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Dr Kathleen Dermody
Committee Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
Canberra ACT 2600

8 Malvina Place
Carlton
Victoria 3053
Australia
T. +61 3 8344 3637
W. www.grattan.edu.au
E. info@grattan.edu.au

Dear Dr Dermody

Senate Economics Legislation Committee – Inquiry into the Tax Laws Amendment (Temporary Budget Repair Levy) Bill 2014 and related bills

Thank you for your invitation to provide a submission to this inquiry.

In May this year, Grattan Institute published a report on the state of Australian budgets. The report, *Budget pressures on Australian governments: 2014 edition* analysed Commonwealth and State budget positions, and found that substantial effort to repair budgets was necessary to ensure long-term fiscal sustainability.

This report drew on our previous work, *Balancing budgets: tough choices we need* (published November 2013), which surveys all realistic proposals that could contribute \$2 billion a year or more to Australian government budgets. It identified reforms that are big enough to make a difference but do not have unacceptable economic and social effects. While this report found that one of the pre-requisites for effective budget repair is that effort is shared fairly across the community, it also found that there are better ways for the well-off to contribute to budget repair than changes to income tax rates. These include reform of superannuation taxation, negative gearing, and capital gains tax exemptions.

I attach a submission summarising our findings, as well as a copy of the reports mentioned above. If Grattan Institute can be of further assistance to the Inquiry, please do not hesitate to contact me.

Yours sincerely

John Daley
Chief Executive Officer

Grattan Institute submission to the Senate Economics Legislation Committee inquiry into the Tax Laws Amendment (Temporary Budget Repair Levy) Bill 2014 – May 2014

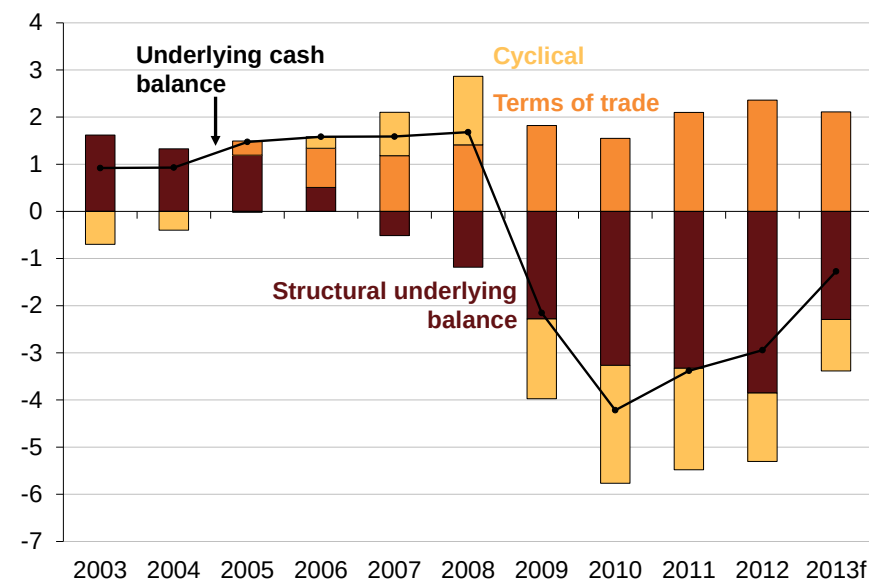
1. Australia has a structural budget problem

The Commonwealth Government – directly responsible for 58 per cent of Australian government expenditure and 76 per cent of the taxation¹ – has had a structural budget deficit of more than 2 per cent of GDP for the past five years. As Figure 1 shows, the Commonwealth spent more than its income after allowing for fluctuations in prices (particularly the mining boom and the terms of trade), and the business cycle (particularly the Global Financial Crisis).

Calculations of the structural deficit by the International Monetary Fund, the OECD, Australian Treasury, the Parliamentary Budget Office, Deloitte Access Economics and Grattan Institute all use slightly different methods and assumptions. But they all come to a similar conclusion: the Commonwealth Government has run a substantial structural deficit for half a decade.²

The mining boom and the Global Financial Crisis (GFC) masked the problem. Australia failed to realise that the income from the mining boom would not last, but that spending increases started during the GFC *would*.

Figure 1: Commonwealth structural budget position
Per cent of nominal GDP



Source: Minifie et al. (2013)

Australian government budgets are benefiting from relatively benign economic conditions. Four years after the GFC, the economy of Australia and its major trading partners in Asia are close to their long run growth rates, even if the economies of many developed countries have not yet recovered to their pre-GFC size.

¹ Daley, et al. (2014) pp.18, 29.

² McDonald, et al. (2010); Daley, et al. (2013); Deloitte Access Economics (2013); Minifie, et al. (2013); PBO (2013)

Combining these effects, one would expect Australian governments to be running comfortable surpluses at this point in the mining and economic cycles in order to pay back the stimulus spending of the GFC, and to absorb the likely hit to budget balances when the terms of trade return to more normal levels. Instead, Australian governments are relying on current minerals prices only declining slowly, and even then the effect will be to maintain current deficits or thin surpluses. Governments are very exposed to the risk of a scenario in which mining investment and earnings slow more quickly. Consequently there is a strong case for adjusting budget revenue and expenses sooner rather than later to prepare for this.

While the policy changes announced in the 2014-15 Budget bring the headline budget balance close to surplus, they do not do enough to fix the underlying *structural* problem. This is especially the case with the Temporary Budget Repair Levy, which has no effect on the budget at all after 2016-17.

2. **Balanced budgets matter**

Over the economic cycle of boom and bust, balanced budgets are much better than the alternative. Persistent government deficits incur interest payments, and limit future borrowings. As a result they can unfairly shift costs between generations, and reduce flexibility in a crisis. Yet in good times it is hard for governments to run a surplus. They are invariably tempted to spend money. Many voters prefer outcomes with no identifiable losers.

Australia has escaped these problems, repairing its debt position over the 2000s, supported by public attitudes that were more averse to debt than those in most other countries. However, there

are concerns that Australian attitudes are softening.

Balanced budgets over the economic cycle make a big difference. Persistent large deficits make both the old and the young vulnerable: the old risk the security of their pensions and health care; the young bear an increased tax burden in the future to pay for past spending. Persistent large deficits lead to high government debt that can reduce flexibility in a crisis.³ Some argue that high government debt can reduce long-run economic growth – although this claim is contested.⁴

Persistent deficits undermine the security of people, such as retirees, who depend on government. High government debt may lead to governments being forced to cut spending dramatically in a crisis. It is almost inevitable that such cuts will hit the vulnerable hard as the largest categories of government spending are welfare (22 per cent) and health (19 per cent), and dominated by spending on older people.

Perhaps the most important argument for budget reform is that deficits borrow from the future. They require future generations of taxpayers to pay for today's spending. There are fundamental issues of intergenerational fairness if future taxpayers are forced to bear the burden of today's spending that they do not have a say in, nor benefit from.

³ Kotlikoff (1984)

⁴ Reinhart and Rogoff (2009), but see the debate summarised in Economist (2010) and Herndon, *et al.* (2013)

3. Criteria for effective budget repair

If Australian governments are serious about fixing their budgets, they need to make tough choices. Grattan Institute's 2013 report, *Balancing budgets: tough choices we need*, presents a range of them.⁵ None are particularly appealing. Nobody likes paying higher taxes or receiving fewer services. But governments need to make these difficult choices rather than put them off for future governments. We cannot simply 'grow out of trouble'. We need structural reform.⁶

Valuable lessons can be learnt from previous Australian and international experiences of budget repair. These experiences, summarised in Grattan's 2013 *Balancing budgets: Supporting analysis*, show that to balance budgets, governments need to clearly explain the problem, share the pain fairly across the community, prioritise large reforms, make structural changes to both spending and taxation, and resist the temptation to delay.⁷

4. How does the Levy measure up?

The Levy meets some criteria of effective budget repair, but not all of them. It is being introduced relatively quickly, has a reasonably clear explanation and rationale, ensures that tax as well as spending is part of the solution, and means that those on high incomes make some contribution to fixing the budget.

However, it fails on some of the most important criteria. The Levy has no impact on the long-term structural position of the Budget,

as it will cease to exist in 2017-18. It does not share the pain very effectively, as it will only have a short-term impact on high-income earners. By contrast, spending cuts that will have a disproportionately large effect on lower income earners are permanent. Bracket creep that has a disproportionate impact on middle income earners continues until specific legislation changes the marginal rates or thresholds. By comparison, the Levy raises relatively little money.

As Figure 2 shows, the policy changes announced in the 2014-15 Budget will collectively do relatively little to drive budget improvement. The Temporary Budget Repair Levy is forecast to raise only \$1.2 billion per year, or around 3 per cent of the total improvement in the budget position between 2013-14 and 2016-17. The total impact of all budget measures in 2016-17 is only \$8.7 billion, or 22 per cent of the total improvement.

The vast majority of the improvement projected between 2013-14 and 2016-17 is due to bracket creep. When income tax thresholds are not increased, wage inflation pushes incomes into higher tax brackets. Individuals then pay more of their income in tax, even if the purchasing power of their income has not increased.

⁵ Daley, *et al.* (2013a); Daley, *et al.* (2013b)

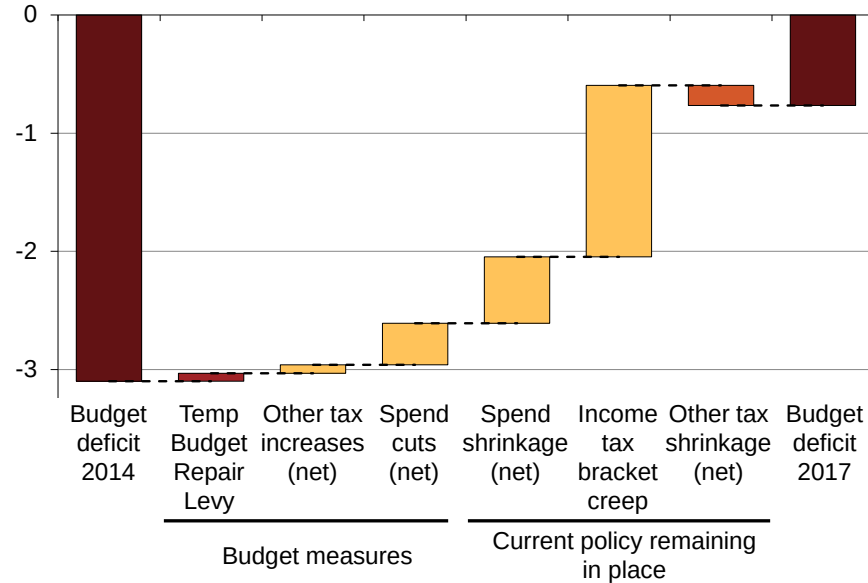
⁶ IMF (2013), p. 10

⁷ Daley, *et al.* (2013b), p. 51-55

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Figure 2: Composition of budget repair, 2013-14 to 2016-17

Per cent of GDP

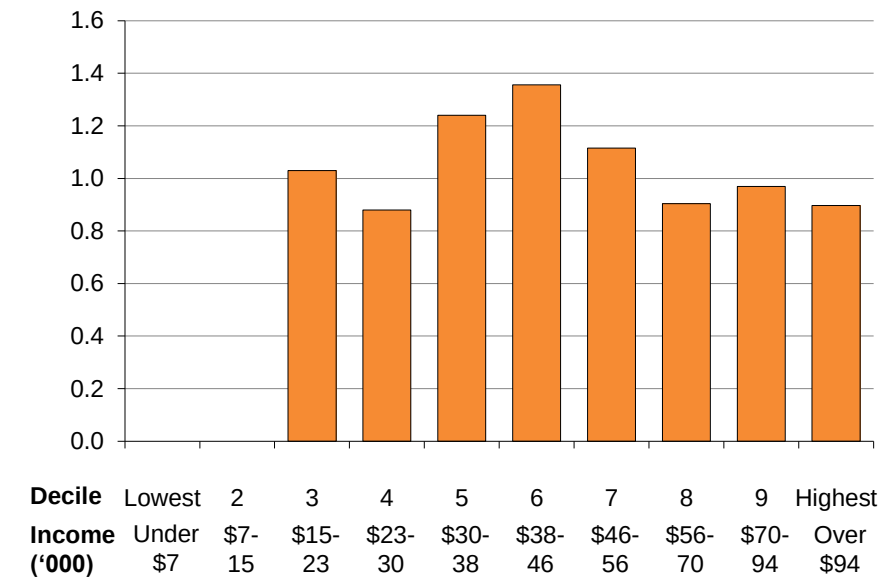


Source: Grattan analysis of Commonwealth Budget Papers 2014-15

The impact of bracket creep falls squarely on middle-income taxpayers. A person earning between \$38,000 and \$46,000 a year will pay an additional 1.4 per cent of their income in tax, or around \$430 (Figure 3). In comparison, a person earning \$94,000 or more would pay an additional \$1,670 per year, or a 0.9 per cent increase.

Figure 3: Impact of bracket creep, 2013-14 to 2016-17

Additional percentage of income paid in tax, by taxpayer income decile



Source: Grattan analysis of Commonwealth Budget Papers 2014-15; ATO (2013)

Relying on bracket creep to fix the budget is a problem for two reasons. Firstly, because it is effectively an income tax increase, it reduces the incentive to work for those on middle incomes, and may decrease workforce participation. This is particularly an issue for women, who already face disproportionately high marginal tax rates due to the cost of child care. Australia's rates of women's workforce participation are already low by international standards; if women in Australia participated in the workforce at the same rate as Canadian women, it would

contribute an additional \$25 billion a year to our economy.⁸

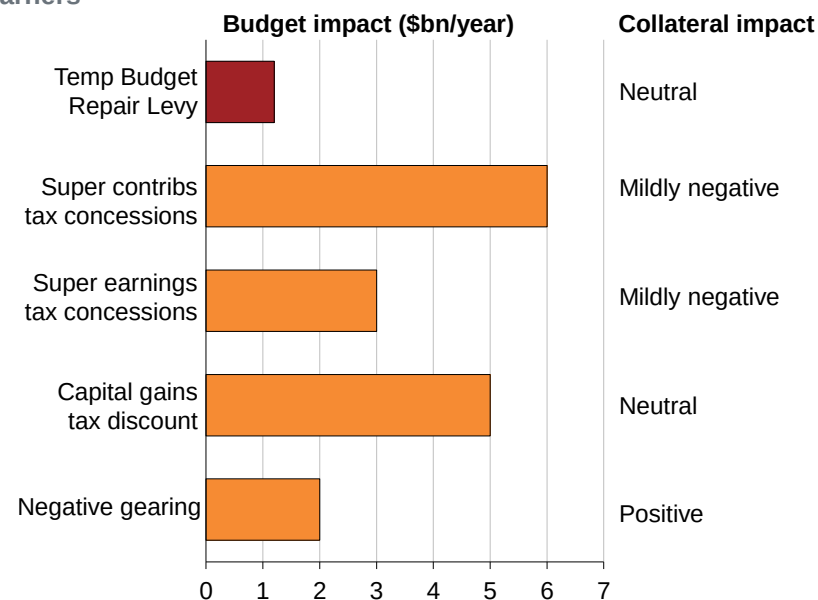
Secondly, it is questionable whether bracket creep of this magnitude is politically sustainable. If government accedes to pressure to provide income tax cuts in the future, the return to surplus will be delayed even further.

5. Better options for budget repair

Ensuring that everyone, including the well-off, contributes to budget repair is a sensible policy aim. As Figure 4 shows, there are at least four options that would raise more money than the Levy, and would not have significantly worse side-effects in economic, social and distributional terms. They also have the major advantage of contributing to a permanent improvement in the structural budget balance.

These options are summarised in the following pages. Further detail of the proposals and their impacts can be found in Grattan Institute's 2013 report *Balancing budgets: tough choices we need*.⁹

Figure 4: Options for budget repair that mostly affect high income earners



Source: Daley, McGannon, et al. (2013a); Grattan analysis of Commonwealth Budget Papers 2014-15

⁸ Daley, et al. (2012)

⁹ Daley, et al. (2013a); Daley, et al. (2013b)

Superannuation tax concessions

Superannuation differs from regular savings because it attracts significant tax concessions. Contributions made from pre-tax earnings are only taxed at 15 per cent up to the \$25,000 or \$35,000 thresholds. Earnings from superannuation funds are only taxed at 15 per cent during the accumulation phase (usually pre-retirement) and not taxed at all when supporting retirement income streams (usually post-age 60); earnings from other savings are taxed at the person's marginal tax rate. People – especially high-income earners – who save through superannuation usually pay substantially less tax than if they save through other investments.

These arrangements lead to workers over 60 paying substantially less income tax than younger workers with similar incomes. They can arrange their affairs so that the first \$35,000 of income is deposited to superannuation – from where it can immediately be withdrawn tax free (conditional on a superannuation balance of more than \$350,000), but is not included in taxable income. As a result a 61-year old working full-time on the Australian average wage of \$77,000 a year may pay at least \$5000 less a year in tax than a person under 60 who only makes compulsory superannuation contributions of 9.25 per cent.¹⁰ A 61-year-old earning \$100,000 a year, and another \$35,000 in super earnings from a super balance of \$500,000 could pay as little as \$17,000 of tax on earnings of \$135,000.

¹⁰ These calculations do not include additional tax concessions from the Seniors and Pensioners Tax Offset. Depending on the spouse's income this might reduce the tax payable by a person aged 65 or over by another \$1600.

Superannuation earnings also attract less tax. Capital gains made on assets inside a superannuation fund are taxed at 10 per cent, and other income — interest and dividends — is taxed at 15 per cent. Franking credits (tax paid on behalf of the shareholder by a company) may be used to offset a tax liability within the fund, including capital gains.¹¹ By comparison, earnings on savings outside of superannuation are again taxed at the marginal tax rate – 38.5 per cent for many taxpayers.

These tax concessions in Australia go disproportionately to those in the top income deciles, as Figure 5 shows. Removing these concessions would have little impact on low-income earners, as they receive little benefit from them.

Grattan's *Balancing Budgets* report proposed two changes to existing superannuation tax concession arrangements:

- Limiting superannuation tax concessions so that only \$10,000 a year can be contributed before tax would raise up to \$6 billion a year at full implementation.¹²
- Requiring those over 60 years old to pay 15 per cent on earnings within their superannuation fund (as those under 60 do) rather than no tax, would raise an additional \$3 billion a year at full implementation.¹³

¹¹ ASIC (2013)

¹² See Daley, *et al.* (2013b) p 10

¹³ See *ibid.* p 12

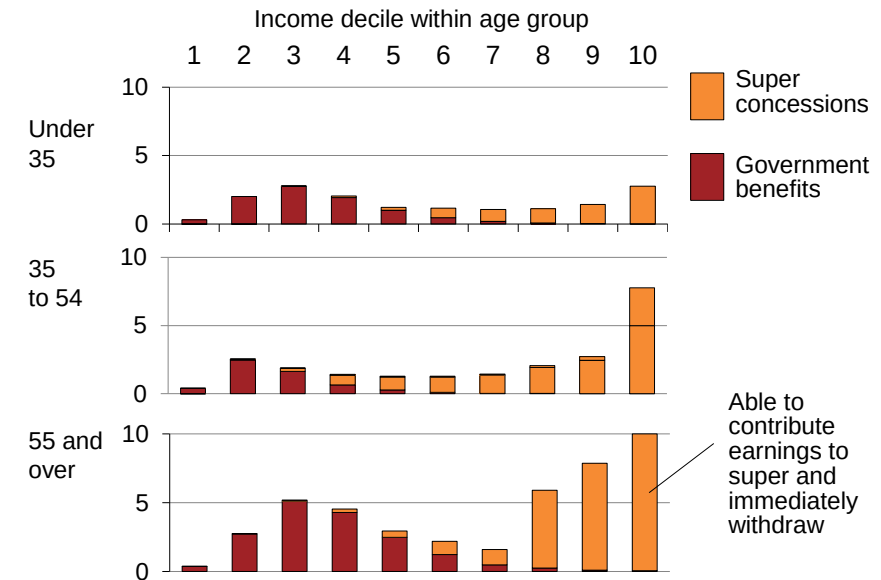
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Not all the superannuation contribution concessions would become revenue if they were revoked.¹⁴ However, income tax would be paid at marginal rates on almost all of the income that would otherwise attract a superannuation contribution tax concession. Although some investments would be switched into other asset classes, there is no alternative investment that allows taxpayers to avoid paying income tax on earnings before they are invested.

Tightening these tax concessions is unlikely to substantially reduce the draw on the Age Pension. Those in the top 10 per cent of earners aged 35 to 54 are likely to have sufficient savings that they will not qualify for an Age Pension. And those in the top three earning deciles aged 55 and over would probably save anyway. The superannuation concessions probably do increase their retirement incomes, but only at the cost of younger people paying more tax.

Figure 5 shows that the benefit of these concessions flows almost entirely to older people on high incomes, so the burden of any changes would also fall on this group. Capping superannuation tax concessions would also support gender equity, as the current concessions primarily benefit men (and their female partners).¹⁵

Figure 5: Superannuation concessions and government benefits
\$000 per person per year, income earners within age group



Note: Assumes those aged 60 and over with income over \$60,000 contribute the full amount allowed by the concessional cap.

Source: Grattan analysis of ATO (2013). See Daley, McGannon, et al. (2013a) p 34

¹⁴ Treasury (2013a)

¹⁵ Jefferson (2012)

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Capital gains tax discount

Under current rules, only 50 per cent of the income received by an individual or trust from a capital gain is taxed.¹⁶ It is not obvious why this income should be taxed less than incomes from other sources, such as working. The discount is highly regressive, as Figure 6 shows: 2 per cent of the highest income earners earn 52 per cent of the capital gains.

When they were introduced, the discounts were rationalised on the basis that they encourage people to become entrepreneurs and invest in riskier assets. Proponents argue that the discounts compensate for capital gains being eroded by inflation, double taxation on savings and reduce potential lock-in effects created by the tax.¹⁷ However, other forms of investment – such as bank deposits – are similarly eroded by inflation and double taxation, but receive no discount, and tax is payable each year rather than being deferred until the investment is sold.¹⁸ Not surprisingly, all of the arguments for the capital gains tax discount are contested¹⁹ and some commentators argue that the discounts reduce equity.²⁰ Freebairn describes the capital gains tax regime as “...an unsatisfactory hybrid with limited logic”.

¹⁶ Superannuation funds are taxed on 67 per cent of their gains, and a range of special provisions apply to small businesses. See Evans (2002); Wood, *et al.* (2006)

¹⁷ Burman (2009), p. 114

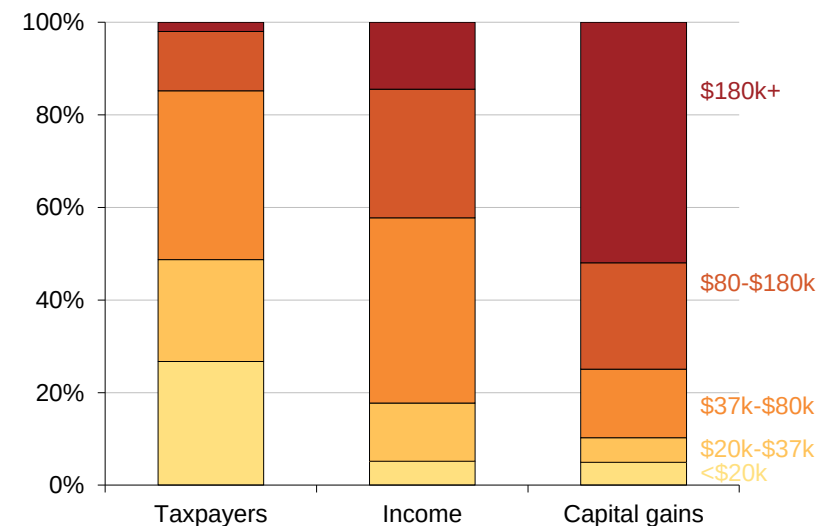
¹⁸ Capital gains are taxed on sale rather than by estimating the increase in value and paying tax each year.

¹⁹ For example, see Burman (2009) p. 113-114 and Evans (2002) p. 120-122

²⁰ For example, see Evans (2002), p. 127

If the discount were abolished, additional tax of \$5 billion would have been collected in 2012-13.²¹ While it is likely that some investors would attempt to change their investment strategy in response to such a policy change, it is difficult to see an alternative strategy that would become more attractive, and so reduce the amount of tax collected if investors moved to alternative investments.

Figure 6: Proportion of taxpayers, income and total capital gains
Percentage of total, by income tax bracket, 2010-11 tax returns



Source: Grattan analysis of ATO (2013) Detailed table 2.8. See Daley, McGannon, *et al.* (2013a) p 42

²¹ Grattan analysis of Treasury (2013b). See Daley, *et al.* (2013b) p16.

Negative gearing

Negative gearing allows taxpayers to deduct any losses they make on investments, (including mortgage interest) from their overall income when they calculate their tax liability. If investors were no longer able to deduct these losses against wage income, it would contribute about \$4 billion a year to the budget in the short term, falling to approximately \$2 billion a year in the long term.²²

Abolishing negative gearing would have limited impact on most low-income Australians, although there are a number of low-income earners who own investor property and make substantial losses (Figure 7). Taxpayers with incomes between \$37,000 and \$80,000 claim the most under negative gearing, but those with incomes under \$20,000 per year made surprisingly large losses totalling over \$2 billion

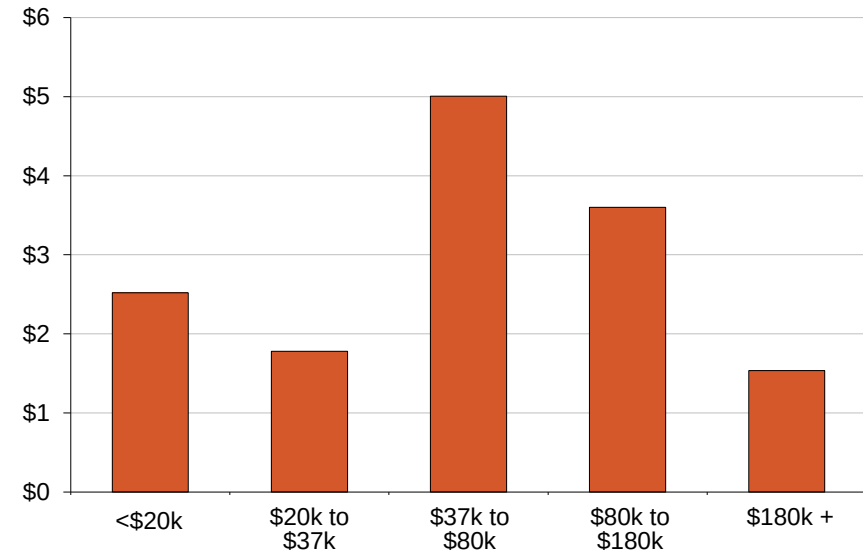
Abolishing negative gearing would have a number of positive social outcomes.²³ It may increase home ownership rates by reducing returns at the margin for landlords relative to first homebuyers. This could then increase investment in other more productive assets.

Although many say that abolishing negative gearing would increase rents, this is a folk memory based on increases between 1985 and 1987 in Sydney and Perth.²⁴ During this period when negative gearing was not permitted, rents did not increase

particularly rapidly in Melbourne, Brisbane or Adelaide, and it appears that the Perth and Sydney rental increases were driven by unusually low vacancy rates.

Figure 7: Total rental loss by taxable income bracket after deductions

\$ billion, 2010-11



Source: Grattan analysis of ATO (2013). See Daley, McGannon, et al. (2013a) p 48

²² These estimates are particularly sensitive to changes in the housing market. See Daley, et al. (2013a) p46

²³ See Kelly, et al. (2013)

²⁴ Eslake (2013)

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Further reading

Grattan Institute: Budget pressures on Australian governments. May 2014

<http://grattan.edu.au/publications/reports/post/budget-pressures-on-australian-governments-2014/>

Grattan Institute: Balancing budgets: tough choices we need. November 2013

<http://grattan.edu.au/publications/reports/post/balancing-budgets-tough-choices-we-need/>

Grattan Institute: Balancing budgets: tough choices we need: Supporting analysis. November 2013

<http://grattan.edu.au/publications/reports/post/balancing-budgets-tough-choices-we-need/>

Contact

John Daley
Chief Executive Officer

03 8344 3637

john.daley@grattan.edu.au

Cassie McGannon
Fellow, Australian Perspectives

03 9035 7530

cassie.mcgannon@grattan.edu.au

Grattan Institute
8 Malvina Place, Carlton VIC 3053

www.grattan.edu.au

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