



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

15 September 2015

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Introduction

We are pleased to have the opportunity to make a submission to the Standing Committee on Tax and Revenue Inquiry into the Treasury's Tax Expenditures Statement (TES).

However, at the outset, we should express our frustration and disappointment that Parliament, via the Tax and Revenue Committee, believes such an inquiry is necessary when most of the issues that will be raised regarding the TES were thoroughly canvassed in the report to the Treasurer in 2009 by the former Treasury Secretary, Dr Ken Henry, entitled "*Australia's future tax system*" (AFTS). We are also aware of the reports previously published by the Australian National Audit Office and the Joint Committee of Public Accounts and Audit and note that this Committee is now specifically tasked to inquire into those prior recommendations.

However, we also note that the Committee's Terms of Reference are very broad and not limited to these three reports. In this context, we believe very strongly that such a broad inquiry should therefore consider the effectiveness of the TES in achieving its objective.

We believe that a thorough review of the purpose, content and format of the TES process is long overdue and hope that any constructive conclusions from your inquiry will be promptly implemented. We hope our submission will be useful to the Committee in its deliberations.

We first raised issues with Treasury regarding the treatment of "Superannuation" Tax Expenditures in early 2013 following publication of the 2012 TES and remain concerned that our views are either not understood or are being ignored.

There appear to us to be three issues regarding the TES:

1. Is the content and methodology correct and appropriate?
2. If not, then has its publication been misleading?
3. If so, has Treasury taken appropriate steps to rectify any misleading views derived from its publication of the TES?

We have concerns on each of these three points.

Protecting the integrity and credibility of an institution such as the Treasury, and the information it publishes, is clearly important.

Governments rely on Treasury advice in making policy decisions and obviously this advice should be as objective and factual as possible. Representative groups engaged in policy debate are also entitled to expect that information provided to the public by Treasury is accurate and reliable.

We believe that when Treasury information is flawed or consistently and persistently misinterpreted or misused, Treasury has an obligation to promptly correct the information and draw attention to its misuse.

The frequent claim that the cost to the budget of superannuation tax concessions is \$32 billion and that this is the sum that could be saved if the concessions are removed, is a classic case of the misuse, at best, or deliberate misrepresentation, at worst, of a Treasury number.

We are concerned because a rational debate as to any restructuring of superannuation tax system should be based on accurate and meaningful figures and that the use of the headline \$32 billion number does not help progress such debate to reach community consensus on the best taxation approach. It is also used to advance arguments by some that superannuation tax concessions cost the budget too much and superannuation taxation should increase.

1. Accuracy and appropriateness of TES

It is important that there be agreement as to why the TES is produced. We assume that the aim of tax expenditure analysis is to improve control of the use of government resources on the revenue side of the budget. Indeed, the 2014 TES states that *“The TES is intended to facilitate scrutiny of tax expenditures by Parliament and parliamentary committees, the media and the general public. Transparent reporting of tax expenditures also helps inform debate on the efficiency and equity of the tax system.”*

Since the “tax expenditure” concept was first defined by the American tax scholar Stanley Surrey in the late 60s, its calculation has been constantly reviewed around the world. In an ideal world, the benchmark tax system should reflect principles of efficiency, fairness and simplicity. In this way, a tax expenditure attempts to measure a deviation from the most efficient tax basis for each category of income.

We understand that the TES uses the Schanz-Haig-Simons definition of income first developed nearly 100 years ago. Whilst this has been used by many countries in analysis of tax expenditures it has come under increasing criticism as being too rigid.

In particular, it does not appear to recognise that labour and investment income should be taxed differently to have the most economically efficient tax system. The Nordic countries have recognised this by having a dual income tax system with labour income taxed at progressive rates and other income generally taxed at a proportional (flat) rate. Accordingly, their tax expenditure estimates compare tax treatment with these benchmarks. Most countries’ retirement income systems use an expenditure tax benchmark.

We have four principle criticisms of the methodology and presentation in the TES.

- a. Aggregation – adding together two estimates that are interdependent;
- b. Benchmark choice;
- c. No reference to positive impact of tax concessions on direct budget expenditures; and
- d. Treasury view of “Fundamental structural elements”.

a. Aggregation

Nearly three years ago we wrote to Treasury regarding the table included in the 2012 TES which added together the tax expenditure for superannuation contributions and the tax expenditure for superannuation earnings.

We pointed out that if the TES is intended to illustrate the extent of government taxes ‘spent’ on superannuation then these two figures should not be added together. The TES used the income tax scale as the benchmark for both contributions and earnings. However, if contributions were taxed at the benchmark (income tax) rate, there would be less capital in super on which earnings would be generated.

So if one is attempting to estimate the revenue foregone as a result of the tax treatment of contributions AND the tax treatment of superannuation earnings, one should take into account the reduction in such earnings if the income tax rate is applied to contributions.

The 2012 TES included a clear statement that the figures are not strictly additive. However, immediately beneath this caution, the TES included a prominent table (Table 1) which added the two superannuation tax expenditures. This TES table did not heed the Treasury’s own cautionary advice.

It was from this time that the “mythical” figure of \$32billion (rising to \$50 billion) being the “cost” of superannuation tax concessions arose. It has since been quoted often in the media and by those arguing for superannuation tax concessions to be reduced. However, the \$32 billion number is not valid as a measure of the amount of additional tax that would be received by government if there were no superannuation tax concessions for this reason alone.

In the next TES (2013), Treasury omitted the table but rather than repeat their clear statement that “tax expenditure estimates are not strictly additive” chose to change these words to state that “*Previous editions of the TES have stated that tax expenditure estimates are not strictly additive*” (our emphasis).

The ‘tax cost’ numbers for contributions and earnings were, coincidentally, \$16 billion each, leading to the simple, but wrong, conclusion that the overall cost was still \$32 billion.

This just served to perpetuate that confusion and many media commentators continued to add them together.

So did Treasury. In a paper presented to the Superannuation Roundtable on 23 April 2013 – “Distributional Analysis of Superannuation Tax Concessions” – Treasury said:

“Value of tax concessions

The 2011 Tax Expenditure Statement estimates tax concessions on superannuation at approximately \$32 billion in 2012-13. This is the second largest tax expenditure. Concessions on contributions are estimated at \$16.5 billion and on superannuation earnings at \$15.5 billion.”

Early in 2015, at a superannuation industry conference, a senior Treasury official conceded that the TES was not a reliable estimate of the amount that could be saved if superannuation tax concessions were withdrawn. When questioned on this subject, the Executive Director of Treasury’s Revenue Group, Rob Heferen, said:

“When people report things that say this (\$32 billion) is a measure of tax expenditure and therefore that’s the amount the Government could save if they did something about it, that is untrue.”

He went on to say the TES is not a document with a policy message:

“When it is reported in the press...there seems to be an inference that simply because there is a large measured tax expenditure, the Government should do something about it. That is not the case. There is no policy message in the Tax Expenditure Statement.”

And:

“We are asked to do an audit, so we do. But be wary on the revenue gain estimates. Don’t use them, they are too unreliable. On the revenue foregone (estimates), done according to international best practice, that is not a measure of what is saved. Anyone who says this is not reading the fine print - it’s not even in fine print, it’s in bold print. Every year when we put it out, we get criticism so I wanted to make it clear.”

Treasury’s admission of the limitations of the TES, and that it is not a figure on which policy decisions should be based, was welcome but too late and inadequate. We believe this message should be stated in very clear language in each TES. It should also be made very clear that the estimated tax expense for concessions on contributions and on earnings are different components and should not be added together.

Our correspondence with the former Treasury Secretary and the former Assistant Treasurer on this matter is in Attachments A – D. Our media release of 28 February 2015 in response to Mr Heferen’s comment is Appendix E.

b. Benchmark choice

Whilst the current approach of benchmarking superannuation contributions and earnings against our progressive income tax scale could be defended as being consistent with historical treatment of such matters, there is increasing criticism of its use in this way.

If indeed the intention of the TES is to measure tax treatment that deviates from the best (most efficient) tax treatment of each category of income, then arguably an expenditure benchmark should be used for savings.

Dr Henry recommended this supported by compelling argument in the AFTS.

The AFTS report stated, inter alia, that:

“Australia’s personal income tax system should continue to represent a hybrid personal income tax – with income from long-term, lifetime, savings taxed at a lower rate than other income or exempt from income tax.”

“The essential reason for exempting lifetime savings or taxing them at a lower rate is that income taxation creates a bias against savings. The income taxation of savings therefore discriminates against taxpayers who save.”

“Superannuation and owner-occupied housing should continue to be taxed at relatively low rates or be exempt from income tax, consistent with an expenditure tax benchmark.”

“Most countries’ retirement income systems use an expenditure tax benchmark.”

“It is possible to achieve a system that provides a similar tax outcome as other OECD countries. This system would tax contributions at a rate lower than the marginal tax rate on employment income and have earnings and benefits largely tax-free.”

This is one area in which the TES publications over various years become confusing and misleading.

For the TES to meet the objectives stated above and be a useful, transparent and meaningful tool, the benchmark against which tax treatments are measured should reasonably approximate the most appropriate tax treatment for that activity.

Serious economists agree – as stated by Dr Henry in the AFTS – that long-term savings should either not be taxed or taxed concessionally.

Whilst it is clear that the tax expenditures reported for superannuation earnings do not meet this standard, it is less clear whether Treasury do this because they believe such earnings should be taxed at earned income tax rates or whether they do not intend their tax expenditure estimates with regard to such earnings to be a measure of deviation from their desirable tax treatment. If the latter then the whole exercise becomes meaningless.

In 2013 TES, Treasury stated that the tax expenditures result from a deviation from the “standard” tax treatment (benchmark) but then said that their choice of benchmark “*should not be interpreted as indicating a view on how an activity or class of taxpayer ought to be taxed*”.

This seems to be clear although if this is their view one must question the value of the figures being produced. What are they intending to show beyond a mathematical exercise? If this is true it would be better to cease publication.

However, we note that in 2014 TES this qualification was dropped! These words were removed leaving the description of tax expenditures as a measure of deviation from the “*standard tax treatment that applies to similar taxpayers or types of activity*”. Without the 2013 qualification, the implication is that this “standard” is the appropriate taxation of that activity.

Readers would then tend to take the resultant figure as a more meaningful measure of the revenue foregone because of the particular tax treatment.

In Treasury’s defence, they did include an Appendix in the 2013 TES showing tax expenditures against an expenditure tax benchmark. This was described as “experimental” and was not repeated in 2014 despite the fact that most countries use the expenditure tax benchmark, Dr Henry recommended it and it would be a more useful benchmark.

c. Offsets by direct budget savings

Some tax concessions are legislated for social reasons (e.g. income tax redistribution) and others lead to savings in direct budget expenditures. We believe that, for the TES to adequately inform any debate of tax concessions, it should identify prominently whether a tax expenditure may lead to budget savings, what they are and provide an estimate – or estimated range – of the possible savings.

In particular, with respect to superannuation tax concessions, whilst their objective is not solely to reduce the government's Age Pension payments, this is a clear and substantial benefit that should be prominently identified in the TES. The Age Pension is 100% funded by the government whereas superannuation is very substantially funded by an individual's own savings. The tax concessions should:

- provide the individual with an incentive to give up some consumption during his/her working life and save such funds,
- remove the discrimination against saving in the income tax system; and
- compensate him/her for locking up their savings until retirement and then complying with strict rules regarding the subsequent use of their funds

but they form less than 10% of final funding of superannuation.

Structured properly, tax concessions for superannuation is therefore a better use of government funds leaving the government better able to provide sound financial support for a minority of Australians for whom the superannuation system does not work.

If this was more clearly communicated through the TES leading to a better understanding by media and commentators, some parties that claim that reducing tax concessions to provide more funding for more Age Pension payment might become more realistic and temper their comments accordingly.

d. "Fundamental structural elements"

Treasury consistently state that the benchmark choice should neither favour nor disadvantage similar taxpayers or activities. However this is qualified by their view that they may *"incorporate certain elements of the tax system which depart from a uniform treatment of taxpayers where these are fundamental structural elements of the tax system."*

This is Treasury-speak for avoiding measuring the impact on certain taxpayers of our progressive income tax system because it has been a long-standing feature of our tax system.

However, it is unclear why they do not consider the taxation of superannuation earnings in pension phase as a "fundamental structural element" because such earnings have NEVER been taxed in Australia.

Indeed, up until the Government introduced taxes on contributions and superannuation earnings in accumulation phase, such activities have always been tax exempt. The introduction of such taxation would not have been justified on the basis of improving taxation efficiency but presumably as a revenue raising exercise. It reduced the incentive to save and increased the bias against long-term savings. However, these taxes have continued at rates that are proportional and lower than income tax rates.

On this basis, it is a fact that superannuation contributions and earnings have ALWAYS been taxed at rates lower than income tax rates and their treatment as "fundamental structural elements" would be equally as justified as earned income.

One could perhaps further argue that in today's environment in which our income tax scale has become one of the most progressive in the world, a TES that measured positive or negative tax expenditures against an internationally recognised "standard" progressive tax scale would be of great assistance in any debate over tax reform.

In summary:

- a. The aggregation of figures for the separate components of superannuation tax expense in the TES is wrong and should be stopped;
- b. The TES should use an expenditure tax benchmark for savings as used by most countries and as recommended by Dr Henry in the 2009 AFTS;
- c. The TES should clearly identify which tax concessions are expected to lead to savings in direct government expenditures and if possible provide an estimated range the Age Pension savings that are one of the benefits of superannuation; though
- d. Arguably, some aspects of superannuation should be excluded from the TES because they have been longstanding fundamental elements of our tax system. Alternatively, for the TES to be more useful it should include tax expenditures regarding our progressive income tax scale benchmarked to an internationally acceptable "standard" progressive scale.

2. Has TES been misleading?

With regard to superannuation, the TES has been used, either knowingly or unwittingly, in misleading media reports and commentary and also appears to be guiding some organisations' policy formulation.

3. Has Treasury's response been appropriate

We don't believe Treasury has done enough to put the TES in proper perspective and to put the record straight when the TES has been misrepresented or misinterpreted.

After SMSF Owners first pointed out the problems we had identified with TES, we met with Treasury officials in Canberra in 2013 and again in Sydney in 2014. We had the clear impression that they continued to misunderstand our point on aggregation and appeared to believe we were talking about behavioural impacts on tax expenditures. When we suggested that they should immediately issue an explanatory statement to correct the misleading media stories, we were told they would not do this but would handle the matter in the next TES.

We have already described above what then happened. Treasury removed the table aggregating the figures in 2013 but also removed the qualification that they should not be added.

Directors and officers of public companies have strict liability to correct in a timely fashion any misleading information. Such persons are custodians of shareholders' funds and must have a strong sense of responsibility in this regard.

We believe that officers of Treasury, effectively as custodians of taxpayers monies, should have the same degree of responsibility as company directors have for ensuring that information put into the public domain is accurate and reliable and that if such information is persistently mis-reported or wilfully misrepresented, then Treasury has a responsibility to correct these errors by public statement.

We note that there have been some attempts to spell out the limitations of the TES, for example:

- The numbers in the TES are not budget costings;
- The TES is not meant to show how much better off the budget would be if the tax concessions were removed;
- It is misleading to add together the tax concessions on contributions and earnings; and
- A higher tax rate would lead to smaller contributions and higher Age Pension payments but the TES does not take account of the broader effect on Age Pension expenditure.

If there were to be no change to the benchmark used for superannuation tax concessions then we believe that a clear statement along these lines in the annual TES would better assist in understanding its purpose and limitations.

Conclusions

We believe – along with most overseas countries and serious economists – that the expenditure tax benchmark should be used for estimating the cost of superannuation tax concessions. There is certainly more support for this than the use of the income tax benchmark.

At a minimum, tax expenditures with regard to savings using the expenditure tax benchmark should be shown alongside figures using the income tax benchmark with equal, or more reasonably stronger, prominence.

It should be made clearer that that tax expenditures should not be added with a clear explanation as to why.

It should be clear which tax expenditures are expected to lead to substantial savings in direct expenditure, for example in future Age Pension costs, and provide an estimated range of such savings.

If tax expenditures for superannuation are to continue to be reported then tax expenditures for other fundamental structural elements of the tax system, such as the progressive income tax scale, should be reported against an internationally acceptable benchmark.

There should be a strong culture (consistent with the Australian Public Service Values and Code of Conduct with regard to managing official information) within Treasury that, as servants of the Australian people and advisers to Government on the taxation of people's money, they should bear greater responsibility for ensuring their reports are clear, not misleading and not open to inadvertent or wilful misinterpretation. If they are misinterpreted by the media and advocates for policy change, then such misinterpretations should be corrected promptly.

Attachments

- A** 11 February 2013 - SMSF Owners' letter to Treasury Secretary, Martin Parkinson
- B** 26 February 2013 – Treasury Secretary's response (with emailed correction)
- C** 10 March 2013 – SMSF Owners' letter to Treasury Secretary, Martin Parkinson
- D** 11 February 2014 – SMSF Owners' letter to Assistant Treasurer, Senator the Hon Arthur Sinodinos
- E** 28 February 2015 – SMSF Owners' media release "Finally its official - focus on \$32 billion cost of superannuation is misleading."
- F** 22 May 2015 – SMSF Owners' media release "Labor's case for superannuation tax based on double accounting."
- G** 9 March 2015 – Robert Gottlieb, Business Spectator "Treasury's hoax is tormenting the super debate."