29 September 2015

House of Representatives Standing Committee on Tax and Revenue
PO Box 6021
Parliament House
CANBERRA ACT 2600

Email: TaxRev.reps@aph.gov.au

Dear Madam/Sir,

SMSF ASSOCIATION SUBMISSION ON TAX EXPENDITURE STATEMENTS

The SMSF Association welcomes the opportunity to make a submission to the inquiry by the House of Representatives Standing Committee on Tax and Revenue into the Tax Expenditures Statement (TES). As the peak professional body representing the self managed superannuation fund (SMSF) sector, the focus of our submission will be limited to the estimates of the superannuation tax items in the TES.

The SMSF Association has been a critic of the TES measurement of the superannuation tax concessions due to the distortionary effect they have on the public debate regarding superannuation policy. We understand that the annual TES is an important exercise in the ongoing evaluation of the Australian tax system. However, due to the shortcomings of the TES measurements, we believe that the TES estimates of the superannuation tax concessions inappropriately influence the view of superannuation tax concessions in policy debates.

We believe it is critical to the long-term success of the superannuation system to have an informed public debate of how the system can best achieve its goals, however, the inaccurate and overly simplistic nature of the TES measurement of the superannuation tax concessions do not help inform or stimulate meaningful debate. Instead, the large size of the revenue forgone estimates of the superannuation tax concessions often distorts public debate of the superannuation policy settings. This leads to simplistic observations that by reducing the superannuation tax concessions the result would be a substantial revenue gain to Government. The view that the TES estimate is the “cost of the superannuation system” to the Government is inaccurate and skews debate towards an over simplified conclusion. The ‘cost of the superannuation system’ is more complex and should take into account the increased cost to revenue in other policy areas such as social security.

We believe that the inaccurate nature of the TES superannuation tax concessions measurements is caused by four key issues. These issues are:

- The TES use of a comprehensive income tax benchmark.
- The lack of behavioral change factored into the TES estimates.

- The TES estimates do not account for the long-term benefits of the superannuation tax concessions (such as reducing the Government's expenditure on the Age Pension).
- Misuse and misinterpretation of the TES estimates.

We have explained these issues in more detail in the Attachment.

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak professional body representing the SMSF sector throughout Australia. The SMSF Association continues to build integrity through professional and education standards for advice and education of trustees. The SMSF Association represents professionals, irrespective of their personal membership and professional affiliations, who provide advice and services to individuals aspiring to higher levels of participation in the management of their superannuation savings. The SMSF Association is consisted of individual members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries.

If you have any queries about our submission please do not hesitated in contacting us.

Yours sincerely,

[redacted]

Andrea Slattery
Managing Director/CEO
SMSF Association

ATTACHMENT

TES use of a comprehensive income tax benchmark

We believe that a key problem with the TES estimates is the comprehensive income tax benchmark that is used in measuring the magnitude of tax concessions. The comprehensive income tax benchmark assumes that all income derived by a taxpayer is taxed at their marginal tax rate and any deviation from this tax treatment for tax purposes is regarded as a tax expenditure.

Choice of benchmark

The comprehensive income tax benchmark views the tax settings for superannuation as highly concessional because pre-tax contributions to superannuation and superannuation earnings are taxed at a rate lower than most taxpayers' marginal tax rates. Superannuation benefits are exempt from tax under a comprehensive income tax benchmark as contributions and earnings are assumed to be fully taxed under the benchmark.

Accordingly, the comprehensive income tax benchmark embodies a "TTE" model of superannuation where the first two phases of superannuation are fully taxed under the ideal benchmark and benefits paid out of superannuation are exempt from tax. The Australian superannuation system embodies a "ttE" system where the first two phases are concessionally taxed rather than fully taxed. The difference between the TTE and ttE system is the amount that the TES statements measure as the revenue forgone to Government by having superannuation tax concessions.

The choice of using a comprehensive income tax benchmark that embodies a TTE taxation of superannuation results in superannuation tax concessions having a large TES estimate of superannuation tax concessions. Choosing this methodology to estimate the cost of superannuation tax concessions results in the relevant TES measurements indicating that significant amounts of revenue will be forgone by Government. These large revenue forgone estimates are used by various special interest groups to assert that superannuation tax concessions are too generous or inappropriately reduce Government revenue which could be used for other outlays. However, these large revenue forgone estimates, which can influence retirement income policy debate, are largely a consequence of the Treasury's choice to use a comprehensive income tax benchmark in estimating the cost of superannuation tax concessions.

As explained above, Australia's existing superannuation system does not of having a complete tax exemption for returns to savings for superannuation (as envisaged in a TEE benchmark), but instead both contributions and earnings are taxed at concessional rates (i.e. a ttE system). Accordingly, we believe that instead of using a comprehensive income tax benchmark, alternative tax benchmarks that better embody our superannuation system should be considered for the TES measurements of superannuation tax concessions.

An appropriate benchmark to explore would be a pre-paid expenditure tax benchmark. Under a pre-paid expenditure tax benchmark, labour income is taxed and returns to savings are exempt (as income contributed to savings has already been fully taxed under this benchmark). It is arguable that this is an appropriate benchmark to measure superannuation against as superannuation is a concessionally taxed savings vehicle which encourages savings for use in retirement (where benefits are drawn down tax free).

A pre-paid expenditure tax benchmark resembles a TEE benchmark. Accordingly, the revenue forgone to Government is estimated as the difference between a TEE benchmark and our ttE system. This would result in the only revenue forgone against this benchmark being the concessional taxation of contributions. However, tax on superannuation earnings would be a gain for the Government.

Another alternative may be to use a post-paid expenditure tax where taxation is levied on final expenditure on goods and services. This embodies an EET tax benchmark. If this was used to estimate superannuation tax concessions the taxes on contributions and earnings would be a revenue gain to Government while the tax exemption on superannuation benefits over the age of 60 would result in revenue forgone to Government.

In the 2013 TES, Treasury undertook an experimental estimate of the cost of the tax concessions superannuation using an expenditure tax benchmark.[1] The 2013 TES states that this was undertaken "to facilitate discussion and understanding of the impact of utilising different benchmarks." Under the expenditure tax benchmark the benchmark treatment is for contributions to be taxed at marginal rates, while earnings and benefits are exempt from tax.

Using an expenditure tax benchmark, the cost of the superannuation tax concessions fell from $32 billion to $11.24 billion. The effects of choosing a different benchmark can be seen in the following table:

Superannuation Tax Concession Measurements 2013-14 ($m)		
	Expenditure Tax Benchmark	*Comprehensive Income Tax Benchmark*
Taxation of employer contributions	$16,000	$16,000
Taxation of personal/self-employed contributions	$670	$670
Taxation of unfunded superannuation	$490	$490
15% tax on earnings in accumulation phase	-$4,700	$16,100
0% tax on earnings (including capital gain)	$0	
10% tax on capital gains in accumulation phase	-$1,100	
Measures for low-income earners	$130	$130
Tax on funded lump sums	-$250	-$250

The use of the expenditure tax benchmark changes the current tax treatment of superannuation fund earnings from a $16.1 billion cost to the Government to a $5.8 billion revenue gain. This is because under the expenditure tax benchmark returns to savings are exempt from tax, so the 15% tax on superannuation earnings is a gain to Government revenue. This is in contrast to the comprehensive income tax benchmark where the difference between a taxpayer's marginal tax rate and the 15% superannuation earnings tax is recorded as a loss of revenue to the Government. This illustrative of how the choice of tax benchmark influences the outcomes of the TES estimates for superannuation tax concessions.

While the separate tax concession measurements are not to be used in an additive fashion, the total superannuation tax concessions in the above table shrink from $33.35 billion to $11.24 billion under the

[1] http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2014/TES%202013/Documents/PDF/04_Appendix_A.ashx

expenditure tax benchmark. Again this illustrates the effect of setting an arbitrary benchmark for costing tax concessions.

This is illustrative of how the choice of benchmark for estimating a tax expenditure can have a dramatic impact on the outcome of the measurement exercise and consequently perceptions of the effectiveness of the superannuation tax concessions.

An unrealistic benchmark?

Further, the use of the comprehensive income tax benchmark is unrealistic in maintaining an assumption that all income will be taxed at a taxpayer's marginal tax rate. It is widely accepted that the tax system is not purely in place to derive revenue to fund Government expenditure. Instead, taxation policy is often used to promote certain Government objectives such as encouraging business activity or incentivising particular behaviour. For instance, the superannuation tax concessions are in place to encourage people to save for retirement by forgoing current consumption for future income in retirement. However, the comprehensive income tax benchmark is not designed to account for using the tax system to achieve economic or social policy objectives and views a deviation from the ideal benchmark as a loss to Government. This is plainly inconsistent with modern tax policy.[2]

On this note, it is a common feature of retirement income systems across the world to have Government support through concessional tax arrangements. However, under the comprehensive income tax benchmark, the use of a tax incentive results in a large short-term loss of revenue to Government. In our view, while this may be theoretically correct under the chosen benchmark, it does not reflect the broader and longer-term policy goals of Government, the taxation system or the retirement income system, and disproportionately skews superannuation policy debates.

Therefore, in our view it would be prudent to consider the use of an alternative benchmark or publishing alternative estimates of the superannuation tax concessions that have a longer-term perspective.

The lack of behavioral change factored into the TES estimates

The TES estimates do not account for behavioural change resulting from changes to the relevant tax settings. In the case of altering superannuation tax concessions this makes an unrealistic assumption that people will not seek alternative low-tax investments for their superannuation contributions or existing superannuation investments. This results in the TES estimates for the superannuation tax concessions overstating the revenue that the Government forgoes from maintaining them.

People could minimise their marginal tax rate by investing in:

- Negatively geared assets.
- Capital gain orientated assets.

[2] The comprehensive income tax benchmark is based on the Schanz-Haig-Simons income definition which was established between the late 1890s and 1938. This raises the question as to whether the modern Australian tax system should be judged against an idealised tax benchmark created over 70 years ago. That is, is an income tax benchmark created in the late 19th and early 20th centuries an appropriate benchmark to measure the current income tax system against?

- Family trust arrangements.
- Investment bonds.
- Investment companies.
- Lower taxed foreign jurisdictions.

We would expect that people shifting from superannuation to other tax-preferred forms of savings would substantially reduce the amount of revenue that would be gained from removing superannuation tax concessions.

SMSF Association research has shown that taxpayers respond to changes in tax arrangements for superannuation by finding other tax advantageous investments or increasing their consumption. Our research has shown that the decrease in superannuation contribution caps from $100,000 per annum to $25,000 saw contributions to superannuation fall by $16.4 billion in 2013, $16.8 billion in 2012, and, $12.4 billion in 2011.[3] Taxpayers invested 74.6 per cent of these forgone superannuation contributions in other tax effective investments, with a high proportion moving into negatively geared property. Most concerning though, was that the other 25.4 per cent of forgone contributions were consumed rather than saved for retirement.[4]

Treasury undertakes a 'revenue gain' estimation of superannuation tax concessions which factors in limited behavioural change. The revenue gain estimates show lower costs for the superannuation tax concessions.

Treasury warns on the reliability of the revenue gain estimates stating:

> *In practice, the revenue gain can be difficult to estimate as there is usually little, if any, information on how taxpayers might react to the removal of a tax expenditure. Assumptions about taxpayer behavioural responses therefore need to be made, and these assumptions can be difficult to meaningfully substantiate.*[5]

While we appreciate the difficulty in modelling and estimating complex behavioural effects that would result from changing tax settings, we believe that this weakness severely undermines the credibility of TES. However, we do acknowledge that Treasury attempts to convey this message through the material contained in the annual TES publication.

This unrealistic assumption implicit in the TES estimates that a tax expenditure may be abolished with the resulting revenue gain being returned to the budget bottom line grossly distorts policy debates around superannuation.

The TES estimates do not account for the long-term benefits of the superannuation tax concessions

A substantial concern with the TES estimates for superannuation tax concessions is that the estimates do not account for the long-term savings that superannuation returns to the Government budget by reducing expenditure on aged support in the future. Given that reducing future dependence on Government welfare is a key objective of the superannuation system and a key policy rationale behind the tax concessions, it is

[3] SPAA/Russell Investments, Intimate with Self-Managed Superannuation 2012, 2013, 2014
[4] SPAA/Russell Investments, Intimate with Self-Managed Superannuation 2013
[5] http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2015/Tax%20Expenditures%20Statement%202014/Downloads/PDF/TES_2014_Chapter_3.ashx

inconceivable that our public policy measurements do not attempt to capture the value of the reduction of future Government expenditure created by superannuation tax concessions.

While we acknowledge that the TES exercise is aimed at reporting the magnitude of tax expenditures and not assessing policy rationales or how effective a policy is, we believe that this results in an inappropriate assessment of the "cost" of superannuation tax concessions. Excluding the future savings to Government expenditure on Age Pension results in a myopic and overly simplistic analysis of both the true costs of the superannuation tax concessions and the effectiveness of the superannuation system.

The TES measurements also do not take into account that superannuation balances would be lower if there was higher tax on superannuation contributions and earnings, resulting in an inconsistent long-term approach to estimating the tax expenditures. Lower superannuation balances would increase the future reliance on the Age Pension, placing greater pressure on Government expenditure in the long-run.

The need to incorporate long-term savings to the Government from superannuation in the measurement of superannuation tax concessions may mean that estimating the cost of the superannuation tax concessions should occur outside of the TES process in a standalone exercise. This would allow for a more fulsome assessment of the superannuation tax concession to occur, including the potential savings to Government in their costs. Otherwise, the TES could include alternative measurements of the superannuation tax concessions that include long-term savings to Government. This would provide an important alternative perspective to better inform policy debate.

Some may argue that the superannuation tax concessions do not warrant special treatment in regards to how their cost to Government is estimated. However, we believe the magnitude, future policy importance and controversy that often is generated by the TES costings of superannuation tax concessions justifies the need to undertake alternative measurements for superannuation tax concessions.

Misuse and misinterpretation

In addition to the technical issues with the TES superannuation tax concession estimates, there is a significant misunderstanding and consequent misuse of the TES estimates in public policy debates. While we appreciate the efforts Treasury has made to convey that the TES estimates are not accurate costings of policy changes or represent policy commentary, this is often how the TES are interpreted by media and other policy commentators.

This skews the superannuation policy debate and creates false influences, centring it on the perceived "cost" of superannuation tax concessions to the budget bottom line. Again, this should provide a rationale to shift the estimates of the superannuation tax concessions out of the TES process or, to provide more detailed alternative estimates using expenditure tax benchmarks within the TES to assist more informed retirement income policy debate.