



28 April 2014

Senator Richard Di Natale
Chair
Senate Select Committee into the Abbott Government's Commission of Audit
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Chair

INTERNATIONAL MONETARY FUND WORKING PAPER ON TAX EXPENDITURES IN ITALY

I am writing to you to follow up a discussion at the Committee's public hearing on 15 April 2014 about an International Monetary Fund (IMF) working paper, "*Reforming Tax Expenditures in Italy: What, Why and How?*" (16 January 2014, WP/14/7). In particular, Treasury considers that the Committee should be cautious about drawing conclusions from this working paper about the size of tax expenditures in Australia relative to other countries.

There are longstanding and well-recognised concerns about comparing the level of tax expenditures across countries. Such international comparisons typically draw on national reporting of tax expenditures, such as Australia's annual Tax Expenditure Statement (TES). However, different countries typically report their tax expenditures using different methodologies, and may not report their tax expenditures as comprehensively or as regularly as each other, making international comparisons highly problematic.

A particular concern involves the specification of 'benchmark' tax treatments. Broadly, a tax expenditure arises where a tax law deviates from the standard or 'benchmark' tax treatment. Using different benchmarks can significantly affect the size of a tax expenditure or even whether it exists at all. A key concern with international comparisons of tax expenditures is that different countries use different benchmarks to define their tax expenditures. This can result in significantly different estimates for the same or similar tax expenditures in different countries.

Key examples relevant to Australia are the tax treatment of capital gains realised on disposal of the family home and the way in which the GST benchmark is established.

The categorisation of tax relief on capital gains on owner occupied housing varies significantly across countries. Some (such as Germany, South Korea and the Netherlands) do not count tax subsidies on capital gains as tax expenditure but rather as a structural relief. Other countries (for example, the United States) have an upper cap or maximum percentage on the amount of income for which relief is provided, limiting the scale to which these are reflected as tax expenditures.

Certain countries (such as Finland and Sweden) include VAT/GST exemptions in their tax expenditure benchmarks, artificially reducing their tax expenditure figures. However, many countries use a similar benchmark to Australia, taking the standard VAT/GST rate as the base and treating any deviation from this (such as exemptions) as an expenditure. Such countries include the United Kingdom, Canada, Denmark and Norway. The choice between different benchmark methodologies is made by individual countries.

It is worth noting though, that for VAT/GST most other countries (including Japan, Italy, the United Kingdom and Germany) treat health and education services as input-taxed, rather than GST-free as it is in Australia, leading to lower level of reported tax expenditures as they do not return any input tax credits for the exempt activities.

I would add that international comparisons of the level of tax expenditures in different countries assume that estimates of the value of individual tax expenditures can be aggregated to give a national total. However, the 2013 Australian Government TES does not aggregate tax expenditure estimates. This is because tax expenditures are not strictly additive as, for example, the removal of one tax provision might affect the utilisation of other provisions for accounting and behavioural reasons. This issue is being reviewed for the 2014 TES.

A further consideration is Australia's superannuation-related tax expenditures, which reflect our "defined contributions" system under which Australians make concessional-tax personal contributions throughout their years in employment, resulting in the accumulation of around \$1.7 trillion in savings in the system to date. Many other countries have adopted very different policy settings, under which concessional-tax personal contributions play a less significant role, with individuals relying instead on either their employer (including the Government) to supplement their retirement income under a "defined benefit" setting or via Government payments under a public pension system. These will be reflected as Government cash outlays rather than as tax expenditures.

Finally, it is worth noting that the IMF working paper is not a systematic comparison of tax expenditures in different countries. Rather, as its title indicates, the working paper examines tax expenditures in Italy. The chart comparing tax expenditures as a proportion of GDP in various countries draws entirely on pre-existing studies, particularly *Tax Expenditures in OECD Countries* (OECD, 2010), and is likely to have been included simply to provide context for the ensuing discussion of Italian tax expenditures.

Yours sincerely

Rob Heferen
Executive Director, Revenue Group

28 April 2014

Cc: Senator the Hon Kate Lundy, Senator David Bushby, Senator Sam Dastyari, Senator Sean Edwards,
Senator Sue Lines, Senator Dean Smith