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Submission to Standing Committee on Tax and Revenue inquiry into the Tax Expenditures Statement

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1 Summary

We welcome the Standing Committee on Tax and Revenue's inquiry into the Tax Expenditures Statement (TES).

Tax expenditures are government revenues foregone because certain activities or classes of taxpayers receive preferential tax treatment. Tax expenditures can take many forms including exemptions, deductions, concessional rates or deferral of tax liabilities.[1]

Estimates of tax expenditures inform public discussion of the cost of tax concessions. Because tax expenditures are inherently more difficult to measure and observe than government spending, they do not attract the same scrutiny, despite their often large budget impact.[2] The annual TES provides a regular assessment of the size and scope of these expenditures. Ultimately, this improves the transparency and accountability of government. Transparency could be further improved by publishing long-term projections of the costs of major tax expenditures in the Australian Government's *Intergenerational Report* every five years.

This submission considers three criticisms frequently levied at the tax expenditure estimates and presents our views on whether refinements to the TES reporting and methodology are justified.

A common criticism of the TES is the choice of benchmark for estimating expenditures for savings tax concessions. Some argue that concessional tax treatment of savings, relative to other income, is a desirable structural feature of the tax system so tax expenditures should be measured from an expenditure rather than an income tax benchmark. But the income benchmark remains the best measure of the revenue costs of providing these concessions. Policy arguments in favour of the concessional tax treatment of savings are separate from the question of how the costs of these concessions are measured.

There are also complaints that the standard "revenue foregone" tax expenditure estimates do not factor in behaviour change. Revenue foregone estimates are useful because they are a mirror of the government payment estimates reported in the Budget. But for large and contentious tax expenditures such as superannuation tax concessions and GST exemptions we see merit in Treasury separately publishing "revenue gain" estimates that incorporate behaviour change.

A further criticism from the superannuation industry is that tax expenditures for superannuation do not account for reductions in government outlays on the Age Pension. Treasury's approach of excluding "second round effects" is consistent with the international standard and should be retained. However there would be value in Treasury publishing additional estimates of the net fiscal cost of superannuation tax concessions to inform the retirement incomes debate.

[1] Treasury (2015), p.3; Brixi, *et al.* (2004), p.3.
[2] Treasury (2010), p.719.

2 The choice of benchmark

A recurring issue with tax expenditures is the choice of benchmark. A benchmark is the standard tax treatment or "tax norms" against which the size of any tax exemptions or concessions can be assessed.[3] The challenge is defining the standard tax treatment. As one commentator puts it "[o]ne person's idea of an unjustifiable concession could be another's idea of a desirable structural feature of the tax system".[4]

For taxes on income, Australia's tax expenditures use a comprehensive income tax benchmark. This compares the tax collected under the concessional regime with the tax that would be paid if the income were taxed at an individuals' marginal rate of personal income tax.[5]

Some commentators and industry groups argue that an income tax benchmark is not appropriate for savings tax concessions, particularly for long term savings such as superannuation, because it would be "inappropriate" to tax savings in the same ways as ordinary income. In particular, taxes on savings create a bias in favour of current over future consumption.[6]

These commentators often claim that an expenditure tax benchmark – which implicitly sets a zero tax benchmark on income from savings – would be more appropriate.[7]

It is unsurprising that those who prefer lower taxes on savings in general also prefer benchmarks that reduce the apparent size of the tax expenditures. Under the 'pre-paid' expenditure tax benchmark advocated by some, [8] earnings and benefits are untaxed but contributions are fully taxed at marginal tax rates. This substantially reduces the size of the estimated tax expenditures. In 2013-14, the estimated tax expenditures were $16 billion for superannuation contributions concessions and around the same for earnings tax concessions relative to an income tax benchmark.[9] In contrast, using the pre-paid expenditure benchmark, contributions concessions still cost $16 billion in foregone revenue while the earnings regime provides a

[3] Treasury (2015), p. 3; Brixi, *et al.* (2004), p. 9.
[4] Carling (2015), p.6.
[5] Personal income tax rates include the Medicare Levy and the Low Income Tax Offset, plus the Temporary Budget Repair Levy for 2014-15 to 2016-17. The income tax benchmark for assessing tax expenditures also incorporates some structural elements of the tax system such as the progressive income tax rate scale for individual taxpayers. The structural elements considered in the benchmark are themselves open to debate. Treasury (2015), Appendix A.

[6] Taxes on savings are double taxation, wage income is taxed when it is earned and again when it generates investment income. This promotes current consumption at the expense of saving. This bias is reinforced when there is inflation because effective tax rates on *real* returns are high if *nominal* gains are taxed at marginal income tax rates.
[7] There are two types of expenditure tax benchmark: (a) a pre-paid expenditure tax benchmark based on the direct taxation of labour income with an exemption for saving; and (b) a post-paid expenditure tax benchmark based on the taxation of consumption, with no taxation of income.
[8] See Carling (2015), p.6; Sloan (2015).
[9] Treasury (2014), p.12.

gain to the budget of $5.8 billion, on the basis that the earnings paid at least some tax.[10]

However, an expenditure tax benchmark is divorced from reality: few people seriously suggest that income generated by savings should be tax free.[11] A benchmark should reflect the standard tax treatment of a particular activity: it should not favour one activity over another.[12] Other types of savings income such as bank interest are taxed at a taxpayer's full marginal rate of income tax. Bur even where there are other tax-advantaged savings vehicles taxpayers could choose, this does not mean they are the relevant benchmark. The point of tax expenditures is to allow comparison of all such tax-advantaged vehicles so that the policy outcomes can be compared with their costs.

For this reason the comprehensive income tax benchmark remains the most appropriate benchmark for estimating the Commonwealth Government's tax expenditures on concessional tax treatment of superannuation earnings and other forms of savings income. This is not to say that there is no policy case for treating savings income concessionally. But the income tax benchmark allows the community to understand the costs of providing these concessions and to assess whether they provide "value for money" in meeting those policy goals.

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[10] Ibid., p.193.
[11] Most economists accept the equity and efficiency arguments for some taxation of savings income, although they do not always agree that labour and savings income should be taxed at the same rate. Carling (2015), p. 8; Treasury (2010), p. 4.
[12] Treasury (2014), p. 195.

3 Accounting for behavioural change

Consistent with most OECD countries, Treasury estimates tax expenditures based on the “revenue forgone” to the budget from the expenditure. Revenue forgone estimates indicate the benefit to taxpayers from a particular concession.

There are frequent complaints that revenue forgone estimates do not provide an accurate measure of the tax revenue that would be gained if the expenditure was abolished. [13] This is because they do not account for behavioural change. But revenue forgone estimates are not intended to measure incremental revenues from policy changes. Instead, they are a mirror of the estimates of government payments reported in the Budget. Spending estimates do not adjust for offsetting fiscal impacts from behavioural change if spending were ceased. For example, estimates of outlays on the Age Pension measure the value of Age Pension payments to individuals *not* the saving to the budget if the Age Pension were abolished. The latter would be far more difficult to produce as it would need to account for things like the offsetting impact of higher spending on other welfare and social programs.

Of course, tax expenditure estimates that account for behaviour change are also informative, where they can be credibly estimated. Such “revenue gain” estimates provide a better picture of the revenue benefits should the government abolish the concessions. These estimates also provide a useful response to vested interests seeking to discredit tax expenditures on the grounds they do not include behavioural change.

Superannuation tax concessions are a prominent example of how the failure to account for behaviour change can be used as a smokescreen to distract from the size of the tax expenditure. Although many have commented at length about the failure to account for behaviour change,[14] it doesn’t make much difference. Even if substantial elements of the superannuation regime were changed, behaviour would change little. Alternative savings vehicles are *much* less generous than superannuation. Unlike other savings vehicles, superannuation allows saving from pre-tax income (less 15 per cent), and imposes much lower tax rates.

Treasury estimates that if superannuation tax breaks were abolished, the additional revenue after accounting for behaviour change would only be marginally lower than the revenue forgone estimates. Treasury estimates that revenue forgone from contributions concessions was $16.3 billion and earnings concessions was $13.4 billion in 2014-15.[15] Treasury’s revenue gain estimate for contributions concessions is 95 per cent of the original tax expenditure and 88 per cent for super earnings concessions.

Treasury uses a sophisticated approach to estimating behavioural change. It assumes that if contributions tax concessions were abolished, contributions to superannuation would instead be directed towards alternative tax-preferred investments. The revenue gain estimate for earnings concessions factors in lower

[13] Clare (2015); ASFA (2015); Mercer (2013)

[14] For example see ASFA (2015), p.3, 28.; Mercer (2013), p.7; FSC (2015), p.13.
[15] Treasury (2015), p. 7.

contributions as super becomes a less attractive savings vehicle and account holders withdraw savings to take advantage of tax-free thresholds and offsets available outside of superannuation.

Treasury's revenue gain estimates for superannuation tax concessions advanced the public debate. But requiring all tax expenditures be reported net of behavioural changes would substantially increase the complexity and cost of the calculations. In our view, this exercise should only be undertaken where there is significant benefit because the tax expenditures are large and contentious.

4 Tax expenditures and offsetting spending impacts

A final criticism of tax expenditures is they do not adjust for offsetting impacts on government outlays. The superannuation industry claims that estimates of tax expenditures for super tax concessions are overstated because they do not account for reduced Age Pension payments as superannuation benefits increase.[16]

In Australia and across other economies, tax expenditures are measured as the difference between total tax revenue in the presence and absence of the particular tax concession, *assuming everything else remains unchanged*.[17] Excluding second round effects on government spending or tax collections ensures the analysis is tractable and consistent across measures. There is no case for Treasury departing from the standard approach to estimating expenditures for superannuation tax concessions.

However, given the centrality to the retirement incomes debate there would be value in Treasury producing a separate estimate of the net fiscal impact of superannuation tax concessions, including fiscal savings from reduced Age Pension outlays. Treasury already has the modelling capability to do this: it previously prepared estimates of the long run fiscal impact of increasing the Super Guarantee rate to 12 per cent as part of the Cooper Review.[18]

[16] Mercer, p.5-6; FSC (2015), p.13-14; Clare (2015), p.3.
[17] Brixi, *et al.* (2004), p.26.
[18] Cooper Review (2013), p.11.

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