CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

23 October 2017

Tax Expenditure Statement Consultation
Tax Analysis Division
The Treasury
Langton Crescent
PARKES ACT 2600

By e-mail: taxexpenditures@treasury.gov.au

Dear Sir

The Tax Expenditures Statement – consultation paper

Thank you for the opportunity to provide a submission regarding the consultation paper entitled "The Tax Expenditures Statement" (TES).

Executive summary

Chartered Accountants Australia and New Zealand (Chartered Accountants) supports the principle that "tax expenditures should ideally be subject to the same levels of transparency and accountability as equivalent spending programs."[1] The TES is meant to be an important part of the budgeting process. As such, Chartered Accountants commends the government on retaining the existing TES benchmarks and encourages the publication of explanatory material in a technical manual as a compendium to the annual TES and greater integration of the calculation caveats within the TES .

Choice of benchmark

The Charter of Budget Honesty Act 1988 requires the budget papers to provide an overview of tax expenditures and the annual publication of the TES. Information contained in the TES is essential as the amount provided by way of tax expenditures is significant[2].

[1] Australia's Future Tax System

[2] For 2012-13, the Commonwealth has around 280 tax expenditures under the income tax, worth around $100 billion. This is around 6 per cent of GDP. Direct expenditure of the Commonwealth for the same period was around $360 billion, which is around 24 per cent of GDP. http://www.abc.net.au/news/2014-03-12/boccabella-to-cut-fairly-you-must-look-at-tax- expenditures/5315620

"Tax expenditures incur an opportunity cost—they can represent revenue that, if collected, would have been available to fund spending programs (or outlays) to meet similar objectives or to increase the Budget surplus/reduce the Budget deficit."[3] Given that our tax system is mainly based on income, the benchmarks that are currently used, whilst not perfect, are appropriate for this purpose[4]. We support the Government's decision to retain the current benchmarks.

The alternative benchmark that is discussed in the paper is the pre-paid expenditure tax benchmark. The paper notes that under this benchmark investments are purchased from post-tax income but then investment returns are not subject to further tax and that this reflects the position that taxing investment income is more distortionary than taxing labour income and that investment income should be taxed at a lower rate. Adoption of this benchmark would reflect a theoretical economic allocation ideal and would make comparison between direct expenditure and tax expenditure even harder in the budget process. Given the current debate about concerns regarding equity, especially intergenerational equity, if the TES was to include a pre-paid expenditure benchmark in addition to a comprehensive income benchmark then distributional analysis should be incorporated into the analysis that is presented in the TES.

It is not clear that generating pre-paid expenditure tax benchmarks in addition to the comprehensive tax benchmark will contribute significantly to the policy debate about the treatment of principal place of residences and superannuation – other less pure economic analysis may prove to be more useful and easier to generate. For example, in relation to:

- Superannuation it would be beneficial if long run projections (over a period of 30 years and not just one point in time) of the impact of both superannuation (including higher contribution tax for higher income earners and the new Transfer Balance Cap) and the aged pension were undertaken both in absolute terms and through a distributional analysis.
- Housing, it would assist if an additional numbers could be generated that reflect what would be the revenue impact under the existing tax laws if a principal place of residence exemption was removed. In that case the cost base would include amounts paid but not deducted (as it was a private expense) and would include items such as interest, rates, repairs and maintenance, capital improvements etc. as well as access to the 50% discount.

Presentation of the TES should be adjusted

We submit that one reason why the caveats in the TES are ignored is that there aren't any other alternative calculations which are better than the TES calculations or easily accessible descriptive explanations regarding TES calculations. Thus people use TES, potentially inappropriately, as an inappropriate number is better than nothing at all.

When Treasury is making these calculations, they are presumably documenting how they derived the numbers. For example there would be information about data sets used and assumptions made. Releasing this information would assist in understanding how the numbers were derived and would be of great benefit from a policy perspective especially in relation to the revenue gain method.

[3] Paragraph 3 https://www.anao.gov.au/sites/g/files/net616/f/ANAO_Report_2007-2008_32.pdf
[4] We note that the numbers generated do not necessarily represent a potential revenue gain as the method of calculation, the revenue foregone method, does not take into account behavioural changes. An alternativee method of calculation, the revenue gain estimate does attempt to take some behavioural changes into account. To date the use of the revenue gain estimate has been very limited and heavily qualified.

It is noted that Treasury has tentatively started such a process in relation to its general economic modelling. For example, it has recently released working papers entitled "Development of Treasury's new model of Australian retirement incomes and assets: MARIA" and "Modelling Australia's exports of non-commodity goods and services". In addition, Treasury has arranged a presentation on revenue costings, revenue forecasting and distributional analysis. Gradually opening up these processes to external parties is appreciated.

Ideally, Treasury would move to a model of communication and engagement that is similar to that of the Congressional Budget Office (CBO). The CBO regularly communicates and engages with the community in relation to a range of issues. For example, it has recently released presentations on:

- projection and alignment methodology used in its individual income tax microsimulation model;
- Congressional Budget Office: Its Role, Long-Term Projections, and Use of Research; and
- Why Is CBO's Projection of GDP Growth Slower Than Past Rates of Growth?

Such communication brings along the community with current thinking and allows a large variety of people to engage in debate and bring new ideas to the table so better numbers can be generated or at least existing numbers are better understood.

Chartered Accountants supports the creation of a technical manual as a compendium manual and the proposal to publish appendices focusing in additional detail on a single issue relevant to the policy debate. The current TES treatment of capital gains tax in relation to the principal place of residence is a great example of where better documentation of tax expenditure calculations would be helpful. Unless you are prepared to trawl through every addition of the TES and peruse it for additional insights, the vast majority of people would be totally unaware that the benchmark treatment of owner-occupied housing for CGT purposes was different to that of other CGT assets[5].

Another suggestion is that the summary presentation of the TES have other columns added to it, with the capacity for insertion in relation to each item, "Qualifications" and "Further references". This could allow greater cross-referencing of specific as well as general cautions thus enhancing understanding of the TES process and necessary cautions in relation to particular items.

Gaining better insights into the operation of tax expenditures is essential to both the budget and tax reform processes. Chartered Accountants encourages greater explanation and understanding of tax expenditures.

Appendix one contains comments about the proposals regarding small tax expenditures.

Appendix two contains information about Chartered Accountants Australia and New Zealand.

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[5] Page 133 of the 2016 TES states that "imputed rent from owner-occupied housing is not included in income. Expenditure incurred in earning imputed rent is not deductible." Page 213 of the 2008 TES explains this by stating that "The second benchmark removes the eligibility for deductions on the basis that they were associated with imputed rental income, which is not taxed. However, this neglects the fact that the owner-occupiers still receive income in the form of capital gains. Thus, it is still possible to make a case for allowing deductions in the presence of (expected) capital gains while imputed rent is untaxed. This is because deductions are generally allowed against relevant expenses incidental to capital investments as long as the investment is made with the intention of receiving capital gains."

If you wish to discuss our comments please contact me on 02 9290 5609 or Michael.croker@charteredaccountantsanz.com

.Yours sincerely

Michael Croker
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Appendix One: Small tax expenditures – questions 1, 2 & 3

The consultation paper explores the possibility of reviewing smaller technical tax expenditures every three years on a rolling basis and reporting their quantum in size ranges.

Question 1 – what is an appropriate annual threshold below which expenditures could be updated less frequently and reported as ranges?

From the way in which question 1 is framed it appears that smaller technical tax expenditures (which is what the Parliamentary recommendation discussed) will be defined only by reference to an annual threshold. By only using size to identify a tax expenditure as a ‘smaller technical tax expenditure’, no consideration is being given as to whether the tax expenditures is technical or not.

We note that ‘clumps’ of smaller items taken together might be material. Thus a disadvantage of only using size in the definition, is that oversight could be lost of related tax expenditures that may be small individually, but large in aggregate.

If an annual threshold is used, then when setting the threshold consideration should be given to the impact that the threshold has on the feel of the TES. The 2014 TES had over 49% of tax expenditures as unquantifiable. Adding a new tax expenditures category of ‘slightly out of date’ estimates does not help its credibility. That said it is understood Treasury’s resources need to be appropriately allocated. Maybe a way of judging success is if there are fewer large unquantifiable TES items and that there are higher levels of reliability amongst the large TES items.

In setting the annual threshold, the role of the TES in the budgetary process should be considered. Tax expenditures are equivalent in effect to grants and other government expenditure. Thus if a certain level of grants or government expenditure does not require detailed submissions to the expenditure review committee, then it would be appropriate for the same level to apply to small technical tax expenditure.

Other practical issues that need to be addressed if an annual threshold is used include:

- When is the annual threshold measured? The TES has 8 consecutive years of estimates in it. Do you pick the annual threshold for the current year, the prior year, the next year, or do you take the highest amount for all of the years. The latter would be consistent with how the level of unquantifiable tax expenditure is determined.
- If a tax expenditure is not expected to have a future impact (for example due to repeal or passing a period of operation) should it immediately be put in the smaller technical tax expenditure category?
- If a tax expenditure is trending upwards and is expected to breach the small technical tax expenditure annual threshold should it be excluded from being a small technical tax expenditure?
- Would new or materially altered tax expenditures have their impact calculated in the first year and then be classified based on that work or would it rely on the costings associated with the legislation implementing the change?

The use of ranges for smaller TES could be a useful way to indicate that the number is not a ‘magic bullet’ and that this could reduce the misunderstandings by TES users.

We are attracted to the use of ranges for TES smaller expenditures. The use of a range identifies that the number is not a ‘magic bullet’ number which can lead to much misunderstanding by readers and by the public.

We recommend indeed that the use of ranges could be considered for more significant expenditures, together with more extensive reference to the uncertainty and cautions and related issues. Again this approach would assist readers to understand on the face of the TES (rather than from its later pages) that the TES numbers are not final, immutable, and certain and the only way the TES items can be estimated.

Question 2 – what is an appropriate frequency for updating these small tax expenditures?

The consultation paper suggests three year rolling reviews. That seems like an appropriate length of time.

The issue that this raises is how to ‘smooth’ the amount of work associated with these reviews. If all small technical taxation expenditures are taken out at once, then there will be two years of low work load and one year with a very full work load. To produce a smoother work flow, it may be better to identify small technical taxation expenditures but only remove a third of them from the review process in the first year, remove another third from the review process in the second year, and the final third from the review process in the third year. Thus the renewal of the review would be more stable.

It is noted that if all small technical taxation expenditures were removed in the first year and only a third reviewed in the third year, then another third in the fourth year and the final third in the fifth year, then some small technical taxation expenditures would not be reviewed for six years.

Question 3 – what are appropriate bounds for the ranges?

For consistency within the TES, it could be argued that it is worth considering using the same ranges that are used for unquantifiable tax expenditure, that is: nought to $10M and $10M to $100M. However, that would appear to be too large given the materiality threshold used in the budgetary processes. Thus ranges that are smaller and equivalent to those used for grants in the expenditure review process would appear to be more appropriate.

Appendix Two: About Chartered Accountants Australia and New Zealand

Chartered Accountants Australia and New Zealand is a professional body comprised of over 117,000 diverse, talented and financially astute members who utilise their skills every day to make a difference for businesses the world over.

Members are known for their professional integrity, principled judgment, financial discipline and a forward-looking approach to business which contributes to the prosperity of our nations.

We focus on the education and lifelong learning of our members, and engage in advocacy and thought leadership in areas of public interest that impact the economy and domestic and international markets.

We are a member of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries.

We also have a strategic alliance with the Association of Chartered Certified Accountants. The alliance represents 788,000 current and next generation accounting professionals across 181 countries and is one of the largest accounting alliances in the world providing the full range of accounting qualifications to students and business.