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Right or Rort?
Dissecting Australia’s Tax Concessions

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Executive Summary

At a time of entrenched budget deficits and calls for a new round of tax reform, Australia's tax concessions have come under more critical scrutiny than ever before, which will continue as part of the Abbott government's white paper review of the tax system. The concessions most often targeted are: those for superannuation; capital gains on principal residences; capital gains in general; negative gearing on investment in housing; dividend imputation; and a range of exemptions from the Goods and Services Tax (GST).

The premise of this report is that, while action is needed to correct structural budget deficits, the criticism of tax concessions has lost sight of the legitimate reasons for many of them. In the search for budget savings, it is important to keep tax concessions in proper perspective and not throw out the good with the bad. The legitimate scope for additional revenue from cuts to concessions is much narrower than is often suggested.

The purpose of this report is not to repeat the demonisation of concessions heard from so many others, but to explore their basis and provide a balanced assessment of their purpose and justification. It is to be hoped that a more balanced critique of tax concessions will contribute to a more informed public discussion and less hyperbole.

Typically criticism of tax concessions relies heavily on the official estimates of tax expenditure published by Treasury in the annual Tax Expenditure Statement (TES), but a great deal of mythology has grown up around such expenditures. The inherent limitations of estimates are often overlooked and the figures are misinterpreted even against the advice of the Treasury. The caveats surrounding the estimates amount to a strong warning to users, but one that often goes unheeded by the critics of particular tax expenditures.

Each tax concession should be assessed on its own merits.

The 50% **capital gains tax (CGT) discount** is probably the most unfairly maligned of all tax concessions. There is a strong case that the optimal capital gains tax rate is zero. It is now part of the folklore surrounding capital gains tax that the reform in 1999 'halved' the tax on capital gains. It did no such thing — as there was already an effective discount for inflationary gains — but there was a reduction in CGT, which was and remains sound policy. Further easing of CGT would be beneficial. Increasing the severity of CGT would be damaging to investment, and in any case it would not meet its advocates' goal of raising significantly more revenue.

Negative gearing, although not classified as a tax expenditure, is criticised as a tax 'rort' that artificially boosts the demand for housing, and therefore house prices. However, deductibility of interest on borrowings made to undertake an investment is nothing more than a specific case of the general principle that expenses incurred in generating income are deductible for tax purposes. Rational investors will engage in negative gearing only in the expectation of future net income, which is taxable. A case for limiting deductibility of expenses could be justified only if rental income was in some way taxed concessionally, which is not the case.

Dividend imputation was once proclaimed as one of the significant reforms of the 1980s, but is now questioned by official inquiries such as the Henry tax review, the recent Murray Financial System Inquiry, the recently issued discussion paper for the white paper review. The effect of imputation is to eliminate double taxation of dividends as both company and personal income. Tax experts believe the benefits of this have diminished as Australia has become more open and integrated with global capital markets, while for the same reason international investment considerations weigh in favour of a lower company tax rate. Domestic capital market considerations, however, favour retention of imputation. Ideally both imputation and a lower company tax rate would apply, but fiscal constraints may preclude this.

Superannuation tax concessions present a large target to their critics, but the belief that these concessions are grossly excessive and poorly structured lacks firm foundations. Superannuation, with its long-term focus, is the best example of why saving needs to be taxed at relatively low rates to avoid tax-induced distortions. This principle is widely recognised in tax systems around the world — and Australia is no exception.

Statements often made about the huge fiscal cost of Australia's superannuation tax concessions are based on the comprehensive income tax benchmark for measuring tax expenditures, but the characteristics of superannuation make it unsuitable for such a benchmark. The most appropriate benchmark is an expenditure tax under which contributions and fund earnings would be tax-exempt but end-benefits fully taxed. When measured against such a benchmark, tax expenditure on superannuation is much lower than commonly believed, or non-existent.

Apart from the overall fiscal cost, other issues to be addressed are: the large relativity between superannuation concessions and the tax rules for other forms of saving; the distributional effects of superannuation concessions; and the implications of tax-free superannuation benefits being available as early as age 60.

GST concessions are substantial, and removing some of them could raise as much revenue as another policy option often flagged: increasing the rate to 12.5%. In some cases, removing concessions is not straightforward — for example in education, health and medical services, the subsidy from government is such a large component (if not all) of the 'price' that imposing GST on them would discriminate against private providers. The problems with an extension of the GST base are least acute in the cases of uncooked food and water supply. However, equity and compensation issues loom large.

Table 1 provides an overview of key points that arise in evaluating the above concessions.

If reductions in tax concessions are found to be justified, they should form part of a broad, revenue neutral tax reform with offsetting reductions in income tax rates.

Table 1: Overview of Selected Tax Concessions

CONCESSION	WHAT IS IT	THE RATIONALE	REVENUE Forgone $ billion	EFFECT Gain $ billion	USUAL OBJECTIONS	TYPICAL CHANGE PROPOSALS
CGT exemption for principal residence	No tax payable on capital gain from sale of 'family home'.	Expenditure tax treatment is appropriate (don't tax income on savings). Family home is main form of household saving. Most sales are to fund purchase of another home.	46	n.a.	Equity: main benefit goes to owners of expensive homes. High revenue cost. Encourages over-investment in homes relative to other assets.	Remove exemption above a threshold value.
CGT 50% discount	Capital gains on disposals of assets held for longer than 12 months are discounted by 50% for individuals and trusts	Tax savings more lightly than other income to reduce anti-savings bias. Flat discount is simple. Beneficial to investment and international competitiveness.	5.8	n.a.	Main benefit to the wealthy. Biases investment towards capital gain.	Abolish or reduce discount. Replace with inflation allowance as applied in 1985 - 99.
Negative gearing	Net operating losses on investments in rental housing may be deducted from other income.	Principle of deductibility of expenses incurred in earning income. Benefits the supply of rental housing.	4.0	n.a.	Distorts investment decisions. Artificially boosts house prices. Favours high earners.	Disallow deductions in excess of rent income or set net losses against future capital gains.
Dividend imputation	Individuals and super funds pay tax on dividends grossed up by franking credits for company tax paid, and receive full refund of franking credits	Avoid double taxation of dividends (as both company and personal income). Reduce cost of equity capital and bias to debt funding.	20?	n.a.	No longer relevant as cost of capital is set by international forces.	Abolish and cut company tax rate or limit refunds of franking credits to amount of tax liability.
Superannuation	Rates of tax on contributions and fund earnings are lower than individuals' marginal rates. Benefits are tax-free.	Expenditure tax treatment is appropriate. Tax saving more lightly to reduce anti-savings bias. Super is main form of long-term household saving after family home.	30	27	High revenue cost and distribution favours high earners. Goes beyond scope of retirement income scheme.	Cap lifetime as well as annual contributions or cap individual balances. Tax contributions more. Tax fund earnings in pension mode.
GST - food	Fresh or uncooked food is free of GST. Other food taxed at 10%.	Protection of low income earners; too difficult to compensate precisely through tax/transfer system.	6.4	6.3	Benefits middle and high earners as well as low income. Low earners can be compensated. Distinction between different types of food creates distortion.	Make all food subject to GST and compensate through the tax/transfer system.
GST - education and health	Education (such as private school and uni fees) are free of GST, as are health services such as doctor and hospital charges, pharmaceuticals, private health insurance.	Such services are heavily subsisdised by government or have no price at point of delivery. Neutrality between public and private providers. Essentials of life.	7.6	7.1	High revenue cost. Exemption disproportionately favours high earners.	Make all or selected education and health services subject to GST.
GST - financial services	Some financial services such as insurance are subject to GST. Others such as bank net interest margins are input-taxed (banks cannot claim credits for GST paid on inputs).	Complexity in applying GST to some financial services - better to input tax.	3.6	3.6	Complexities are exaggerated. Revenue is being lost.	Make all financial services subject to GST.

Introduction

Recognition of the chronic nature of the federal budget deficit has triggered, among other responses, a torrent of mostly hostile commentary directed at tax concessions that are said to be costing many billions in unaffordable forgone revenue. The motives of the many critics range from blunt revenue raising to income redistribution and the removal of perceived tax-induced distortions of resource allocation and the patterns of saving and investment.

This report — *Right or Rort? Dissecting Australia's Tax Concessions* — is motivated by the conviction that much of the hostility towards tax concessions is based on skewed analysis, a misunderstanding of the facts, and a failure to recognise the valid reasons for many (but not all) of the concessions. The report aims to set the record straight. If it appears one-sided, that is because it is a response to a one-sided barrage of criticism. It aims to restore some balance to a popular narrative that sees tax concessions as nothing but rorts offering easy revenue gains. There is an alternative narrative, which this report aims to provide. To label something a 'tax concession' does not automatically render it bad policy.

There is a constant stream of commentary in the media about the unsustainable fiscal cost and inequitable distributional consequences of some concessions, stimulated by official inquiries such as the current government's National Commission of Audit and by reports from think tanks such as the Grattan Institute and The Australia Institute.[1]

Hardly a day goes by without suggestions and speculation as to what cuts may be made to tax concessions to help balance the budget and rationalise the tax system. The more colourful of such talk lambasts 'rorts' that favour the rich and the elderly at the expense of ordinary folk and young workers.

The concessions most often mentioned in this context are: those for superannuation contributions and fund earnings; capital gains on peoples' principal place of residence (the 'family home'); capital gains in general; negative gearing on investment in housing; dividend imputation; and a range of exemptions from the Goods and Services Tax (GST). Critical scrutiny of these items is hardly new; in some cases it goes back many years. However the scrutiny has become more intense as the fiscal problem has become seemingly more entrenched. Box 1 provides a small sample of recent public statements critical of concessions.

The premise of this report is that, while action is needed to correct structural budget deficits, the public discussion has lost sight of the legitimate reasons for many existing tax concessions and has turned into a one-sided campaign conducted through and by sections of the media. The purpose of this report is not to join in the demonisation of concessions but to explore their basis and provide a balanced assessment of their purpose and justification.

The Tax Discussion Paper issued in March 2015 to launch the Abbott government's white paper review of the tax system provides a more balanced assessment than much of the public commentary, but goes far enough in questioning a range of tax concessions to ensure their future remains open to lively debate during the long period of the review.[2]

The arguments in the report are intended to stand independently of any personal biases towards smaller or larger government. The author's perspective is that the economy and society function better with smaller government and lower taxation (within reason), but if a concession is bad policy it should not be defended on the grounds of smaller government; rather the extra revenue from removing it should be used to lower other taxes. Others might say that it should be used to lower the deficit or fund new spending.

The public discussion of tax concessions draws heavily on estimates of so-called 'tax expenditures'. The Treasury annually compiles a comprehensive accounting of tax expenditures, the Tax Expenditure Statement (TES), the last of which was published in January 2015.[3] This report argues the TES is often misinterpreted and the revenue cost of some concessions is greatly exaggerated. The scope for additional revenue is much narrower than is often suggested. Some critics are less focused on raising additional revenue and more on what they see as loopholes and distortions, but this report argues that many of what are labeled 'tax expenditures' or 'concessions' are in fact desirable structural features of an efficient and equitable tax system. This is not to deny that there is a need to review concessions as part of a broad review of the tax system, but in the search for budget savings it is important to keep tax concessions in proper perspective and not throw out what can be justified along with what cannot. It is to be hoped a more balanced critique of tax concessions will contribute to a more informed public discussion and less hyperbole.

The TES identifies 297 individual tax expenditures and attempts to put a dollar value on some of them. In aggregate, those that can be valued are worth more than $100 billion a year to taxpayers — a figure that has encouraged the belief that closure of tax concessions could contribute tens of billions to deficit reduction with relative ease. This belief is especially apparent among those who favour reducing the deficit by increasing revenue rather than by cutting expenditure.

Concessions for superannuation and capital gains (in general and on the principal residence in particular) and GST exemptions account for over 80% of the tax expenditures that Treasury judges to be quantifiable. These are illustrated in Figure 1. The statement of tax expenditures does not include negative gearing or dividend imputation, neither of which the Treasury classifies as 'tax expenditures'. However, they fall within the scope of this report as they are often labeled as concessions ripe for the cutting. States also provide tax concessions and issue tax expenditure statements, but these fall outside the scope of this report.

BOX 1: A SAMPLE OF CONCESSION CRITICISMS

"We are struggling to find good reasons to keep these policies (negative gearing, capital gains tax concessions, superannuation concessions, dividend imputation). They are resulting in a loss of money, primarily benefiting the wealthy, and are counterproductive from a policy perspective."

John Daly, Grattan Institute, quoted in *The Australian Financial Review*, 9/12/14

"Tax concessions in the superannuation system are not well targeted to achieve provision of retirement incomes. This increases the cost of the superannuation system to taxpayers and increases inefficiencies arising from higher taxation elsewhere in the economy, and the distortions arising from the differences in the tax treatment of savings."

Final report of the Financial System Inquiry, November 2014

"The notion that someone like me should be getting concessions (is wrong) – I pay 48 (sic) cents in the dollar tax but if I put my super in I pay 15 (sic). I get a 33 (sic) cents in the dollar concession. Superannuation concessions are costing the government $49 billion (sic) a year."

Broadcaster Alan Jones, speaking on ABC TV *Q and A*, 9/2/15

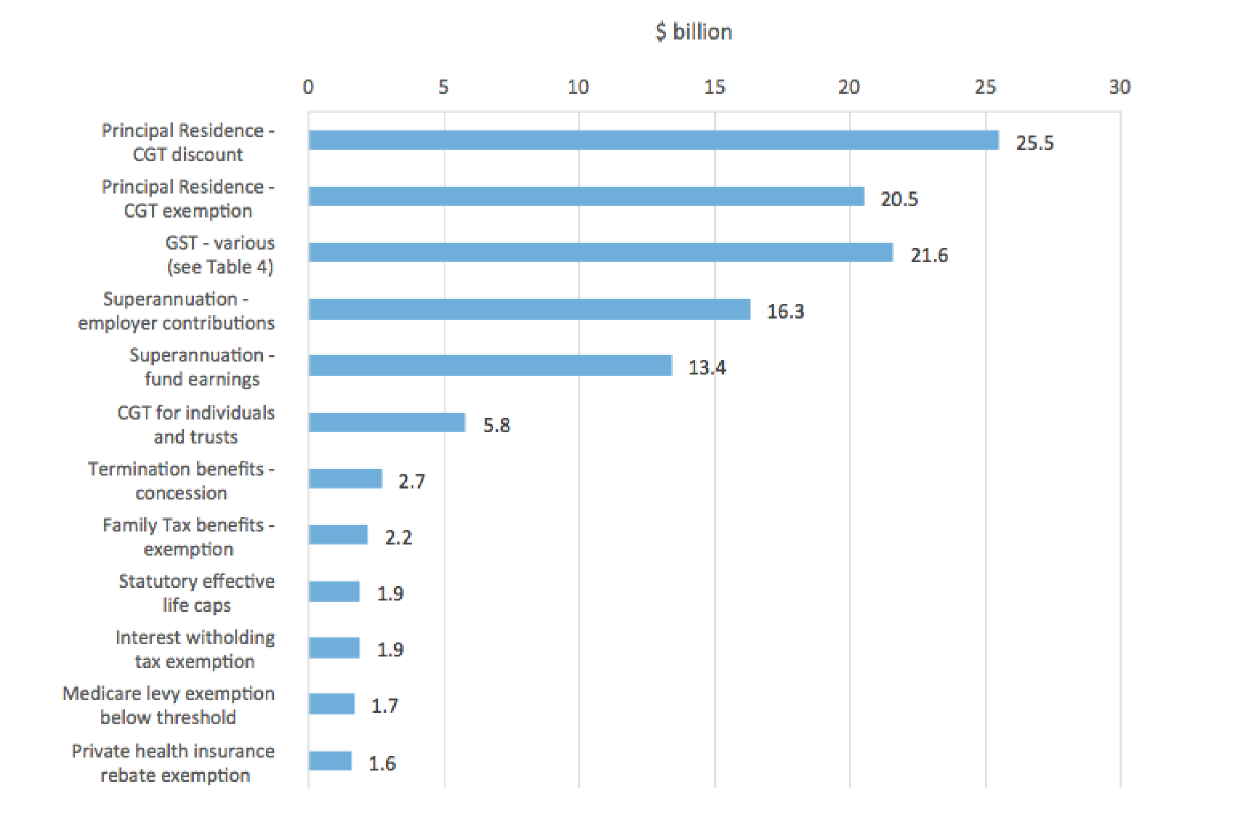
"Another long-standing policy which I have long argued has not only failed to deliver on its oft-stated rationale of boosting the supply of housing but has actually exacerbated the mismatch between the demand for and supply of housing, as well as having distorted the allocation of capital and undermined the equity and integrity of the income tax system, is so-called 'negative gearing' ".

Saul Eslake, '50 Years of Housing Failure', speech to 122nd Annual Henry George Commemorative Lecture, 2/9/13

"The current system of tax concessions is in need of fundamental reform: it is too costly and the cost rises steeply with time; the system redistributes billions to the well-off; it distorts saving into superannuation with no guarantee that national saving is increased as a result; it is complex, creates arbitrary categories of favoured and non-favoured contributions and makes no economic sense."

David Ingles, 'The Great Super Tax Concession Rort', The Australia Institute Research Paper No. 61, February 2009

Figure 1: Selected Tax Concessions - Tax Expenditures (Revenue Forgone Basis) above $1.5 billion, 2014–15



Source: Treasury, Tax Expenditures Statement 2014 (Commonwealth of Australia, Canberra, 2015).

There is no doubt the increased scrutiny of concessions in recent years is a result of the persistent budget deficit. However, they are also integral to tax reform and have therefore been a key focus of the 2010 Australia's Future Tax System (AFTS) review and more recently the Financial System Inquiry (FSI), which made a number of observations covering tax concessions because of their implications for the financial system and for neutrality in the treatment of different forms of saving and investment.[4] Looking ahead, tax concessions are bound to be a key area of focus by the Abbott government's tax system review in 2015 as is apparent from the tax discussion paper issued on 30 March.

Tax Expenditures Myths

This report deals with features of the Commonwealth tax system that are generally referred to as concessions. Most, but not all of them, are also officially classified as tax expenditures (see Box 2). Typically when tax concessions are criticised, the critics rely heavily on the official estimates of tax expenditures, but a great deal of mythology has grown up around such expenditures, encouraged by the very large sums involved. The inherent limitations of tax expenditure estimates are often overlooked and the figures are misinterpreted even against the advice of the Treasury, which is the main source of the estimates.

BOX 2: WHAT ARE TAX EXPENDITURES?

One definition that captures the essence of tax expenditure is provided by Tyson (IMF, 2010, p. 3): 'Tax expenditures are government revenues foregone as a result of differential, or preferential, treatment of specific sectors, activities, regions, or agents. They can take many forms, including allowances (deductions from the base), exemptions (exclusions from the base), rate relief (lower rates), credits (reductions in liability) and tax deferrals (postponing payments)'.[6]

Treasury's definition (TES, 2013) emphasises the notion of a benchmark: '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.

According to the 2014 TES, the benchmark should represent the standard tax treatment that applies to similar taxpayers or types of activity. But it qualifies this by stating 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.

Box 2 continued overleaf

The 2014 TES reports $46 billion of tax expenditure 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. A tax treatment that applies to the entire population of homeowners can hardly be characterised as a narrow loophole serving sectional interests. Given these facts, it is questionable whether full taxation of capital gains on principal residences can be regarded as a 'standard' or 'benchmark'.

Dividend imputation is not classified as a tax expenditure because it is considered to be a structural feature, but some would say the classical income tax system should be the benchmark, in which case dividend imputation is a tax expenditure. Such ambiguities make the very concept of tax expenditure nebulous.

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 it is bad policy. Concessions may have legitimate purposes such as promoting equity, overcoming biases towards economic inefficiency, or simplifying tax administration and compliance.

One thing that should be clear is that whether or not a concession is classified as a tax expenditure, its removal results in someone paying more tax, and this represents a tax increase. Any suggestion it is a reduction in expenditure rather than a tax increase is word-play by those eager to see an increase in the tax burden, for whatever reason.

BOX 3: THE TAX FRAMEWORK: OPTIMAL VS COMPREHENSIVE TAXATION

What is considered to be a tax concession or tax expenditure depends on the chosen benchmark, the definition of which is somewhat arbitrary and judgmental. One person's idea of an unjustifiable concession could be another's idea of a desirable structural feature of the tax system.

For the GST it may be thought obvious that the benchmark is uniform taxation of all household consumption expenditure, but even here some may argue that not all consumption is equal and that necessities of life should be taxed at lower rates than luxuries, or not at all.

For income tax, the appropriate benchmark is even more contentious. The income tax concessions counted as tax expenditures 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 anything less than full taxation of capital gains at an individual's marginal tax rate constitutes a concession and a tax expenditure.

The comprehensive income tax base has, however, come increasingly into question and the alternative of optimal income taxation has gained credence. The AFTS 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 optimising the tax system rather than attempting 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 tax expenditure on some items (see Box 5).

The first 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 tax expenditures 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 should be a warning to users.

The second issue is that the definition of tax expenditure is contentious as it requires specifying a ‘benchmark’ tax treatment against which to measure actual practice. The benchmark is defined as ‘a standard tax treatment that applies to similar taxpayers or types of activity’. 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 huge difference whether taxation of savings is assessed against an income benchmark or an expenditure (consumption) tax benchmark (see Box 3).

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 tax expenditures are often used as a measure of departure from the ‘correct’ tax treatment, with any tax expenditures relative to the benchmark pejoratively labelled ‘subsidies’, ‘loopholes’ or ‘rorts’. Treasury itself discourages using the figures in this way because ‘the choice of benchmark should not be interpreted as indicating a view on how an activity or taxpayer ought to be taxed’ (TES, 2013).

Another important qualification is that tax expenditure estimates do not indicate the amount of tax revenue to be gained by removing the concession that gives rise to a tax expenditure; 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 tax expenditure being abolished. In some cases, the revenue gain estimate is billions of dollars smaller than the revenue forgone estimate (see Box 4).

Finally, there is a warning that the estimates of individual tax expenditures cannot necessarily be summed to provide a global tax expenditure figure because some tax expenditures are not independent of others. For example, removing one tax expenditure 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.

The caveats surrounding tax expenditure estimates amount to a strong warning to users, but one that often goes unheeded by the critics of particular tax expenditures.

While the tax concessions discussed below are part of the Abbott government’s white paper tax review, there have already been numerous reviews of tax concessions in the context of broader tax reviews over the years. These include the 2010 AFTS review (the Henry review), the 1999 Review of Business Taxation (the Ralph review), and the 1998 A New Tax System (ANTS) review that led to the GST. The key findings of these reviews in relation to selected tax concessions are summarised in Table 2.

BOX 4: REVENUE FORGONE VS REVENUE GAIN

One of the most common misuses of tax expenditure data is to assume that if particular concessions were removed, the budget would gain an amount of revenue equal to the estimate of the tax expenditure associated with the concession. This may be close to the truth in some cases, but wide of the mark in many others. Tax expenditure estimates traditionally aim to measure the revenue foregone by the budget, not the revenue that would be gained by removing concessions. The difference arises because the behaviour of beneficiaries adjusts, where possible, to the loss of a concession.

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. These need to be treated with particular care as they are only as valid as their underlying assumptions about taxpayer behaviour in response to the removal of concessions — which is a hypothetical event given that the concessions in fact exist. However, the results are a warning to those who persist in using tax expenditure data prepared on a ‘revenue foregone’ basis to assert revenue of that magnitude is available to government only if 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. In contrast, there is little difference between revenue gain ($6.3 billion) and revenue foregone ($6.4 billion) in the case of the GST exemption for uncooked food, because the consumption of food is assumed to be fairly insensitive to whether it is subject to GST or not.

Ideally, revenue gain and revenue foregone data would be available for all tax expenditures, but this is never likely to be the case.

BOX 5: TAXATION OF SAVING AND INVESTMENT

Many of the contentious issues concerning tax concessions relate to taxation of saving and investment (capital gains, negative gearing, dividend imputation and superannuation). That such features of the tax system are heavily represented in summaries of tax concessions and expenditures should not be surprising. This is not because governments want to be generous to savers and investors, but because taxing saving and investment at 'standard' rates (according to a comprehensive income benchmark) would be inappropriate. The so-called 'concessions' are often not concessions at all but ways of removing biases and distortions that a comprehensive income tax treatment would put in the way of saving and investment. Whether they do so in accordance with the principles of tax efficiency, equity and simplicity is a matter for case-by-case review.

Taxation theory and principles provide a strong justification for taxing saving at lower rates than other income. If saving is taxed at the same rates as other income, the choice between consuming today and consuming in the future (that is, saving) is biased against the future. The bias is reinforced in the presence of inflation, which boosts real effective tax rates — the more so the longer an asset is held.

There is wide agreement with that proposition among tax economists, but less agreement about precisely how heavily saving should be taxed, if at all. At one extreme, some economists have proposed in the past that the income tax be replaced by an expenditure tax (broad-based consumption tax), meaning income devoted to saving, as well as the return on saving, would not be taxed at all until the income saved and the returns to saving are spent on consumption. The more general contemporary view among tax economists is that expressed by Auerbach:

> "In summary, there are now serious qualifications as to the desirability of replacing the income tax with a broad-based consumption tax, and many arguments in favour of retaining capital income taxes in some form ... but there remains little logical support for the proposition that these two types of income (labour and capital) should generally be taxed at the same rate."[5]

The AFTS review accepted the principle that while savings income should not be tax-free as a general proposition, it should be taxed at a lower rate than labour income. The 2015 tax discussion paper reiterates the acceptance of this principle. In the cases of principal residences and superannuation, the AFTS review thought the expenditure tax represented an appropriate benchmark for policy assessment. The 2013 TES picked up this theme, observing that "The current benchmark applied for the income tax treatment of savings is the comprehensive income tax benchmark. There is, however, a question about whether using an expenditure tax benchmark, either in addition to the income tax benchmark or as a replacement, would be appropriate, given the tax treatment of assets held by Australian households". The TES then went on to provide 'experimental' estimates for superannuation using an expenditure tax benchmark for the first time.

As well as looking at how saving and investment income is taxed relative to other sources of income, another issue for tax reform is how different forms of saving and investment income are taxed relative to one another. The more uneven the tax treatment, the more biases and distortions there are, the greater the opportunities for tax-driven arbitrage, and the stronger the interference with the most productive allocation of capital. The 2015 tax discussion paper highlights this issue.

Table 2: What Tax Reviews Have Said About Selected Tax Concessions

AREA OF TAX CONCESSION:	AFTS (HENRY REVIEW) (1)	ANTS/BUSINESS (RALPH) REVIEWS (2)
Capital gains tax on principal residence	Leave untaxed. Assess against expenditure tax benchmark	Leave untaxed
Capital gains tax - general	Reduce discount from 50% to 40% in context of uniform 40% discount for other savings income	Replace full taxation of inflation-adjusted gains with 50% discount if asset held longer than 12 months
Negative gearing	Retain deductibility of net losses, but discount by 40% as for other savings income	Not addressed
Dividend imputation	Retain in short to medium term. In long term, consider alternatives if major revision of company tax system	Retain, and allow full refund of franking credits
Superannuation	Retain tax-free end-benefits (as required by ToR); cut fund earnings tax to 7.5% and apply to funds in pension as well as accumulation mode; tax contributions at members' marginal rates less credit of 20%	Not addressed
GST	Not addressed (outside ToR)	Introduce 10% GST including all food, but excluding health, education, water; input-tax financial services

(1) Australia's Future Tax System review, 2010.
(2) A New Tax System white paper, 1998; Review of Business Taxation, 1999.

CAPITAL GAINS TAX

'While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax rate was zero'. (Alan Greenspan, 1997)

Capital gains tax concessions are probably the most maligned of all tax concessions. The 50% capital gains tax discount appears on many target lists of ways for the government to raise more revenue, and to do so in a way that affects higher income households most. Principal places of residence enjoy an additional concession in that capital gains on disposal are not taxed at all. This too has attracted criticism.

The notion that these provisions represent concessions at all rests on the unstated and dubious assumption that the appropriate benchmark is comprehensive income. Against a more appropriate expenditure tax benchmark, the CGT discount and exemption for principal residences do not generate tax expenditure at all — in fact there is negative tax expenditure equal to the revenue raised from taxing 50% of capital gains. It is not as if housing is otherwise tax-free: investment in new dwellings faces a separate expenditure tax in the form of GST; while all housing transactions are subject to state stamp duty.

There is a case that the optimal capital gains tax rate is zero. In the words of Kirchner, "The economic case for taxing capital gains is widely acknowledged to be weak, even by supporters. CGT raises little revenue, but at a substantial cost in terms of economic welfare".[7] The economic cost (excess burden) of capital gains tax is relatively high because of the high mobility of capital, and the economic efficiency gains from lowering or eliminating the tax would generate dynamic gains to economic growth and general tax revenue more than offsetting any static revenue losses. Kirchner also points out that taxing capital generated by saving and investment out of after-tax income represents a form of double taxation, which not only discourages saving and investment but rewards accumulation of debt.

CGT has typically made a minor contribution to revenue. Even a decade after its introduction it was still raising less than 0.4% of GDP and on average since the mid-90s it has raised about 0.6%, albeit with considerable volatility broadly in line with the fortunes of the share market. Significantly CGT has raised more revenue, on average, since it was eased in 1999 (Figure 2) than before. Any attempt to raise more revenue would face the strong disincentive that a higher CGT would place in the way of realisation of accumulated gains.

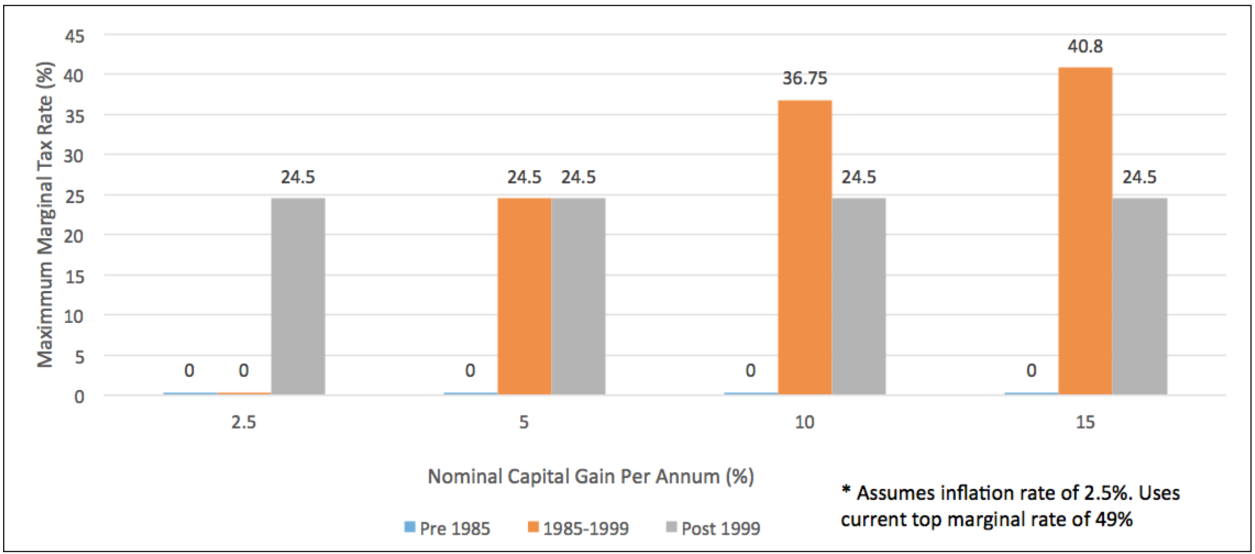
It is instructive to recount the history of Australia's capital gains tax. The rate was indeed zero until 1985, when the then Labor government introduced a CGT (though not for principal residences) as part of a tax reform package that saw marginal income tax rates reduced substantially in the context of base-broadening, of which bringing capital gains into the base was part. While full marginal rates were applied to capital gains in the true spirit of the comprehensive income benchmark, an allowance was made for inflation. Thus, it was a tax at full marginal rates on real, rather than nominal, capital gains.

This approach continued until 1999 when the Howard government accepted a recommendation of the Ralph Review of Business Taxation that capital gains tax be eased in recognition of its economic harm and limited revenue-raising power.[8] The change was to remove the allowance for inflation but grant a discount of 50% for assets disposed of after a holding period of longer than 12 months. (There were some other changes such as the removal of averaging provisions which, like the removal of inflation adjustment, went against the interest of taxpayers.)

It is now part of the folklore surrounding CGT that the Ralph reform 'halved' taxation of capital gains. It did no such thing, as introduction of the discount was accompanied by removal of inflation adjustment and averaging provisions. The pre-Ralph indexation provision represented a discount in another guise. Indeed, for assets that generate a capital gain of less than double the inflation rate, indexation delivered a larger effective discount than the post-Ralph 50% discount. In times of long-term average investment returns, the 50% discount would be larger than the indexation 'discount', but there is no reason to regret this as a policy mistake — it was an unequivocal improvement.

Figure 2 illustrates the maximum effective marginal capital gains tax rate under the three tax regimes at various average annual rates of nominal capital gain over holding periods of more than 12 months. Under the indexation regime of 1985–1999, an inflation rate of 2.5% is assumed. For illustrative purposes, the current statutory top marginal rate of 49% (including Medicare levy) is used.

Figure 2: Capital Gains Tax Regime: Pre 1985; 1985–1999; Post 1999*



Source: Author's calculations based on statutory tax rates.

When anyone now talks about 'removing' the CGT 50% discount, taken literally those words mean taxing nominal capital gains at full marginal rates. It is important to understand that such a regime has never applied in Australia. Its supporters hanker for something we have never actually had. It is also difficult to find any other country that taxes capital gains in that way. For those who like to emphasise the tax policies of other OECD countries as a policy benchmark, it should be understood that the standard treatment among OECD countries is concessional relative to a comprehensive income tax base. In fact some countries, such as New Zealand and Singapore, still have no CGT at all. The motivation for the Ralph reform was that "Australia taxes capital gains more harshly than most other comparable countries and certainly more harshly than other countries in our region competing for international investment".

In Australia, the 2010 AFTS review recommended a reduction in the CGT discount to 40%. However, this was in the context of a package of reforms that would have seen all forms of savings and investment taxed more uniformly. The 40% discount would also have applied to interest earnings and net rent. It is not clear the AFTS review would have recommended a reduction in the 50% discount in isolation. The choice of a uniform 40% discount appears to have been a pragmatic one based on the higher revenue cost of applying a 50% discount to all forms of saving and investment. Opting for 40% instead of 50% for capital gains alone on conceptual grounds would have involved more fine-tuning than the conceptual arguments could bear. Interestingly, the AFTS review defended the CGT exemption for principal residences as being fully consistent with an expenditure tax benchmark.

According to TES 2014, the CGT discount for individuals and trusts results in revenue forgone of $5.8 billion and for principal residences $25.5 billion, while the further exemption of principal residences costs the revenue $20.5 billion. But the implication that there is $51.8 billion of revenue waiting to be scooped up by a reform-minded government is outlandish for two reasons.

First, these amounts are calculated against an inappropriate comprehensive income benchmark. Under a more appropriate expenditure tax benchmark, capital gains would not be taxed at all, and the TES would record negative tax expenditures resulting from revenue from taxation of 50% of capital gains.

Regarding the principal residence exemption, the 2013 TES stated that "Given owner-occupied housing is the largest form of savings held by Australian households, and is taxed consistently with an expenditure tax benchmark, arguably this benchmark could be used for savings rather than the current comprehensive income tax benchmark". Yes indeed, and then $46 billion of 'tax expenditure' would disappear at the stroke of a pen. It should also be said that as a political proposition, the very idea of taxing capital gains on principal residences is particularly outlandish. It has never been in the policy platform of any Australian political party. In addition to state stamp duty, it would be a major impediment to efficient turnover of the housing stock and lock people into inappropriate locational and housing choices. Where it applies in other countries, it typically comes with generous thresholds and rollover provisions that ensure it raises little revenue. The 2015 tax discussion paper appears to accept that owner-occupied housing will remain free of CGT, noting the 'strong consensus' for this approach and declining to articulate counter-arguments.

Second, even with a comprehensive income benchmark, the amounts estimated in TES are revenue forgone, not revenue that could by gained by eliminating the concessions. Treasury does not attempt to make revenue gain estimates for the CGT concessions because the behavioural response of taxpayers — while strong — is too difficult to model. In practice, CGT has a powerful lock-in effect and the turnover of assets subject to the tax is highly sensitive to the rate. It is quite possible that removal of the concessions would raise no extra revenue at all. As Kirchner points out, revenue actually strengthened after the Ralph reforms of 1999.[9]

Another criticism of CGT concessions is that they are 'poorly targeted', meaning that the tax savings are skewed towards richer households. But this views the concessions as if they were a fixed pot of money to be doled out like a social benefit, which they are not. The conceptual case for a discount (or indeed a zero rate) applies equally at all levels of income and wealth. If the government wishes to pursue distributional objectives, there are other more appropriate ways to go about it.

Finally, it is worth commenting on housing, as the CGT discount is often blamed for contributing to overheated housing markets and inflated prices. As Kirchner (2009) argues, there is no basis to such claims. Housing is not treated differently from any other asset class. Supply-side constraints, such as state and council planning regulations, are more important in inflating house prices in Australia.

Given all the above, there should be no suggestion of increasing the severity of CGT, which would not in any case meet its advocates' goal of generating significant additional revenue. The appropriate policy options are:

1. Leave CGT as it is.
2. Abolish CGT.
3. Convert CGT to a flat rate (eg 15%) in the context of a dual income tax.
4. Abolish the 12 months holding period requirement for the discount to apply.
5. Keep the discount at 50% or some lesser amount but also reinstate indexation for inflation.

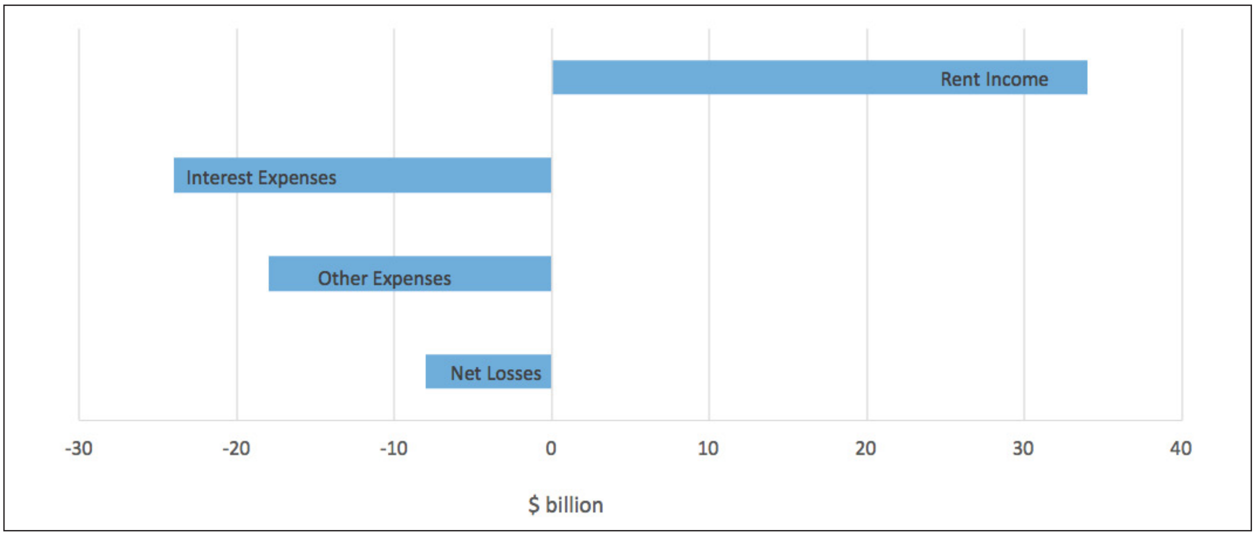
NEGATIVE GEARING

Negative gearing is another favourite target of those opposed to tax concessions, but it is debatable whether it is a concession at all. The term is something of a misnomer as it refers to an investment financed with a high level of gearing (debt), not 'negative' gearing. What is negative about such investments is not the gearing, but the net income they generate. The terminology is uniquely Australian, but not the concept, as some other countries also allow deductibility of net losses.

Rational investors tolerate net losses in the knowledge they are deductible from other income for tax purposes and in the expectation they will ultimately be more than offset by capital gain. It should be noted the tax deductibility of a net loss reduces, but does not eliminate, the after-tax loss. Thus investing to make a loss would be totally irrational without the expectation of future profits from positive net income or capital gain or both.

Although 'negative gearing' is popular in Australia and may have been rewarding to most users of the strategy in the past, it is a risky proposition and will not necessarily be rewarding in the future. The Australian Taxation Office reports that in 2011–12 individual taxpayers declared $34 billion in gross rent income, but after all deductions this became an aggregate net loss of almost $8 billion, a figure that has been growing.[10] The main deduction was interest on borrowings ($24 billion). The aggregates for rental income, deductions and net losses reported by individual taxpayers are illustrated in Figure 3.

Figure 3: Negative Gearing (2011–12)



Source: Australian Taxation Office, *Taxation Statistics* 2011–12

Almost 2 million individual taxpayers declared net rental losses. Assuming an average marginal tax rate of 40% for the landlord population, the net loss reduced tax revenue by $3.2 billion. These figures do not include self-managed superannuation funds, which have been increasingly attracted to geared property investment in recent years. However the attraction of net losses is less to such funds as their earnings face a maximum rate of 15%.

For all the animosity that negative gearing attracts from certain economists and other commentators, it should be noted that Treasury does not classify it as tax expenditure. Deductibility is considered a structural feature of the income tax system and does not therefore lead to 'tax expenditure'. Allowing taxpayers to deduct net rental losses from other income may be considered in some sense 'concessional', but deductibility of interest on borrowings made to undertake an investment is nothing more than a specific case of the general principle that the expenses incurred in generating income are deductible expenses. In this sense, investment in real estate is no different from investment in other assets such as equities, yet 'negative gearing' for sharemarket investments attract no attention. As long as rent income is treated and taxed as part of comprehensive income, expenses incurred should be deductible from comprehensive income. Unless investors are irrational, their 'negatively geared' investments will ultimately lead to positive net income and/or realised capital gains that will on average contribute positively to tax revenue.

The 2015 tax discussion paper comments on negative gearing at length and defends the principle of deductibility of interest expenses and net rental losses. It argues that if investor housing is under-taxed it is because of the 50% CGT discount rather than the deductibility of net losses.

Critics of negative gearing often argue net investment losses should be quarantined for tax purposes and offset against future realised capital gains. However, a case for limiting deductibility of expenses could only be justified if the rental income was in some way taxed concessionally rather than as part of comprehensive income. The AFTS review, for example, recommended a 40% discount for net rent income, which meant discounting both the gross rent and the relevant expenses by 40%. Net losses, therefore, would be discounted by 40%. The review did not recommend quarantining discounted net losses, but the discounting would reduce the loss of tax revenue.

Negative gearing and the 50% capital gains tax discount are often blamed for contributing to unaffordable housing by attracting investor demand that would not otherwise take place. This housing affordability myth (along with seven others) has been exposed by Kirchner (2014), who argues that the tax deduction for net rental losses and the CGT discount have positive supply side as well as demand side effects, the net effect of which is ambiguous.[11] Kirchner further argues that strong trend growth of house prices has been observed in many countries with different tax characteristics, and the trend can be explained by other forces such as the secular decline in real interest rates and policy-induced supply restrictions. The oft-heard opposition to negative gearing is really an objection to the tax deduction as such, rather than its implications for house prices; there are no objections to investment in housing that generates a positive net income.

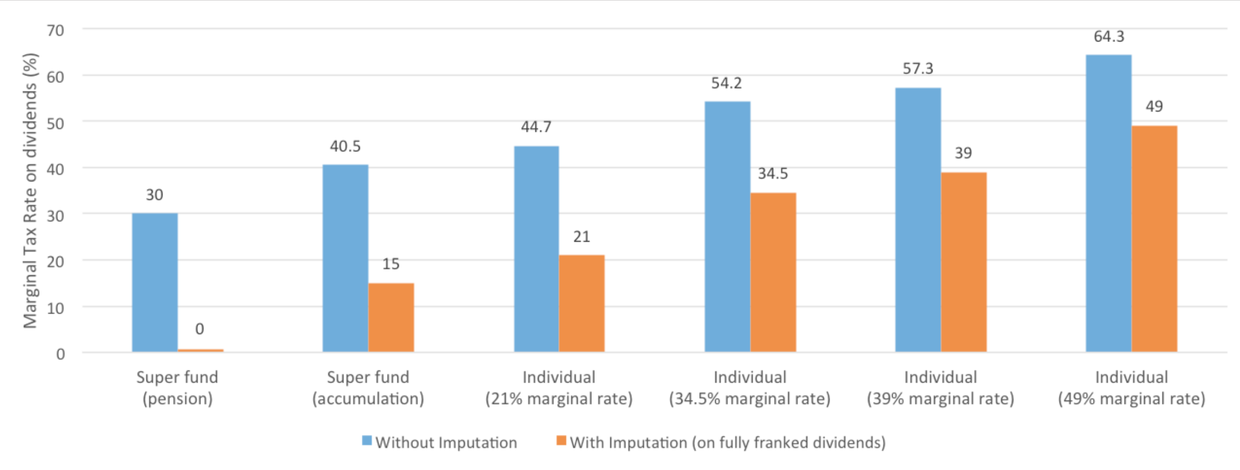
The conclusion for policy is that unless the design of the tax system is changed so rental income becomes concessionally taxed, so-called 'negative gearing' should be left as it is. If rent income were to be discounted or subject to a low rate of tax — presumably as part of a broader reform of taxes on saving and investment —there would be a case for curtailing deductibility of relevant expenses.

DIVIDEND IMPUTATION

Like 'negative gearing', removal or dilution of dividend imputation is often targeted for its potential to raise billions more in tax revenue, but is not officially classified as 'tax expenditure' because it is considered a structural feature designed to prevent double taxation of dividends. The imputation system provides a tax credit to shareholders for the company income tax already paid on the dividends paid to them. This part of company income tax collections is therefore treated in effect as a prepayment of individual income tax, which generates franking credits for shareholders when they come to make their tax returns. The result is that dividends are not taxed twice as they otherwise would be (first as company income and then as personal income), but to the extent the shareholder's personal marginal rate is higher than the corporate rate, the effect of the imputation system is that they pay extra on their dividend income for the difference. The progressive structure is preserved.

Imputation has been in place in Australia since 1987, when it was introduced by the Hawke Labor government as part of a package of income tax reforms. The main change in the system since then came in 1999, when franking credits were redefined as an uncapped refundable tax credit. Prior to this, the amount of franking credits a taxpayer could claim in any year was capped at the amount of their tax liability. Dividend imputation is an entrenched feature of the investment landscape and any major change in it would represent a major upheaval. It was once proudly proclaimed as one of the significant economic reforms of the golden era of reform in the 1980s, but came under critical scrutiny by the 2010 AFTS review and again more recently by the FSI led by David Murray.

Figure 4: Tax on Dividends with and without Imputation (company + personal or super fund tax)



Source: Author's calculations based on statutory tax rates.

The 2015 tax discussion paper states that individuals, superannuation funds and charities claim imputation credits of $19 billion a year, and companies a further $10 billion. However, aggregate franking credits are not a measure of tax revenue foregone by the imputation system, because the franking credits are not only refunded but also added to taxpayers' assessable income (the 'grossing-up' of dividends). It is clear, nonetheless, that the imputation system has a large revenue cost relative to the classical company tax system that preceded it.

This large cost has attracted the attention of tax concession critics, some of whom have labelled dividend imputation a subsidy to shareholders. However it is difficult to see how something that merely removes double taxation of dividends can be properly called a 'subsidy'. Without imputation, double (company and individual) income tax on dividends would be 64.3% for a top marginal rate taxpayer, 57.3% at a 39% marginal rate, and 54.2% at a 34.5% marginal rate. It was these very high tax rates that the imputation system was deliberately designed to avoid.

Figure 4 illustrates the total effective tax rate (both company and personal or superannuation fund income tax) on dividends at the various marginal rates (including Medicare levy) for individuals and superannuation funds, with and without imputation, assuming the same company tax rate under both regimes.

Both the AFTS review and FSI, while raising questions about the imputation system, recognised its benefits. The AFTS review concluded that imputation should be retained for the 'short to medium term' (p 198), while the FSI only went as far as stating that 'the case for retaining dividend imputation is less clear than in the past'. Imputation is beneficial in eliminating double taxation of dividends, lowering the cost of equity capital and reducing the bias towards debt funding. However, these benefits have diminished as Australia has become more open and integrated with global capital markets. In this situation, imputation creates a bias for domestic investors to invest in domestic equities. The 2015 tax discussion paper reiterates the pros and cons of imputation but is non-committal as to its future.

The conversion of franking credits to a fully refundable form in 1999 has attracted criticism because it results in net tax refunds to taxpayers with low marginal rates, particularly superannuation funds. However the logic of the imputation system leads to full refundability. A superannuation fund on a tax rate of 15%, for example, would pay an effective rate of more than 15% if it did not receive a full refund of the 30% company tax paid on its dividends.

There has been a trend for countries that once practiced dividend imputation to abolish it, leaving only Australia and New Zealand with imputation systems among advanced economies. However this in itself is not a reason for Australia to abolish imputation. Many other countries, while not practicing imputation, provide dividend tax relief in other forms such as zero or concessional rates of tax, or have much lower rates of company income tax.

Proper evaluation of imputation calls for the balancing of international investment considerations against domestic considerations. The more the former dominate, the weaker the case for imputation. If imputation were to be abolished, however, those same international investment considerations would argue for a large, offsetting cut in the company tax rate. Gruen, for example, has argued that a cut to 19% would be possible, and that this would be more effective in lowering the cost of capital than is the imputation system.[12]

Ideally there would be both a lower company tax rate and imputation. If fiscal constraints preclude this, however, a choice may need to be made between the benefits of imputation and the benefits of slashing the company tax rate.

SUPERANNUATION[13]

Superannuation tax concessions present a $30 billion a year (and fast growing) target for the critics of tax expenditures, or so they claim. The belief that the concessions are both excessive and poorly structured has become so widespread it appears to be only a matter of time before the current government or a future one curbs and reshapes the concessions.[14] However, much of the criticism lacks firm foundations.

Superannuation, despite all its bells and whistles, is at base a form of saving, and its long-term focus makes it the best example of why saving needs to be taxed at relatively low rates to avoid tax-induced distortions. Saving represents the deferral of consumption, and the income from saving is the reward. The more that reward is taxed and the longer the period over which it is taxed, the stronger the bias against savings. Savers face higher lifetime taxation than non-savers with the same earnings. Thus, tax concessions for superannuation (depending on their size and structure) need not be the distortion they are often accused of being, but the means to correct a distortion. The principle of taxing saving for retirement at concessional rates is widely recognised in tax systems around the world and Australia is no exception.

The 2015 tax discussion paper recognizes 'there are policy grounds for superannuation being taxed at a lower rate than labour income', but goes on to note concerns about the distribution of the impact of concessions and the complexity of the system.

Statements often made about the huge fiscal cost of Australia's superannuation tax concessions are based on the comprehensive income tax benchmark for measuring tax expenditures, but the characteristics of superannuation make it singularly unsuitable for a comprehensive income benchmark. The expenditure tax benchmark (Box 5) is more suitable, and on that basis revenue forgone is dramatically lower than routinely claimed.

The Treasury has lent credence to the expenditure tax benchmark by publishing selective data on the revenue cost of superannuation tax concessions measured against that benchmark. The AFTS review published an estimate of $4.6 billion for 2007–08, dramatically lower than the estimate of $26 billion for the same year using a comprehensive income tax benchmark. Then in the 2013 TES Treasury published what it called 'experimental' estimates for 2013–14 to 2016–17 using an expenditure tax benchmark. For 2013–14, for example, the figure came to about $11 billion, just one-third of the figure based on the comprehensive income tax benchmark. Figure 5 illustrates the large discrepancy between tax expenditures measured against the two benchmarks.

Two points should be made about these estimates. First, they refer to revenue forgone, not the revenue that could be gained from removing the concessions, which would certainly be less (see Box 4).

Second, Treasury has defined an expenditure tax treatment of superannuation as being full taxation of contributions at individuals' marginal rates and zero taxation for fund earnings and pay-outs — what Treasury calls a 'pre-paid' expenditure tax, with the acronym 'TEE'. Another variant, however, is a 'post-paid' expenditure tax, which would exempt contributions and fund earnings but fully tax benefits at recipients' marginal rates (the so-called 'EET' structure). This definition of the expenditure tax gives rise to lower estimates of tax expenditures because retirees' tax rates are on average lower than when they are working, but Treasury does not calculate them on that basis. This EET structure is the one favoured by superannuation experts, and the most common in other countries. It would be useful to know how much closer to zero (or even a negative figure) an estimate of tax expenditure on this basis would come, but no such data have been published. The system Australia has had since 1988 is neither TEE nor EET, but a hybrid.

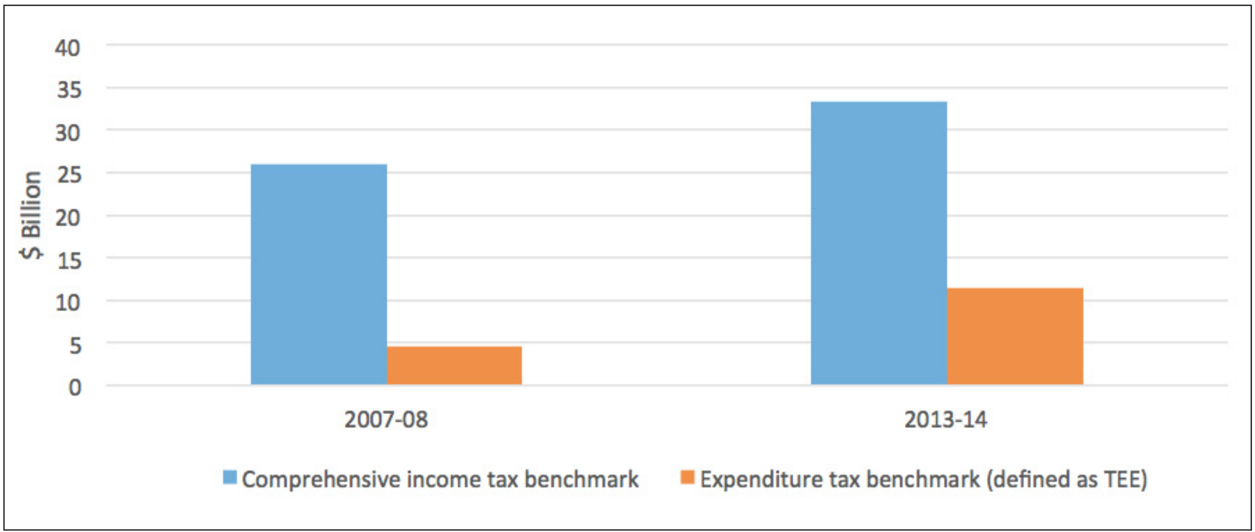
Table 3 provides a summary comparison of the current hybrid superannuation tax scheme with past hybrid schemes and some alternatives.

If, as appears to be the case, the true figure for superannuation tax expenditure is a fraction of what is commonly believed, or perhaps even zero, much of the case against the concessions disappears; but there are three other legs to this case that deserve attention. The first is that superannuation concessions are so generous relative to the tax rules for most other forms of saving that the discrepancy distorts savers' decisions and creates a bias against non-superannuation saving. The discrepancy is most glaring between superannuation at one extreme and interest income at the other. This is more an argument for lowering tax on other forms of saving than for raising it on superannuation. If this is not affordable to the budget, then superannuation concessions could be trimmed to pay for tax cuts on the currently non-concessionally taxed forms of saving. However, no such trade-off is suggested by the critics of superannuation concessions, who are more focused on raising additional net revenue.

The second leg of the popular critique is that superannuation concessions are poorly 'targeted' or 'distributed' because they flow disproportionately to higher income earners. As noted earlier in relation to CGT, this argument tends to view the concessions as a fixed sum to be distributed like a social benefit program, which they are not. As the case for superannuation concessions applies at all income levels, they should be applied neutrally. Even with neutrality, however, given that higher income earners pay most income tax they will receive most of the benefits of the concession; this is a natural consequence of progressive income tax.

One distributional feature that attracts particular criticism is that since benefits became exempt from tax

Figure 5: Superannuation Tax Concession (income and expenditure tax benchmarks)



Sources: Australia's Future Tax System (AFTS), Part Two, *Report to the Treasurer December*, 2009 (Commonwealth of Australia, Canberra, 2010); Treasury, Tax Expenditures Statement 2013 (Commonwealth of Australia, Canberra, 2014).

Table 3: Alternative Tax Schemes for Superannuation

SCHEME TYPE:	CONTRIBUTIONS	EARNINGS		END-BENEFITS
		Accumulation	Pension	
Hybrid, 1988 - 96	15%	15%	15%	Taxed at individuals' marginal rate less 15% credit
Hybrid, 1996 - 2005	15% plus 15% surcharge (1) if earnings above threshold	15%	15%	Taxed at individuals' marginal rate less 15% credit
Hybrid, 2007 - 12	15%	15%	0%	0%
Hybrid, current	15% plus 15% surcharge(2) if income above $300,000	15%	0%	0%
TEE (pre-paid expenditure tax)	Taxed at individuals' marginal rate (ie contributions out of after-tax income)	0%	0%	0%
EET (post-paid expenditure tax)	0%	0%	0%	Fully taxed at individuals' marginal rates
AFTS proposal (3)	Taxed at individuals' marginal rates less 20% credit	7.5%	7.5%	0%

(1) The 15% surcharge applied above an initial threshold of $85,000 and was phased out between 2003 and 2005.
(2) Surcharge has applied since 1 July 2012.
(3) Australia's Future Tax System (Henry) review, 2010.

at age 60 in 2007, concessional contributions have been able to escape a progressive income tax scale as they pass through the system; contributions and earnings (in accumulation phase) are taxed at a flat 15% and then zero when benefits are taken from age 60. This is said to undermine the progressive income tax, although it should be noted the previous government in 2012 imposed a surcharge rate of 30% on contributions by those with taxable incomes above $300,000, which has restored a degree of progressivity to the structure. This change receives little recognition in the 'fairness' debate, but went a long way to addressing concerns (valid or not) about the lack of progressivity.

The AFTS review recommended a more comprehensive reform that involved taxing contributions at full (progressive) marginal rates for everyone, subject to a flat tax credit calculated as a fixed percentage of contributions. This in effect would have given the tax on contributions a progressive shape, just as benefits were taxed progressively until 2007.

Attitudes to the degree of flatness or progressivity in taxation of superannuation clearly depend on one's attachment to the basic principle of a progressive income tax. Those who favour a flatter income tax, such as the author of this report, may welcome a flat tax on superannuation contributions and fund earnings as the direction in which the entire income tax should be reformed. However even those firmly wedded to progressivity should accept that applying a single rate of tax to superannuation brings important simplification and compliance benefits, and that what really matters is the degree of redistribution effected by the tax/transfer system as a whole, not any single component of it. The 2015 tax discussion paper goes to considerable lengths to explain that the current tax/transfer system is highly progressive and redistributive notwithstanding the distributional impact of superannuation concessions.

The third criticism is that tax-free superannuation benefits are available too early, at age 60. This creates an incentive for people to retire early and run down their superannuation balances in order to qualify for the age pension. This criticism has some validity, and just as the pension eligibility age is being raised in recognition of longer life expectancy, there is a case for increasing the age 60 threshold. However, the parallel is imperfect, as superannuation draw-downs represent peoples' own money being returned to them rather than payments of taxpayers' money from the budget. For this reason alone it would be unreasonable to raise the superannuation eligibility age much beyond 60.

Ideally, Australia would have an EET system.[15] Indeed, there was such a system until the 1980s, when the Labor government began tinkering to generate tax revenue from contributions and fund earnings. The complexities involved in a transition from the current system back to the EET structure are such that it is unlikely ever to happen. Any further systemic change is likely to be much less ambitious. However the EET structure still represents the best benchmark against which to assess the current system.

As it appears inevitable superannuation tax will come under scrutiny yet again, the appropriate place to start is with the relevant information, not the massive but meaningless 'tax expenditure' costs of superannuation concessions measured against a comprehensive income benchmark. The relevant information is the overall cost of the current system relative to the EET benchmark, which has not been provided by the Treasury but we know to be a small fraction of the tax expenditure figures that currently underpin the public debate. If this information suggests a prima facie case for trimming tax concessions, the issue becomes how to go about that without further complicating the system, or desirably with simplification. The AFTS review proposed one package but other designs are possible.

While there are strong reasons to defend concessions for superannuation, it must also be recognised that governments may seek to limit the accessibility of such concessions on fiscal policy grounds rather than make concessions open-ended. Since 2007, this limit has taken the form of age-based ceilings on an individual's annual contributions, both concessional and non-concessional. The levels at which such limits are set is essentially arbitrary and could at any time be changed to tighten or liberalise access to concessions. However, the caps have already been changed down and up several times since 2007. Such instability is not conducive to the desirable predictability and confidence in the system, and further changes to these caps should be avoided.

Many changes to superannuation tax arrangements have been suggested, ranging from taxing contributions more heavily to taxing fund earnings in pension mode, reintroducing the tax on end-benefits, or placing caps on lifetime contributions or on individuals' total balances in super funds. However many of these are knee-jerk responses to huge estimates of tax expenditure that are of poor quality and little relevance. Rather tha0n venture forth with any specific proposals, it is better here to suggest principles for a review of superannuation tax based on the discussion above:

1. Use the EET variant as a benchmark for the current system and get as close to it as is feasible.
2. Apply taxes and concessions in a non-discriminatory, neutral way.
3. Any changes should not further complicate the system, and preferably simplify it.
4. Ensure that the system has broad support and is fiscally sustainable for the long term.
5. Any adverse changes should recognise that current participants in the system have made long-term plans under the current rules and those plans should not be disrupted by sudden changes.

GOODS AND SERVICES TAX

A range of goods and services are GST-free or input-taxed, resulting in revenue forgone of more than $20 billion a year in 2014-15 terms according to TES 2014. The most important among these are shown in Table 4.

For most of these tax expenditures Treasury's revenue gain estimates are not substantially lower than the revenue forgone estimates. For example, demand for GST-free food is judged to be relatively unresponsive to the price increases that would result from lifting the exemption, and therefore the revenue gain estimate is only $200 million lower than the revenue forgone. Assuming this is correct, removing some or all of the above exemptions could augment current GST revenue to a significant degree — for example, removing the first four would raise more than another policy option often flagged: namely, increasing the rate to 12.5%.

Rent does not appear in Table 4 because the TES does not classify it as a tax expenditure even though it is not subject to GST. Imputed rent (that notionally paid and received by owner-occupiers) is not considered part of the tax base because it is a transaction within the household; for neutrality (and equity) reasons, actual rent paid to landlords is therefore also not subject to GST.

The exclusions from the GST base result in around half of household consumption expenditure being either GST-free or input-taxed. Figure 6 illustrates this point. However, it should be noted that in addition to household consumption expenditure, purchases of new dwellings are subject to GST.

The usual benchmark for GST is household consumption expenditure in its broad definition (but excluding notional consumption within the household such as imputed rent). However, this does not mean that removing all the above concessions is necessarily the best policy. Some of the goods and services in question may be considered 'essentials' of living and it may be difficult to compensate consumers with sufficient precision through the income tax or transfer payment systems. In other cases such as education, health and medical services, the subsidy from government is such a large component (if not all) of the 'price' that imposing GST on them would discriminate against private providers.[16] This was the main reason given for their GST-free status when the proposed new tax system was launched in 1998.[17]

It is worth recalling that uncooked food was to be subject to GST in the Howard government's initial proposal. Food was made GST-free only in order to win the Australian Democrats' agreement to pass the legislation in the Senate. This exemption is probably the biggest distortion and source of avoidable compliance costs in the GST system, as the borderline between taxed and untaxed food is blurred. However, the history of the exemption suggests that it will only ever be removed if a watertight compensation package is offered as a quid pro quo, involving increases in social security and welfare benefits and tax cuts at low incomes. History also suggests that 'watertight' compensation in political terms means over-compensation for cost of living impacts, and in that sense would not represent the best use of some of the additional revenue.

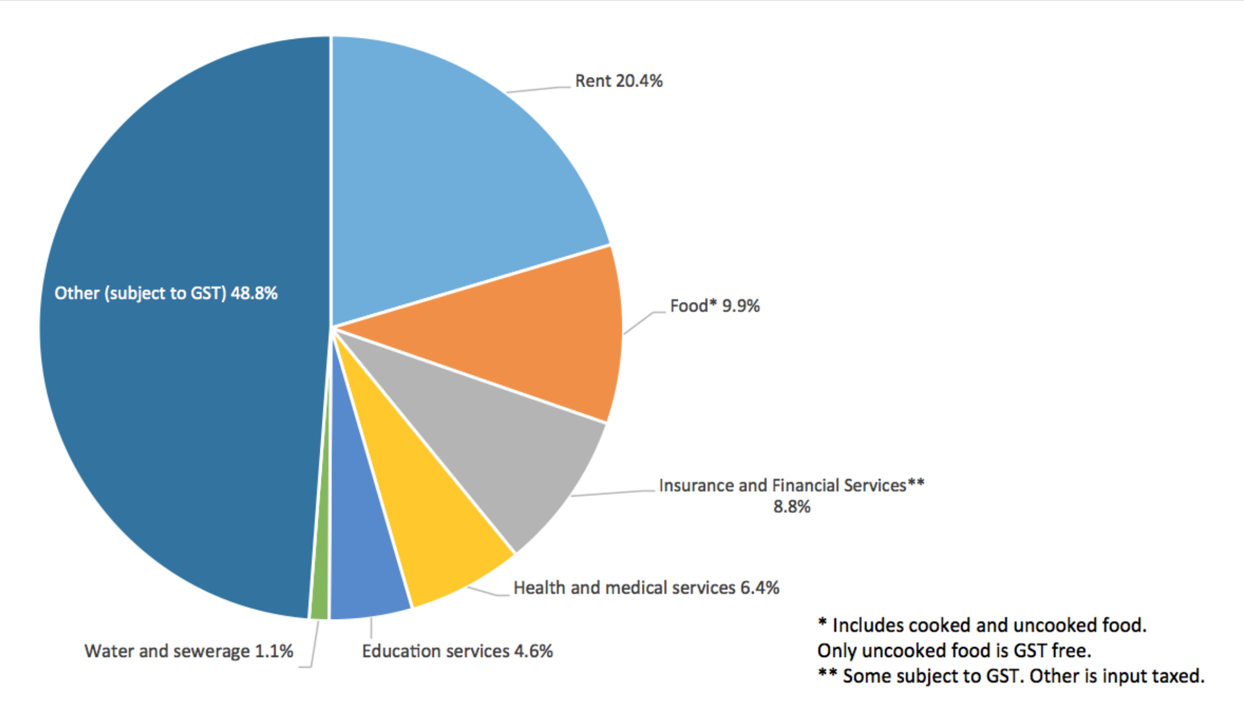
It should also be noted the recent Financial System Inquiry has recommended that the input-taxing of financial services be re-examined as part of the taxation white paper review, as it may be distorting consumption of financial services relative to subjecting them to GST and allowing input tax credits. The 2015 tax discussion paper reiterates the previously stated reasons for making various items free of GST or subject to input-taxing, but also points out that the equity case for exemptions is not clear-cut and that the input-taxing of financial services involves complexities as would subjecting financial services to GST.

Table 4: Goods and Services Tax Concessions

	$ billion	
	Revenue forgone estimates	Revenue gain estimates
Uncooked food	6.4	6.3
Education services	4.0	3.6
Health and medical services	3.6	3.5
Financial supplies (input taxed)	3.6	3.6
Residential and community care	1.1	n.a.
Child care	1.1	n.a.
Water, sewerage and drainage	1.1	n.a.

Source: Treasury, *Tax Expenditures Statement 2014* (Commonwealth of Australia, Canberra, 2015).

Figure 6: Composition of Household Consumption Expenditure



Source: ABS, Australian National Accounts: National Income, Expenditure and Product (Cat No 5206.0)

Removal of these concessions to any significant extent should be matched by income tax reductions, both to compensate consumers and to turn the reform into one that generates economic efficiency gains through lower income tax rates. Under current intergovernmental arrangements, however, the additional GST revenue would flow to the states whereas the revenue loss from income tax reductions would be borne by the Commonwealth. This presents a budget problem to the Commonwealth, but one that could be overcome by reducing tied grants to the states — itself a desirable reform of federalism as it would reduce the Commonwealth's intrusion on state functions. The end result would be budget neutral at both levels of government, but with the states receiving more general purpose funding to be allocated at their own discretion and less in tied grants from the Commonwealth. The details of such a reform are beyond the scope of this paper.[18]

TAX REFORM PACKAGES INCLUDING CONCESSIONS

Much of the public discussion of tax reform options is at cross purposes, with the commentary having multiple and sometimes inconsistent objectives: raising additional revenue; removing tax distortions; revenue-neutral or revenue-reducing restructuring. A revenue-neutral restructuring would be broadly similar to the reforms implemented by the Hawke government in the late 1980s and the Howard government in 2000.

The merits of reducing tax concessions to raise additional net revenue depend partly on the extent to which the structural budget deficit problem should be addressed by increasing revenue or lowering expenditure. This issue is beyond the scope of this report, but two observations are worth making. First, to the extent that revenue-raising is assigned a part in structural budget repair, from economic efficiency and equity perspectives there should be no presumption that reducing concessions is always superior to increasing broad tax rates, given that concessions have efficiency and equity benefits as discussed above.

Second, tax expenditure estimates give a misleading impression of the amounts realistically and appropriately available. The impression that tax concessions are massive and easy pickings is misleading. The additional revenue available from this source is likely to be a few billion a year rather than tens of billions and as such would make only a small impression on a structural budget deficit running in the tens of billions.

Turning to revenue-neutral or revenue-reducing approaches, cutting any of the tax concessions discussed above — if a clear case is established for doing so — would provide the basis for a reform package trading off lower concessions for lower income tax rates, while still respecting the principle of lower taxation on savings income than on labour income. A strong case can be made that standard income tax rates applied to labour income need to be lowered.[19]

There are three problems with such a trade-off. First, there would be strong political pressure not just to compensate but to over-compensate low income earners including those on low wage incomes and social benefits, leading to a leakage of revenue and therefore in the capacity to reduce tax rates at other income levels.

Second, a problem inherent in such trade-offs is that they may unravel over time. This can happen, for example, through the effects of income tax bracket creep gradually reversing the effective income tax cuts that were delivered as part of the trade-off. Taxpayers end up with both higher taxes and no trade-off. This risk can be reduced (but never eliminated) by cutting rates rather than increasing the thresholds, and then effectively freezing the thresholds in real rather than nominal terms by instituting automatic indexation. Australia does not currently have automatic indexation but its introduction would itself be a desirable reform.

Third, it would be politically difficult to include a cut in the company income tax in such a trade-off, even though the economic case for such a cut is at least as strong as for personal income tax.

These limitations only serve to emphasise that the most enduring route to lower tax rates is not a trade-off for other tax increases but a reduction in government spending.

Another type of revenue-neutral tax reform trade-off would involve rearranging income tax concessions to reduce the large disparities between the effective tax rates on different types of saving and thereby make the allocation of savings less distorted by taxation. The main beneficiary in such a reform would be interest income, which is currently taxed at full personal rates. Reducing the disparities is what the AFTS review proposed with its uniform 40% discount, though that involved far from complete uniformity because superannuation and principal residences would have continued to be favoured by more generous concessions than the 40% discount.

CONCLUSION

This report reviews the arguments surrounding several major tax concessions and emphasises in each case the justification for them in an attempt to balance the many one-sided criticisms often heard in contemporary public debate. These criticisms typically give little or no recognition to the arguments that can be made for most concessions — whether on grounds of economic efficiency, equity or administrative simplicity.

In fact, although this report uses the term 'tax concession' in recognition of what has become common usage, it is a term that biases the argument from the outset. It carries the connotation of a grudging gift from government to taxpayers, waiting to be snatched back when circumstances change. On the whole, the so-called concessions discussed in this report are not really concessions at all but legitimate structural features of the tax system, and in some cases are essential to prevent distortions arising from taxation of savings and investment.

There is a defence for all the concessions reviewed, but some have a stronger case than others. Capital gains tax clearly should not be increased and desirably would be eased further. So-called 'negative gearing' deductions should continue to be allowed in full unless there is a move to reduced taxation of rental income. Dividend imputation should only be reconsidered in the event of a major reform of the basic system of company income tax or as a trade-off for a large, across-the-board cut in the current company tax rate. Some adjustment of superannuation concessions may be justified, but the case has not been made by the crude and indiscriminate arguments that are attracting all the public attention. Reductions in some GST concessions would make sense, but uncooked food is the most obvious one and it raises major equity concerns that would need to be addressed through the tax/transfer system, thereby absorbing some of the extra revenue.

Changes to concessions will no doubt be considered by the government as it struggles to balance the budget. However, when concessions are assessed against the principles discussed in this report, the opportunities for additional net revenue are much narrower than often claimed. The extra revenue would not transform the fiscal outlook or obviate the need for difficult spending curbs. The published tax expenditure data suffer serious flaws and are of limited value as a guide to policy.

In general, to the extent additional revenue is raised from changes to concessions, it represents a tax increase and would ideally be offset by other tax reductions of the highest priority, particularly personal and company income tax rates. Tinkering with tax concessions to raise more revenue on its own does not constitute beneficial tax reform. Concessions should only be reconsidered in the context of a broader restructuring of the tax system as a whole.

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