20 October 2017

Robert Ewing
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By email

Dear Robert

Review of Tax Expenditures Statement

The Financial Services Council (FSC) welcomes the opportunity to make submissions on the Tax Expenditures Statement Consultation Paper.

The FSC has over 100 members representing Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks and licensed trustee companies. The industry is responsible for investing more than $2.7 trillion on behalf of 13 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is the fourth largest pool of managed funds in the world.

The Tax Expenditures Statement (TES) is an important document that helps inform public policy. However, the document is often misused and misunderstood, so the FSC welcomes the opportunity to present our views on how the presentation and content of the TES could be improved.

The FSC's detailed response to the consultation paper are in the Attachment; in summary the FSC recommends the following:

- The TES should give equal prominence to estimates using the income benchmark and the expenditure benchmark. The two measures should be presented side-by-side for the expenditures where there is the greatest difference between the two benchmarks.
    - The current TES only uses the income tax benchmark. This implicitly promotes a value judgement that this benchmark is the 'correct' way to tax savings. While the TES is not designed to present a value judgement it is often interpreted as providing this judgement.
    - Changing the TES to present estimates using both the income and expenditure benchmarks would allow readers to make the value judgement of which benchmark is correct, or if the 'correct' approach lies in between the two measures.
    - The TES has indicated benchmarks can be 'arbitrary'; providing readers with a choice of benchmark reduces this arbitrariness.
    - This proposed approach is consistent with the findings of the Henry Tax Review.

- The income and expenditure estimates for a particular tax expenditure should be updated at the same frequency — yearly for the largest expenditures.
- The income tax benchmark incorrectly deals with inflation relating to capital gains.
    - Therefore, the benchmark for capital gains tax should be changed to include a deduction for inflation. This is because the 'compensation' for inflation is not genuine income.
    - Inflation adjustments should in theory occur for all tax expenditures but the priority relates to capital gains as the impact of inflation on the taxation of long-lived assets can be considerable.
- There should be greater emphasis on improving the TES estimates relating to internationally mobile capital, particularly non-resident withholding taxes.
    - The FSC has a broad concern that tax expenditures (and revenue costings) do not adequately factor in increasing capital mobility.
    - Revenue gain estimates, which include behavioural change, should be published for withholding taxes.
    - The benchmark for international taxes also needs clarification.
- The best way to reduce misunderstandings of the TES in relation to the benchmark is to improve the information presented.
    - In particular, the significant debate (and misunderstanding) over the 'correct' taxation of savings means the tax expenditures relating to savings should be presented using the two relevant benchmarks, as proposed earlier.
    - While this is the best solution to reducing misunderstanding, there would also be value in placing a clear explanation of the caveats on the TES in separate text, such as a box, near the start of the document stated in simplified clear language.
    - The layout of the TES should also be changed to discourage the addition of estimates in the TES that should not be added.
- A high priority should be placed on more frequent updating, and more prominent presentation, of the revenue gain estimates (which include behavioural change) and the estimates of the overall budget impact of removing tax expenditures.
- The FSC supports the government's decision to reject the recommendation to remove the tax expenditure for the CGT exemption for the home.
- Less frequent updating of smaller tax expenditures seems a reasonable compromise. This change would allow Treasury resources to be devoted to the other important changes to the TES.
- Publication of a TES technical manual every few years appears worthwhile. This doesn't need to be a formal, standalone document that is completely revised every few years; instead it could be a number of linked webpages that are updated on an as-needs basis.

We would be happy to discuss this submission; I can be contacted on [redacted].

Yours sincerely,

[redacted]

Michael Potter
Senior Policy Manager

Attachment

The Tax Expenditure Statement (TES) should be a valuable contribution to public debate; however it is often misused and misunderstood. As a result, the value of the TES to public policy is substantially reduced.

The FSC recommends a range of improvements to the TES to address these issues.

Equal prominence to income & expenditure benchmarks

The TES currently measures tax expenditures for income tax against an 'income' benchmark. This implicitly imposes a value judgement that this benchmark is the correct, or ideal, way to impose tax. Treasury and the government may argue the TES is not imposing a value judgement, but the TES is often interpreted as providing this judgement. It is also highly unlikely that providing caveats (discussed later) on their own would address this problem.

This issue particularly affects the taxation of savings and investment. The supposed tax 'concessions' for many types of saving no longer exist if the taxation of saving is compared to the alternative benchmark of expenditure taxation. In fact, some savings vehicles (superannuation and bank accounts) would likely have a *punitive* tax treatment compared to this benchmark.[1]

But the TES implicitly rejects the expenditure benchmark and promotes the income benchmark. It has been argued that this is the correct approach: the expenditure benchmark should be rejected because not many experts believe that this is the appropriate way to tax savings.[2] This is debatable;[3] but regardless this argument operates the other way: many experts who reject zero taxation on savings also reject the taxation of savings at full tax rates. In other words, many experts accept savings should be taxed somewhere between the income benchmark and expenditure benchmark.

- This is consistent with actual tax policies in other developed countries: most of the OECD and EU impose an expenditure-style tax on retirement savings.[4]

Hence to be unbiased between these two benchmarks, the TES should give equal weight and prominence to each. This would allow readers of the TES to make the value judgement as to where the benchmark lies.

The presentation of two benchmarks, reducing the implicit value judgement of which benchmark is 'correct', is consistent with statements in statements by Treasury and in the TES:

- "plausible arguments may be made in support of using an income tax benchmark and an expenditure tax benchmark for savings tax expenditures"[5]

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[1] For superannuation, see Australian Government (2014) Tax Expenditures Statement 2013, Appendix A.

[2] John Daley, Danielle Wood, Brendan Coates (2015) Submission to Standing Committee on Tax and Revenue inquiry into the Tax Expenditures Statement, 4 August.

[3] A well-known result in the economics literature says that the optimal rate of tax on capital is zero (the Chamley-Judd result). Gregory Mankiw said "Perhaps the most prominent result from dynamic models of optimal taxation is that the taxation of capital income ought to be avoided. This result['s…] strong underlying logic has made it the benchmark." See N Gregory Mankiw, Matthew Weinzierl & Danny Yagan (2009) "Optimal taxation in theory and practice", *Journal of Economic Perspectives* 23(4), pp147–174.

[4] See page 3 of OECD (2015) Stocktaking of the tax treatment of funded private pension plans in OECD and EU countries, available from: http://www.oecd.org/daf/fin/private-pensions/Stocktaking-Tax-Treatment-Pensions-OECD-EU.pdf

[5] Treasury (2015) *Submission to Standing Committee on Tax and Revenue Inquiry into the Tax Expenditures Statement*, August, p6.

- "Determining benchmarks involves judgment. Consequently, the choice of benchmark may be contentious and benchmarks may vary over time. The choice of benchmark should not be interpreted as indicating a view on how an activity or taxpayer ought to be taxed."[6]
- "[T]here may be different views on which structural elements to include in the benchmark. Consequently, benchmarks vary over time and across countries and can be arbitrary."[7]

This proposed approach is also consistent with the recommendations of the Henry Tax Review, which argued "Comprehensive income taxation, under which all savings income is taxed in the same way as labour income, is not an appropriate policy goal or benchmark."[8] The Henry Review instead advocated expenditure taxation as the appropriate benchmark.

The two measures of tax expenditures should be presented side-by-side for the most affected tax expenditures; that is, where there is the largest difference between the two measures. This is likely to be for housing, superannuation, and bank deposits.

Consistent with this proposal, the income and expenditure estimates for a particular tax expenditure should be updated at the same time.[9] This would be an annual update for the largest relevant tax expenditures.

Question 7. Should the TES report tax expenditures for income from savings against a pre-paid expenditure benchmark in addition to a comprehensive income benchmark?

Response: Yes, this is essential.

Question 8. If so, should this apply to all forms of savings, or only a subset? Should reporting against this alternative benchmark be done annually, or periodically?

Response: Reporting against an expenditure benchmark is essential for the largest items, and should be updated at the same frequency as the income benchmark estimates for the same item. Less frequent updating of smaller items could occur (as discussed below).

For items where there is only a small difference between income and expenditure benchmark estimates, the TES could present one figure only; but this might still be interpreted as giving some official support to that benchmark for the rest of the TES.

Nominal vs real income benchmark

The current income tax benchmark in the TES has an important problem: it is on a nominal base with no inflation adjustment. The 2016 TES states: "The income tax benchmark incorporates a range of features of the tax system, including the following:…Assessment applies to nominal rather than real income."[10]

As a result, the TES incorrectly deals with inflation. It treats as income any compensation for the erosion of the value of money, even though this compensation is not genuine income. For example, an asset growing by 2% per year when inflation is also 2% is not producing any real ('genuine')

[6] Australian Government (2017) Tax Expenditures Statement 2016, p3.
[7] Australian Government (2015) Tax Expenditures Statement 2014, p129.
[8] Ken Henry, Jeff Harmer, John Piggott, Heather Ridout & Greg Smith (2010) *Australia's Future Tax System: Final Report, Vol 1,* p12.
[9] This does not mean that *all* estimates need to be updated yearly. Instead, this means, for example, that if the income benchmark estimates for superannuation are updated, then the superannuation estimates based on the expenditure benchmark should also be updated at the same time. The frequency of updating is discussed later in this submission.
[10] Australian Government (2017) Tax Expenditures Statement 2016, p133.

capital gains for the owner at all. Taxing the 2% capital appreciation would make the asset owner lose money in real terms (leaving aside regular returns such as rent and dividends).

This may not appear to be an important issue in an era of low inflation. But it can actually make a substantial difference when real rates of return are low, as they are currently for many assets other than housing.[11]

The current benchmark would mean reintroducing CGT indexation would be measured as a tax expenditure. This is clearly not the right result. Notably, when CGT indexation was part of the tax system in 1996, the benchmark at the time didn't count this as a tax expenditure;[12] but using today's benchmark, CGT indexation *would* be counted as an expenditure. There is no clear reason for this change in benchmark.

In theory, inflation adjustments should occur for all tax expenditures but the priority relates to capital gains as the impact of inflation on long-lived assets can be considerable.

Benchmark for international taxes

Over time, capital is becoming more mobile internationally. This means capital tax bases are significantly more responsive to tax rates, and lower tax rates ('tax concessions') have a smaller associated tax expenditure, at least when behavioural changes are included.

For this reason, there should be a greater emphasis on improving the estimates for tax expenditures relating to internationally mobile capital. From the FSC perspective this is particularly important for non-resident withholding taxes. The FSC has for some time been concerned that these withholding taxes are a significant hindrance to Australia's export of financial services; the revenue raised by withholding taxes on collective investments is inadequately measured; and the tax expenditure from reducing these taxes would be small. These concerns are detailed in the attached FSC submission on *Collective investment vehicle non-resident withholding taxes*.

The FSC therefore recommends the TES should publish more revenue gain estimates (which include behavioural change) for more tax expenditures relating to withholding tax.

The benchmark for some international taxes is also unclear. The 2016 TES states the following: "Transfer pricing and thin capitalisation rules…aim to tax appropriately Australian sourced income and are included in the benchmark."[13] No further detail is provided, similarly for other aspects of international taxation including the controlled foreign company and trust rule. Some more detail is provided in relation to withholding taxes but this information is not comprehensive. The TES would benefit from the provision of more detail on these benchmarks.

Question 4. Do you have any concerns about the benchmarks currently used in the TES? How can they be improved?

Response: As argued above, the FSC recommends the income and expenditure benchmarks should have equal prominence in the TES; the income benchmark should include adjustment for inflation, at least for CGT; and the benchmark for international taxes needs to be improved and made clearer.

Question 5. What broad set of principles should be used to inform the choice of benchmark?

[11] And there isn't much capital appreciation in housing outside of Sydney and Melbourne.
[12] Australian Government (1997) Tax Expenditures Statement 1996–97, p60. See also the 1998 TES, p61.
[13] Australian Government (2017) Tax Expenditures Statement 2016, p133

Response: While FSC does not have a detailed list of principles for the benchmark, we propose several principles consistent with the arguments in the rest of this submission:

- Where there is significant disagreement over which benchmark to use, the TES should present several estimates using the different benchmarks side-by-side. This is particularly important if the TES is being misinterpreted as giving official approval to one particular benchmark as the "correct" way to tax.
- Tax expenditures should be retained in the TES even if it is unlikely that the government would ever remove the relevant expenditure (the main example of this is the CGT exemption for the family home).

Question 6. Should standards be developed and published for determining the benchmark tax treatment? If so, who should be responsible for their development?

Response: The FSC does not have a particular view on this issue.

Qualifications/caveats on the TES

As noted earlier in this submission, and acknowledged by in the Treasury consultation paper, the TES can be misunderstood and misused. The FSC therefore supports changes to the TES to reduce these problems.

The FSC considers the best way to address some of the misuse of the TES is through improving the information presented. As noted earlier, the use of the income benchmark for savings is seen as giving official approval to this benchmark as the 'correct' way of taxing savings. To address this misunderstanding, the better solution is to providing the expenditure benchmark estimates as well. This will mean the judgement about the 'correct' tax treatment is left to the reader. Providing this information would work much better in reducing the misuse of the TES than adding many more qualifications to the document.

That said, there would also be some value in placing a clear explanation of the caveats on the TES in separate text, such as in a box, near the start of the document. These caveats should be stated in clear language, such as the following non-exhaustive list:

- Don't add the numbers together for separate items
- Don't compare this year's estimates to previous years
- Some estimates are very uncertain
- Some estimates are quite subjective
- These are <u>not</u> estimates of the revenue increase if a tax expenditure is removed
- These are <u>not</u> estimates of the budget impact of removing a tax expenditure

Additional clear caveats would be needed for the revenue gain estimates.

The details of these caveats could be provided elsewhere in the TES or the technical manual (discussed below). The TES largely contains these caveats already; the FSC proposal would highlight the caveats more.

The layout of the TES should also be changed to discourage the addition of estimates in the TES that should not be added, for example by reducing the prominence of tables that allow easy addition of figures; or at least additional clear caveating of these tables.

- If there are some circumstances where TES estimates can be added, this could also be explained in the document.[14]

Question 10. What options are there to improve the visibility and accessibility of caveats in the TES?

Response: The FSC recommends the TES include a clear statement of caveats in a separate box near the start. Tables containing multiple tax expenditure items (such as Table 1.1 in the 2016 TES) should have reduced prominence, and have clear caveats about the estimates not being additive in general.

Question 11. What options or strategies are available to mitigate or reduce the misunderstanding of figures published in the TES?

Response: While increasing the focus on caveats is worthwhile, a better solution is to address the misunderstandings directly by improving the information presented. This particularly includes giving equal prominence to income and expenditure measures for income tax expenditures as proposed earlier.

Additional analysis, including in appendices

The FSC considers a high priority should be for the TES to have more frequent updating, and more prominent presentation, of estimates of revenue gain (which include behavioural responses) and whole-of budget impact for major savings-related tax expenditures. For example, the whole-of-budget impact for superannuation measures includes the reduction in Age Pension spending caused by the superannuation tax measures.

Importantly, the government accepted the recommendation of the Parliamentary committee inquiry that there should be a regular publication of long-run interactions between superannuation and the Age Pension (see response to recommendation 4). The government proposed the whole-of-budget analysis be conducted 'broadly' every five years; the FSC considers this frequency should be a minimum.

The FSC considers it would be preferable for the two types of estimates — revenue gain and whole-of-budget — be updated every year; and be provided more prominently than in an attachment where the estimates can be missed.

The TES should also include:

- more frequent and detailed revenue gain estimates for tax expenditures relating to withholding taxes (as discussed earlier).
- longer-term estimates of tax expenditures, particularly for those tax expenditures where the short-term impact is substantially different from the long-term impact.[15]

By contrast, we do not consider it to be a priority for the TES to include 'costing' of the removal of parts of the tax system that are not defined as tax expenditures such as the removal of negative gearing or the removal of any other tax provisions that are included in benchmarks.[16]

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[14] For example, the estimates of the tax expenditure for superannuation, using the expenditure benchmark, involved the addition of different estimates. See Australian Government (2014) Tax Expenditures Statement 2013, Appendix A.

[15] This is discussed in more detail in Parliamentary Budget Office (2015) Submission to the Standing Committee on Tax and Revenue inquiry into the Tax Expenditures Statement, 17 September.

[16] These 'memorandum items' are included in Canada's equivalent of the TES.

Question 16. Would the value of the TES be enhanced by including appendices that focus in more detail on particular topics (varying each year) relevant to tax expenditures? What topics should be prioritised?

Response: The TES should more frequently update estimates of revenue gain (which include behavioural responses) and whole-of budget impact for major savings-related tax expenditures, tax expenditures relating to withholding taxes, and longer-term estimates of tax expenditures. These should have more prominence than being placed in an Appendix.

It should not be a priority for the TES to estimate the impact of removing segments of the tax system that are not defined as tax expenditures, such as the removal of negative gearing.

Tax expenditure on the family home

The Parliamentary Inquiry into the TES recommended the CGT exemption for the home be removed from the TES — in other words, the family home be included in the CGT benchmark.[17] The Government rejected this recommendation.

FSC supports the Government's decision for the reasons stated: it would be inappropriate for the TES to make a judgement about future decisions of the Government and Parliament, and the CGT exemption is a departure from the comprehensive income tax benchmark. In addition, assessing this CGT exemption against the expenditure benchmark (as proposed earlier) would likely show a dramatically different tax expenditure. The FSC also notes retaining the family home in the TES allows other tax expenditures, including those relating to superannuation, to be kept in perspective.

Question 9. Should the current benchmark treatment of owner-occupied housing be altered to allow deductibility of mortgage interest and capital works deductions against the CGT cost base?

Response: This proposal seems reasonable, and would be consistent with the taxation of other capital gains. However, FSC does not consider this analysis should be a priority for the TES.

Small Tax Expenditures

Question 1. What is an appropriate annual threshold below which expenditures could be updated less frequently and reported as ranges?

Question 2. What is an appropriate frequency for updating these small tax expenditures?

Question 3. What are appropriate bounds for the ranges?

Response: Less frequent updating of smaller tax expenditures seems a reasonable compromise. This change would allow Treasury resources to be devoted to the other important changes proposed elsewhere in this submission. FSC does not have a particular view on the details.

TES Technical manual

Question 12. Would adopting a model where technical descriptions of tax expenditures are contained in a separate technical manual be appropriate?

Question 13. Would it be reasonable to update the technical manual with lower frequency? (Noting that a description of new and changed expenditures would still be included in the annual document.)

[17] House of Representatives Committee on Tax and Revenue (2015) Review of the Tax Expenditure Statement

Response: Publication of a TES technical manual every few years appears worthwhile. This for example could provide more information about the benchmarks for international tax (see earlier concerns that inadequate detail has been provided about these benchmarks).

This does not need to be a formal, standalone document that is completely revised every few years; instead it could be a number of linked webpages that are updated when required.

Note however that removing details from the TES might make it easier to add together separate estimates that are not designed to be added together (a concern noted earlier).

Improving data

Question 14. Is there additional data that taxpayers can provide to the ATO to improve the estimates without significantly increasing compliance costs?

Question 15. Are there existing data sources external to Government that can be used to improve the reliability of existing estimates or allow estimates currently presented as unquantifiable to be reliably quantified?

Response: The FSC encourages the government to improve the TES estimates, but does not have a particular view on how to improve the estimates or which data sources to use. This is partly because it is unclear what existing data sets are already being used in the preparation of the TES.