TREASURY EXECUTIVE MINUTE

Minute No.

22 June 2012

Deputy Prime Minister and Treasurer

cc: Assistant Treasurer, Minister Assisting for Deregulation
Minister for Financial Services and Superannuation

MANAGED INVESTMENT TRUST FINAL WITHHOLDING TAX BUDGET MEASURE: ANALYSIS OF ALLENS CONSULTING REPORT *SMALL CHANGE, BIG IMPACT*

Timing: At your earliest convenience. This draft report was part of a submission to a House of Representatives Economics Committee (which tabled its report on 18 June 2012).

Recommendation: We recommend that you:

- Note that we consider that the draft report prepared by Allen Consulting Group for the Property Council of Australia is deeply flawed.

Noted Signature:...................................... ...../...../2012

KEY POINTS

- A number of recent statements made by commentators criticising the proposed increase in the final withholding tax rate for managed investment trusts (MIT WHT) from 7.5 per cent to 15 per cent have referred to the Allen Consulting Group (Allens) draft report on the economic impact of the effects of the increase in the rate.
- These statements are based on an analysis by Allens that is deeply flawed, which does not effectively translate the Budget measure into the MMRF model.
  - In scenario 1, as the MMRF model does not separately identify the MIT WHT, Allens **have not actually modelled the Budget measure**.
    - : Rather, as the draft report acknowledges, what Allens have actually modelled is a (small) increase in the company tax rate for all sectors of the economy that raises the equivalent amount of revenue as the MIT WHT.
  - In Scenario 2, Allens have simply assumed that the Budget measure will have a negative impact on the aggregate capital stock of the economy.
    - : That is, the results presented for scenario 2 are a **reflection of a change in an unsubstantiated assumption fed into the model rather than being driven by the model itself**.
    - : This is over 15 times the annual reduction in investment for 2015-16 produced under Allens' Scenario 1.
- The approach by Allens is based on analysis (set out in section 2 of their report) that assumes that a change in the MIT WHT is the same as a general increase in the tax applied to mobile capital in a small open economy.

- The key problem with doing this is that the relevant literature (including *Australia's Future Tax System*) says that you get very different results from imposing taxes on mobile capital and immobile capital (such as land).

  : The MIT WHT primarily relates to rental income and capital gains from investments in real property. (That is, immobile capital, or arguably a mix of immobile capital – land – and mobile capital – buildings.)

- Another problem is that the economic impact of increasing a tax applicable to one sector of the economy (ie, real estate development) would be expected to be quite different to one that affects all sectors equally.

  : That is, by applying a lower tax rate to equity invested in real property than other sectors of the economy, the tax system is distorting the pattern of investment towards that sector and away from other sectors of the economy.

- Yet another problem with the modelling is that some investors may choose to switch investment vehicles (ie not use trusts) rather than discontinuing investment in Australia.

• It is also not clear how the analysis in the report assumes other levers of economic policy would adjust to keep the economy fully employed.

- In particular, it is strange that both scenarios result in an enduring negative impact on the level of employment.

  : Under standard MMRF assumptions, any initial reduction in employment leads over time to lower real wages, which restore employment over time.

• In summary, the draft report by Allens unintentionally illustrates many of the pitfalls of attempting to conduct second round analysis for relatively small policy changes.

- In evidence to the House of Representatives Economics Committee last week Treasury outlined the reasons why we do not as a general rule include second round effects on Budget measures in our costings.

• The following areas have been consulted in the preparation of this minute: Tax Analysis Division, Macroeconomic Modelling Division

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ADDITIONAL INFORMATION

- Allens Consulting Group (Allens) has prepared a draft report on the economic impact of increasing the final withholding tax rate for managed MITs from 7.5 per cent to 15 per cent.
  - The draft report uses the Monash Multi-Regional Forecasting model (MMRF) to estimate the economy wide impact of the measure (including second round effects).
  - Two scenarios are presented in the draft report: (i) the impact of an increase in the tax rate; (ii) investment flight resulting in a $1 billion per annum reduction in the stock of investment.
- Allens estimate that the increase in the tax rate (Scenario 1) will result in:
  - a net increase in public sector revenue in 2015-16 of $35 million (an increase of $47 million in Australian Government revenue and a $12 million reduction in State Government revenue); and
  - a decrease of GDP in 2015-16 of $30 million, with household consumption reduced by $69 million, and investment reduced by $59 million.
- Allens estimate that a $1 billion per annum reduction in the stock of investment (Scenario 2) will result in:
  - a decrease of GDP in 2015-16 of $580 million, with household consumption reduced by $533 million, and investment reduced by $1,051 million.
  - a net deterioration in public sector budget position revenue in 2015-16 of around $300 million over the forward estimates.