantly depending on where you are.

As an investment strategy, negative gearing is much more attractive in capital cities, particularly in Sydney and Melbourne and areas where the sorts of properties that can be negatively geared are found. So not a lot of people in rural and regional Australia negatively gear, most of those investments in property are positively geared because the capital gains aren't there. For the bulk of the population outside the cities I don't think these changes will actually result in much of a difference for them. There's not a big capital gain, there's not negative gearing, the changes won't be big. At the margins in some of the suburbs in Sydney and some of the suburbs in Melbourne and probably Perth and Brisbane too, where there's a significant amount of negatively geared property, over time we'll see a couple of things happen.

So property prices will almost certainly fall, I don't think there's a dispute about that, it's just a question of how far, and if you look at the ALP policy it's actually titled *Housing Affordability*. Now "affordable" means cheaper unless they're suddenly magically giving everyone more money, so they know that property prices are going to go down. So that will happen.

JOHN DALEY: Of course the question is how much?

SIMON COWAN: It's really hard to know. It depends a little bit on what investors do with that money, whether they stay in property anyway or they go elsewhere, because there's a belief amongst segments of the community I think that investments in property are always the right thing to do no matter what. They don't trust shares particularly, they've seen these big share market crashes, but they believe if they own some property they'll always own that property. So to an extent there may be irrational reasons for investing in property that will keep people there. I think we'll see a fall in prices and an increase in rents that will be bigger in parts of Sydney and Melbourne than elsewhere, but the overall impact won't be doom and gloom.

JOHN DALEY: Let me give a hypothesis about how big we think it might be. So if you look at the current value of negative gearing, what's the tax deduction that people effectively don't pay? The answer is it's about $5 billion.

So if you go to an investment banker and you say, "How much does it cost me to buy an asset that yields about $5 billion a year after tax?" they'll say, "Oh look, I'll apply a multiple of about 20, 25 depending on how aggressive I'm feeling this week" and therefore the value of that asset producing $5 billion a year is about $100 billion a year. So 5 billion multiplied by 20, $100 billion a year. The total value of residential property in Australia we know from the Australian Bureau of Statistics is a bit over $5 trillion. So you take 100 divided by 5 trillion and what that says is the present value, what you would pay to have an asset that would every year give you about $5 billion a year, of that asset is about 2% of the total value of residential property. Therefore you would expect that if I take that off the table, all of it, which of course is in fact not the ALP policy, but even if you took absolutely everything off the table, rationally property prices would decrease by about 2%.

Another way of thinking about that is if you look at how much does negative gearing increase your return? The answer is it increases your return by about 18%. So if you say that investors are about a third of all owner-occupied housing in Australia, so that equates to about 6%, and of those investors maybe about half, probably a little bit less than half are negatively geared, you wind up with about 3% change in the return on property across the entire market which, again, suggests if the return on property falls by about 3% you'd expect the asset price to fall by about 3%.

SIMON COWAN: Yes, and I don't dispute those figures, but that's an average across the whole market.

JOHN DALEY: Yes.

SIMON COWAN: If the majority of negative gearing is concentrated in, let's say, a fifth or a tenth of the real estate market you'll see a bigger impact in that sector. So I think you could potentially see a bigger impact than 2% in some of the suburbs around Sydney in particular and in Melbourne, and for other parts of the country the impact will be much lower. So in terms of where the impact actually falls, it's an interesting question to look at where it will fall or not fall. The overall average could hide some fairly big changes.

JOHN DALEY: But even then if we think about how big's really big? If we had a suburb that was 100% negatively geared we would expect the prices to fall by about 18%. Now of course there is no such thing as a suburb that's even 100% investors, let alone one that's 100% negatively geared investors. So I would suggest it would be very unlikely we would see a rational fall of more than about 8% or 9% even in the most concentrated of suburbs, although I think what you've got to then factor into that is that's the rational shift and markets have a tendency to overshoot. So if you did see a very sharp movement of, say, 8% in a particularly highly concentrated suburb it might well overshoot that for a period and then come back again, bearing in mind that there's an awful lot of suburbs in Melbourne and Sydney which have gone up more than 8% or 9% every year for several years.

SIMON COWAN: Yes and I'm living in one, I've been trying to buy a house. It's been fantastic. You will also see an impact on rent though. I think you'll see an increase in rent because for some of the investors potentially the transaction costs of getting out of the property will be higher than they're willing to pay, so they'll be looking to make up some of that 18% return by increasing the cost of rent.

JOHN DALEY: But how can they do that? I mean, fundamentally the cost of rent is driven by how many people have got a property to rent out and how many people are out there trying to find a house to rent. I'm guessing that if those investors thought they could get away with putting up the rent tomorrow they'd put up the rent tomorrow and the reason they don't is the balance between supply of rental properties and demand for rental properties, and that doesn't change as a result of negative gearing.

SIMON COWAN: No, but the desired return will impact this, if a significant number of investors will only rent their property for a certain price.

JOHN DALEY: But if there's no change to the number of people trying to rent properties, what are they doing? By definition, the market currently clears, so market prices currently reflect the balance between supply and demand.

SIMON COWAN: With the existing distortions that will change.

JOHN DALEY: No, with the existing supply of properties, because what drives it is supply and demand and that's the supply of properties and the demand to rent them. The one thing that does not change if you change the rules on negative gearing or capital gains tax at least in the short term, we'll come to the long term in a moment, at least in the short term none of that changes. The one thing you can't do with property is make it go away, so I can't see why in the short run there would be any change to rents?

SIMON COWAN: I think in the short run you're right, the restrictions on the market will cause a problem. I think you'll see landlords trying to push up rents. Whether or not they can actually get people to pay that rent is another issue. In the long run it will be different, you will have an impact on supply that will change rents, but I do think you'll at least see an attempt to try and push up the average rent in some of those suburbs where negative gearing is prevalent.

JOHN DALEY: I think my argument would be landlords are trying to push up rent all the time in the same way that renters are trying to pull down rent all of the time and the price is where it is for the precise reason that that's the balance between supply of property and demand for property. But if we go to that longer term question of what will be the impact of this in terms of supply of new property, let's think about two different policy outcomes. Let's go first to something similarish to the ALP policy where you say good news, negative gearing stays in place for property which is brand new, either because you've just subdivided it so it's a bunch of new apartments in the centre of Melbourne, or because it's a new bunch of houses being built on the edge of Melbourne, or any other city for that matter, on what used to be rural land.

So if that incentive is still there, if anything won't there be an increased demand to build new properties?

SIMON COWAN: There might be a shifted demand from investors towards new property which may offset some of the impacts on price. You would probably see a countervailing shift from owner-occupiers to existing property because it would become less advantageous for investors. It's hard to know because you don't just have negative gearing and capital gains impacting these decisions. One of the big things you see in property prices is it's actually driven by the relative release of land, the things like stamp duty in particular. There are all of these other factors that are built into property prices that are external to negative gearing and capital gains that might impact some of these decisions.

JOHN DALEY: And that might actually be a second topic on which you and I can agree, which is that all of that stuff will have a bigger impact. I guess the policy argument here is a claim that by changing the rules on negative gearing and capital gains tax you will see less in the way of building than you would otherwise, all other things being equal, and therefore you would get an increase in rents.

One of the suggestions I would make is the theoretical argument here would be changing those rules will reduce the price of property somewhat, and then one of the big questions is does that change in price fundamentally feed through into land or does it feed through into the development value? My argument would be it's going to feed through primarily into land precisely because the release of land suitable for subdivision is quite restricted, therefore if you change the returns on that land because your after-tax returns are now a little bit lower then what will happen is that that will feed through into the price of land essentially overnight, and the incentives to develop it will be more or less exactly what they are today, therefore the impact of the change in policy on development and therefore rent will ultimately be pretty close to zero.

SIMON COWAN: There are some other complicating factors to that and the first is the possibility that people who are currently negatively gearing will take those investments outside the market altogether. So they'll either go into shares, they'll go into superannuation or they'll start companies, so their investment dollars will fall out of the market completely. The other thing is that there's a different risk profile investing in a new property than an existing property. So an existing property may well have a tenant, but certainly it won't have the defects that you might find in a new building and you won't have construction delays and cost overruns. So there is a different risk profile investing in new assets as opposed to existing ones. The question is whether or not those two factors, the change in risk profile and people dropping out of the market altogether, will have a material impact on price and supply.

JOHN DALEY: We're starting to run out of time so we should move on to what you might actually do. Simon, I know this is hideously unfair but I want you to pretend Malcolm's just rung you up, he's said, "Tony's got it wrong, the bottom line is the change in policy on negative gearing and capital gains tax is actually turning out to be a big winner for the ALP. We're going to have to do something in terms of changing the rules here so that we get a bigger tax take out of property investment. Good news Simon, we're going to plough the whole lot back into general income tax cuts, but we've got to do something". What do you think would be the, if you like, least bad reform here?

SIMON COWAN: This is surprisingly easy. John warned me he was going to make me talk about tax rises tonight, but Henry actually had this right.

So what he said is there's a whole bunch of distortions that impact how people save their money and one of the things we should do is reduce the impact of those distortions by applying a common discount to all forms of taxation on savings. So he proposed that you would get basically a 40% discount on all forms of saving from home saving through bank accounts and that that would apply across every class of asset, and I think that's the right way to go. So I would keep negative gearing intact because I think it makes sense as an element of the tax system, but you could apply a uniform discount rate to savings of 40% which would bring down the capital gains discount on property from 50% to 40% and increase it from zero to 40% on things like savings accounts.

JOHN DALEY: Malcolm says, "Simon, that's a terrific idea, but unfortunately at 40% it's going to cost the Budget a lot of money and the one thing the Budget can't afford at the moment..." Actually, there's probably a third thing we agree on which is that governments shouldn't run deficits as large as they are.

SIMON COWAN: Forever and ever, yes.

JOHN DALEY: So he says, "Unfortunately it's got to be at least more or less Budget positive". So what are you going to advise him then?

SIMON COWAN: I think you model that tax to at least being neutral if not Budget positive. I don't think in the current environment it's going to be possible to substantially reduce tax on anything and if you did it probably wouldn't be in this space. So that's what you would look at doing, what's the discount level that makes it Budget neutral? But once you start getting into superannuation taxation, once you start getting into other forms of taxation you're going to come up with a number that makes it neutral, and as long as it's neutral across all assets classes you would probably see an improvement on what you have today.

JOHN DALEY: So you've solved the easy question. The tough question is so what do I do about transitions? What do I do about all of the people who've bought houses already and who've negatively geared them already, how do you propose to handle the transition?

SIMON COWAN: That's a significant issue in pretty much every form of policy and I've dealt with it substantially in pension policy, because you've got people who are making investments on a long timeframe. The only answer is you've got to move these things in stages. You can't turn around and change the investment rules overnight. Even if you think the impact will be neutral, that thing you were talking about with the rational markets is a significant problem. If you change the rules instantly everyone starts to feel less confident and they start to move in irrational ways. So you've got to either grandfather these things in or introduce them very slowly.

Now in the form of the capital gains tax discount, they introduced that initially quite slowly. So if you owned a property from before 1985, which is quite a rare investment but there are some, you are not eligible for capital gains tax on that property. You could do that in this situation or say over the next ten years that we're going to drop the discount by one percentage point over time, and that would probably have a fairly minimal effect.

JOHN DALEY: I think this is one of the fundamental choices to be made in terms of transition, you either have something which says I'm going to grandfather anyone who's bought anything already and anyone new pays the new tax rate, or you can have a system which says this year you're getting a 50% discount, next year you're going to get, pick a number, a 48% discount, the year after a 46% discount. Is that a better policy?

SIMON COWAN: It depends on who the policy impacts and how much they can ameliorate those impacts. So in the case of pension reform in particular, pensioners don't have a lot of capacity to change the way they hold their savings, they don't have a lot of capacity to increase their income, so springing changes on them is a really bad idea. In the case of investment, particularly a significant pool of investment, it might be that you can just do it over time and everyone will be okay with it. So it's not as simple as it's always better to grandfather or it's always better to apply it gradually, you look at who is being affected and how much and what you think the impacts will be.

The theory behind the discount is that it's supposed to reflect the value of inflation and so each year you have a compounding impact of inflation. So the reason why it doesn't apply in the first year is they assume that inflation doesn't apply. So if your return is a nominal 5% in the first year, half inflation and half return, a 50% discount gives you the real return. In the second year, assuming that that keeps happening, the 50% discount just keeps you at that real return. So the idea is not to encourage people to hold assets longer, it's to reflect the cumulative impact of inflation on the overall returns over time.

JOHN DALEY: I think one of the interesting features about the capital gains tax system which is almost inherent in the system is it in fact works much like you've described, because the effective tax rate on your investment, if you think about effective tax rates as how much tax am I paying divided by the pre-tax return, in effect that falls over time. Because you don't actually pay capital gains tax obviously until you actually sell the asset, and what that means is that in effect the government is giving you a loan of the value of the tax that you would otherwise have paid on the capital gain in year one and then effectively a bigger loan in year two because it's the capital gains tax you would have paid on years one and two worth of gains, and a bigger one again in year three. That's why when you model it out you can see that the longer that you hold the asset the lower the effective tax rate is on your investment.

So that's effectively already built into the system and that's something it will be very difficult to find a policy fix for, because the only way you could undo that is to require people to pay tax on their capital gains as they accrue but before they actually sell the asset, and I'm guessing that will be a genuinely tough policy sell.

SIMON COWAN: If you're desperate enough it could happen.

JOHN DALEY: But it does mean that in effect the current system already does that.

So Keating did essentially wind back negative gearing between 1985 and 1987, rents went up very, very rapidly in Sydney and people drew the conclusion that rents had gone up very fast in Sydney because negative gearing had been removed and therefore they put it back in place. Of course, although Paul Keating may not realise this, the country is larger than Sydney and the policies applied all over the country, and in fact if you look at real rents in Melbourne, in Perth and in Adelaide, they didn't move at all even though the policy had changed just as it did in Sydney. So the conclusion that rents had gone up as a result of the changes in negative gearing policy was, to say the least, a bit of a long bow.

If anything, the episode illustrates that what really drives rents has got nothing to do with negative gearing and everything to do with the fact that there had been an underbuild of new housing in

Sydney in the year or two beforehand and there had been quite rapid population growth, so, surprise, surprise, rents went up. But because political classes dominantly come from Sydney, most of our Prime Ministers have come from Sydney, there is this race memory that changing the rules around negative gearing will increase rents and, alas, the 1985 to 1987 experience proves no such thing. If anything, it probably proves the reverse or at least provides evidence to the reverse.

To come back to the other question of is it disturbing that governments haven't worked all of this out? Some things, no. The bottom line is that some of the things that Simon and I were talking about are what will future returns be on property, what will future returns be on shares, what will future inflation rates be? I can assure you that if Simon and I both knew the answers to those questions to three decimal places we wouldn't be here, we would be in the Bahamas and life would be very sweet indeed. The reality is that it's not possible to know many of those things and government does as good a job as anyone of forecasting, but the problem with predictions is that they're very hard to get right, particularly about the future.

Some of the other things like, for example, what's our best guess about the impact of this on property prices, that's work that I would argue government should have done. It's probably not really good enough for ministers to be making assertions that this will have an enormous impact on the economy when that work doesn't appear to have been done. It's probably not good enough to rely on a report that was written by someone in response to a commission when the commissioner has not been disclosed and it's a fair bet that they had a vested interest or at least an interest in the outcome. And I think it's an extremely good bet that a tax change of about $3 billion, as BIS Shrapnel modelled, is most unlikely to lead to a $19 billion a year reduction in the size of the economy. If we were to award a flying pig for the worst piece of economic modelling for the year it would at least be in the running.

SIMON COWAN: Yes, but it's early in the year. But therein lays the problem. As economics has become more of a hard science and less of a social science there's been a significant attempt to try and turn it into a mathematical model. The models are so enormously dependent on what inputs you put into your model to generate the particular outputs and there are so many examples of reports, high-speed rail is a fantastic one because everyone knows it's going to cost $100 billion and it'll never make that capital cost back. You end up with these models that input happiness for a certain number of billion dollars so they can generate an outcome that looks positive. There's so much guesswork in these models that get treated as absolute certain.

We can debate high-speed rail if you'd like to, but the point is more just that what comes out of a model depends so much on what you put into it and then so much of human behaviour is actually not a rational response anyway. One thing behavioural economics has taught us is that so much of this stuff we thought we knew we actually don't.

AUDIENCE: My question is for John. Even though Simon is committed to the search of truth, I think he made a little cheeky comment earlier when he said that the average person would benefit from negative gearing has a taxable income of $80,000. I know you were going to come back to that John and you didn't get a chance. I'd love to hear what you have to say on that.

JOHN DALEY: This is something where the facts are very easy to get. One of the data sources that we all now have access to are the so-called "tax stats". The ATO (Australian Tax Office) puts out a sample of all tax returns and it's a very, very good read about what the distribution of taxation is in Australia. We can make two observations. The first is $80,000 might sound like an average wage.

SIMON COWAN: It is.

JOHN DALEY: No, it's an average fulltime wage. Most people don't earn the average fulltime wage and if you have a taxable income of $80,000 you are in the top 20% of Australian taxpayers. So 80% of Australian taxpayers or, more accurately, tax filers, so people who file a tax return, make less than $80,000. So that's observation number one. Observation two of course is it's a question about whether you want to look at taxable income, which by definition includes whatever deduction you've got from your negatively geared property, or whether you want to look at your income before you've taken that deduction. If you do that you discover that well over half of the negative gearing tax benefit is going to the top 10% of Australian taxpayers before their negatively geared tax deductions. So it is quite a skewed distribution.

I think Simon's absolutely right, the mere fact that it is skewed is not in itself an argument for change. On the other hand, to claim that this is fundamentally a middle class tax deduction strikes me as tough to maintain when more than half is going to the top 10% before deductions.

SIMON COWAN: There's a distinction as well between income and wealth. I myself don't particularly like trying to look at this from the perspective of what's the income variable where you get a certain amount of negative gearing because it actually skews a lot more towards wealth and people who have more wealth tend to have negatively geared property, and not all of those people have a very high income noticeably because a lot of them are retired.

JOHN DALEY: But not many of the retirees are negatively gearing because there's no point.

SIMON COWAN: No, but people who are approaching retirement, so people who have generated a reasonable amount of wealth but not necessarily a high income are some of the people who benefit from negative gearing.

I think negative gearing as a tax concept and the idea of offsetting your expense incurred in generating an income, I don't think it's helpful to look at that from a perspective of who is this going to from an income perspective. I think John's point is the right one. It doesn't matter if this is something that's used by wealthy people. Is it correct? Is it the right element of the tax system? Is it something that needs to be there because it makes sense to be there? I think in respect of negatively gearing it does because it's clear that the government will pool all your income. Your rental income is taxed at your marginal rate not at a zero rate. If that's the system that applies for income it should be the system that applies for expenses as well and you should be able to deduct your expenses at your marginal rate without having to quarantine it.

JOHN DALEY: I'd just like to add one thing to that, and this is probably something where we almost certainly will disagree. I think one of the things that's become increasingly obvious over the last couple of years is that the amount of resources that people ultimately have to spend over their lifetime, if you like their ultimate welfare via spending money, is partly determined by their wage income and partly determined by their wealth, meaning whatever they inherited plus whatever they managed to save and what it is they have earnt on those savings. We used to be in a world in which your lifetime resources were very dependent on your wage income and not very dependent on your wealth.

Our world appears to be changing. It appears to be a world in which increasingly your lifetime resources depend on how much have you inherited, how much have you saved and how much have you earnt on those savings, and is therefore a much less equal world than it used to be and also a world in which essentially you get rewarded less for working and more for other things. That may not be a world that we want as much as one in which there are incentives to work, and the way that Thomas Piketty puts this is do you want to be in a world in which you encourage people to work really hard and go and be a lawyer, or whatever it is in the story he tells, or do you want a Jane Austen world in which the way you get ahead is to find someone who's already pretty wealthy and shack up with them?

SIMON COWAN: The only thing I would add to that, and we've got some research coming out on this in a couple of weeks, is that the perception is our system has become less progressive over time. The income tax system in particular has become more and more progressive over the last 30 years and so at the moment it is more progressive than it has been at any point since pre-1980. If you count capital gains tax as an element of income tax and negative gearing as an element of income tax, the income tax system has become more progressive. The top taxpayers are now paying a greater percentage of their wage and a greater percentage of the total tax take than they have been for the last 30 years.

JOHN DALEY: Are they earning a greater percentage of the pre-tax earnings?

SIMON COWAN: They are paying a greater percentage of their wages.

JOHN DALEY: No, that's not the question I asked.

SIMON COWAN: But that growth has outstripped income growth. So in the tax whitepaper there's an interesting little statistic that shows what percentage of national income goes to certain groups. The percentage of tax paid by the top two groups exceeds their percentage of wages.

JOHN DALEY: Of course it does and it's a progressive system. So my question is the percentage of pre-tax income going to the top 20%, has it increased?

SIMON COWAN: It's certainly increased. Well, there's been an increase in income at every level. So if you look at the US statistics there hasn't been an increase in income for the bottom two tiers. For Australia, at least until 2010, the fasted growing income quintiles were the bottom and the second. It was the Australian Institute of Family Studies that came up with that data.

JOHN DALEY: Yes, but if you look at a longer period, if you look at over a 15 year period, because we did do this piece of work that looked from about 2000 through to 2014 or something, the fastest growing pre-tax quintile was very much the top one. I think this is very important because if you look at what's the distribution of incomes before tax, Australia is an extreme outlier with the United States. So our pre-tax distribution of income is about the most unequal in the world and quite a long way in front of anyone else. There's then a big difference with the United States, we have a much more progressive tax system than they do, and so the post-tax and transfers outcome is still pretty unequal relative to the rest of the world, but not outrageously so. We're in the most unequal third but, unlike the United States, we're no longer an outlier.

SIMON COWAN: And we also have a higher income, which is the other thing. If you look at, say, pensioner poverty statistics, they're actually impacted by the fact that incomes in Australia are higher than they are elsewhere. So if you measure a relatively poverty based on income, if your income's higher the relatively poverty level is higher.

JOHN DALEY: We've got very distracted, but thank you for a great question.

AUDIENCE: My question is about the issue of will house prices fall evenly and, assuming that they do, whether it's 3% or 9%, we see that as a significant issue for some investors? But if you reverse it back the other way and say if we've got negative gearing now and we've got year on year of 8% or 9% growth, should we be looking at that and saying that's too much? Is it better to pay more for houses every year or is it better to pay less?

SIMON COWAN: It's a very good question and it depends entirely on who you ask. The people who own property think it's better if the prices go up and people who don't think it's better if they go down. I say that flippantly, but one of the big drivers of house costs is the fact that owners of houses have an incentive to drive up prices. So you see the most restrictive planning laws, you see arbitrary opposition to development that, however notionally principled, is entirely based on the idea of driving up prices. Joe Hockey made the point clearly: he's in the business of driving up house prices because it's good for people to drive up house prices.

Australia has got very high house prices, particularly in our capitals. The bulk of that is driven by things like government taxes and charges and restricted planning. There was a research report two or three years ago that found that 50% of the value of a house in Sydney is actually driven by planning and government taxes and charges. So I think you've got a lot of area and a lot of scope for bringing down that distortion in the market before you need to get to negative gearing and capital gains, because that's really only applying at the margins I think.

JOHN DALEY: The thing I'd clarify about your question is the argument is if you change the rules around negative gearing and capital gains tax you will have a one-off impact on house prices, in the same way that those rules effectively have a one-off positive increase impact on prices if you bought them in tomorrow. They are not leading to higher rates of growth year on year, I don't think anyone would argue that. I think the argument is essentially that they create a one-off impact on house prices in one direction or another. I guess this is something else where I do agree with Simon, there's no question that changing the rules will have a differential impact. It will have more of an impact in areas which have more investors and more negatively geared investors and it will have less of an impact where there are more owner-occupiers, therefore any change will ripple across the market in different ways.

SIMON COWAN: I would also add that, unfortunately or not, the places where that change is likely to be the most intense happens to be a lot of the marginal electorates in Sydney. So the political impact of this change could be more significant in those areas than it is elsewhere and that could magnify the political impact across the whole country, because I think that there's a belt of places in Western Sydney that are quite dependent on negative gearing and those are marginal electorates.

JOHN DALEY: To bring this discussion to a close, one of the things that I found most disappointing about this debate is that one of the leading players in it essentially put something out in which it wasn't arguing the rights and wrongs, what's in the public interest or what is an ideal tax system; it was simply pointing out this is the number of people who are negatively gearing by electorate. In other words, that's not an argument about what's the right thing to do here, it's purely an argument about politics. I would suggest that for interest groups that are supposed to be at least some of the time arguing about policy you should be arguing about the public interest, what's ultimately in the public interest, and not simply what's going to win you the next election or potential lose you the next election.

SIMON COWAN: I couldn't agree with that more and I would actually suggest that right now there's an enormous distortion in thinking amongst people in Australia. There's a massive disconnect between the amount of tax that they pay and the amount of services that they demand and politicians are trying to extort this difference all the time. At some point we're going to have to have a serious discussion that says the amount of services that you expect the government to provide are costing X, you are only paying Y and we have to make that gap up some way: either you reduce your expectations of government or you personally, not some bogey rich man in a different suburb, you personally are going to have to pay a lot more for the services you demand. Until someone actually has that debate, until a politician gets up and says, "Look, this is how it has to be" I just don't think we're ever going to see a real debate on some of these issues.

JOHN DALEY: I think that's a lovely note to finish on. Despite my best efforts, Simon and I have actually found a number of things to agree on, not least the last one. So Simon, can I thank you for a very, very interesting conversation, I think this is a detailed issue and it's been terrific to have someone who doesn't have the same viewpoint but, nevertheless, can discuss it in that kind of detail. It's been a fascinating conversation, I've certainly enjoyed it, I've certainly learnt something and I hope everyone else has here too. I'd like to again thank the State Library of Victoria, thank the Grattan staff who organise the events, and of course, most importantly, thank everyone here for coming to be part of the conversation. We hope that it continues in terms of you talking about policy, rather than just politics, to as many of your friends as possible. Thank you all very much for coming.

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