Submission to the House Tax Committee Inquiry into the Tax Expenditures Statement

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Introduction

This submission comments on the technical limitations of tax expenditure (TE) estimates and the frequent misinterpretation and misuse of the data in public policy analysis and commentary, which carries the risk of sub-optimal policy prescriptions and outcomes.

The technical limitations arise from:

- the ambiguities surrounding the appropriate benchmark for measurement;
- inherent imprecision in the estimates;
- the distinction between revenue foregone and revenue gain; and
- the fallacy of aggregation.

The current Tax Expenditure Statement (TES) prepared by the Treasury warns users of these limitations and complexities, but the warnings are often ignored in public use of the data. The frequently observed misuse of the TE estimates suggests that current TES practices need to be revised. This submission makes proposals for change.

There are many examples of misuse of TES data, but perhaps the most prominent is the claim that current superannuation tax policies are resulting in a TE cost of around $30 billion a year, which moreover is rising rapidly. This figure can be derived from the TES but is misleading because:

- it is not based on the most meaningful benchmark;
- it does not purport to measure the potential revenue gain; and
- it is based on the fallacy of aggregation.

More generally, there is a great deal of criticism of tax concessions in the current budget environment, but such criticisms rely heavily on the official estimates of TEs and often on the misinterpretation and misuse of such estimates.

This submission begins by discussing the limitations of TE estimates and then suggests how the TES should be changed. It draws on recent work of the author contained in *Right or Rort? A Dissection of Australia's Tax Concessions.*[i]

Limitations of Tax Expenditure Estimates

1. Choice of benchmark

The main reason the measurement of TE is contentious is that it requires specifying a 'benchmark' tax treatment against which to measure actual practice. Treasury's definition (TES, 2013) explains that: "a tax expenditure results from the provision of the tax law that causes a deviation from the standard tax treatment that would apply to an activity or class of taxpayer; that is, from the benchmark tax treatment". However, this begs the question as to what the benchmark tax treatment should be.

In the words of TES 2014, "Determining benchmarks involves judgment. Consequently the choice of benchmark may be contentious and benchmarks may vary over time".

Further, benchmarks "…..can be arbitrary". As an example of the importance of the chosen benchmark, it makes a big difference whether taxation of savings is assessed against an income benchmark or an expenditure (consumption) tax benchmark.

Thus, what is considered to be a TE and the measurement of it depend on the chosen benchmark, the definition of which is arbitrary and judgmental on the admission of those making the estimates. One person's idea of an unjustifiable TE could be another's idea of a desirable structural feature of the tax system.

Related to this definitional issue is the fact that the choice of benchmark should not be interpreted as indicating a view as to how something or someone should be taxed. This is extremely important, because TEs are often asserted to be as a measure of departure from the 'correct' tax treatment, with any TE relative to the benchmark pejoratively labelled 'subsidies', 'loopholes' or 'rorts'. Treasury itself discourages using the figures in this way because in its words "the choice of benchmark should not be interpreted as indicating a view on how an activity or taxpayer ought to be taxed" (TES, 2013).

According to the TES, the benchmark should represent the standard tax treatment that applies to similar taxpayers or types of activity. But it qualifies this by stating that the benchmark may incorporate certain elements of the tax system that depart from uniform treatment where these are "fundamental structural elements of the tax system". The progressive income tax rate scale is cited as one example of a non-neutral approach that is nonetheless not classified as a departure from the benchmark because it is a well-established structural feature of the tax system.

There are other features of the tax system that could be considered 'fundamental structural elements of the tax system' but are instead classified as TEs. The 2014 TES reports $45.5 billion of TE from the failure to subject capital gains from the disposal of principal residences to full personal taxation, yet principal residences have never been subject to capital gains tax, nor has any political party ever advocated doing so. The capital gains tax exemption applies to the entire population of home owners. Given these facts, the treatment of this exemption as a TE rather than a 'fundamental structural element of the tax system' is questionable.

In this connection, it is instructive to note that the New South Wales state TES treats the exemption of land occupied by principal residences from land tax as a structural feature of the tax system rather than as a TE. As with capital gains tax, principal residences constitute a majority of the land tax base and it seems counter-intuitive to treat their exemption as an exception to the standard rather than the standard itself. This is an illustration of how different judgments can be reached on similar sets of facts, and in this case the New South Wales judgment seems more defensible.

These definitional problems suggest that less emphasis should be placed on what the government chooses to label as 'tax expenditures' and more on the appropriate design of the tax system from first principles. They also mean that just because a concession is labeled 'tax expenditure' does not mean that it is bad policy. Concessions may have legitimate purposes such as promoting equity, overcoming biases towards economic inefficiency, or simplifying tax administration and compliance.

For income tax, the appropriate benchmark is particularly contentious. The income tax concessions counted as TEs in TES are classified as such against a benchmark of comprehensive income. According to this benchmark all income is included in the tax base regardless of how it is generated. Thus it includes not only labour income but also income from savings (such as interest and dividends), realised capital gains, government cash transfers and distributions from trusts. It is this benchmark, for example, that leads to the conclusion that anything less than full taxation of capital gains at an individual's marginal tax rate constitutes a TE.

The comprehensive income tax base has, however, come increasingly into question and the alternative of optimal income taxation has gained credence. The Australia's Future Tax System (AFTS, 2010) review, for example, noted a shift in the international consensus towards recognition that economic growth is affected by the structure of the tax system and that some forms of taxation are more detrimental to growth than others. One of the review's guiding principles was that revenue should be raised from taxes that are least detrimental to economic growth. This is the concept of optimizing the tax system rather than aiming to tax all income at the same rate.

An alternative to the income tax benchmark is an expenditure (consumption) tax benchmark. Such a benchmark represents a tax structure that involves levying a tax only on a person's consumption, which is measured as income less net new savings. It differs from an income tax in that income devoted to increase a person's savings goes untaxed. While an expenditure tax has never been applied in practice, it is of particular relevance as a benchmark for taxation of saving and the income from savings and is more appropriate for measuring TE on some items. The AFTS review, for example, stated that the expenditure tax was a more appropriate benchmark for assessing superannuation tax concessions, but the TES continues to use comprehensive income as the primary benchmark.

2. Unreliability of estimates

Another issue is that users tend to place more weight on the precise estimates than their construction justifies. As TES 2014 states, "Tax expenditure estimates vary in reliability depending upon the quality, detail and frequency of the underlying data, the extent to which calculations are based on assumptions, the sensitivity of the results to those assumptions and whether future taxpayer behavior is reasonably predictable". Out of 297 individual TEs listed in TES 2014, 145 could not be quantified at all, and of the 152 that could be quantified, the estimates for 132 were ranked of less than high reliability.

This unreliability is not so much due to faults in the estimation methodology but to the intrinsic difficulty of quantifying tax revenues under hypothetical tax policies.

3. Revenue foregone vs revenue gain

Another important qualification is that TE estimates do not indicate the amount of tax revenue to be gained by removing the concession that gives rise to a TE; rather they measure the benefit of a concession to taxpayers and therefore the revenue forgone by government. The revenue gain depends on taxpayer behaviour in the event of the TE being abolished. In some cases the revenue gain estimate is billions of dollars smaller than the revenue forgone estimate.

One of the most common misuses of TE data is to assume that if particular concessions were removed then the budget would gain an amount of revenue equal to the estimate of the TE associated with the concession. This may be close to the truth in some cases, but wide of the mark in many others.

As TES 2013 observes, "where taxpayer behaviour is relatively insensitive to a tax expenditure revenue gain and revenue foregone estimates are likely to be similar". However, "…..where taxpayer behaviour is highly sensitive to, or solely motivated by the existence of a tax expenditure, the increase in revenue from removing the tax expenditure could be very small, as this could also remove much of the related activity".

To illustrate the difference between revenue gain and revenue foregone, the TES in recent years has included estimates of revenue gain for a small number of major tax expenditures. The results are a warning to those who persist in using TE data prepared on a 'revenue foregone' basis to assert that revenue of that magnitude is available to government if only it would remove certain concessions. For example the Treasury revenue forgone estimate for concessional taxation of superannuation fund earnings in 2014–15 is $13.4 billion, but the revenue gain estimate is $1.7 billion lower at $11.7 billion.

4. The fallacy of aggregation

Finally, the estimates of individual TEs cannot necessarily be summed to provide a global TE figure because some TEs are not independent of others. For example, removing one TE may drive users of that concession towards greater use of other concessions. For this reason Treasury for the first time removed aggregation tables from the 2013 TES. Nonetheless, this warning has not stopped users from aggregating to obtain very large figures.

Revising TES Practices

Treasury has made some changes to the TES in recent years to address the problems discussed above. In particular:

- The TES has been expanded to included what are labeled 'experimental estimates of superannuation TEs based on an expenditure tax benchmark.
- Each individual TE is rated as being of 'high', 'medium' or 'low' reliability.

- Selected TEs are quantified on a 'revenue gain' as well as a 'revenue foregone' basis.
- Aggregation has been discontinued.

However, further changes are needed. This submission proposes the following:

1. All TEs should be reviewed to consider whether they would be more accurately classified as fundamental structural elements of the tax system than as TEs. The best example of this is the exemption from capital gains tax for principal residences, which exempts the majority of a tax base (residential housing) rather than a small component.

2. TEs involving saving should be measured against an expenditure tax benchmark rather than a comprehensive income tax benchmark. At the very least, both measures should be displayed side by side, rather than the current practice of giving prominence to the comprehensive income benchmark and secondary importance to the expenditure tax benchmark.

3. Estimates of superannuation TEs based on an expenditure tax benchmark should be displayed for both a 'TEE' and an 'EET' superannuation tax framework. (The Treasury's 'experimental' estimates are based only on the 'TEE' framework.)

4. Where feasible, all significant TEs should be measured on a 'revenue gain' basis as well as on a 'revenue foregone' basis.

5. Quantification of TE estimates that the Treasury judges to be of low reliability should be discontinued, or at least shown as a range. In any case, those of medium reliability should also be shown as a range.

These changes would improve the information content of the TES and make it less amenable to misinterpretation and misuse.

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[i] Robert Carling, *Right or Rort? A Dissection of Australia's Tax Concessions,* Research Report 2, The Centre for Independent Studies, Sydney, April 2015.