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16 October 2017

Dear Sir/Madam

We refer to the Government's Consultation Paper of September 2017 entitled *The Tax Expenditures Statement* which has been prompted by a report tabled the House of Representatives Committee on Tax and Revenue on 3 December 2015. We also note the Government's response to this report and its support for recommendations 1, 4, 6, 7, 8, 9 and 10 of the 13 recommendations.

Our detailed comments are set out in Attachment 1 responding to the questions in the consultation paper relating to recommendations 1, 7, 6, 8, 9 and 10 (in that order). In Attachment 2 we make some comments in respect of recommendation 4 and, in particular, the important inter-relationship between the Age Pension the tax expenditures relating to superannuation.

Who is Mercer?

Mercer is one of the world's leading firms for superannuation, investments, health and human resources consulting and products. Across the Pacific, leading organisations look to Mercer for global insights, thought leadership and product innovation to help transform and grow their businesses. Supported by our global team of 22,000, we help our clients challenge conventional thinking to create solutions that drive business results and make a difference in the lives of millions of people every day.

Mercer Australia provides customised administration, technology and total benefits outsourcing solutions to a large number of employer clients and superannuation funds (including industry funds, master trusts and employer sponsored superannuation funds). We have over $150 billion in funds under administration locally and provide services to over 2.4 million superannuation members and 15,000 private clients. Our own master trust in Australia, the Mercer Super Trust, has around 230 participating employers, 224,000 members and more than $21 billion in assets under management.

Please contact me on 03 9623 5464 or by email if you would like to discuss this submission.

Yours sincerely,

Dr David Knox
Senior Partner

Attachment 1 – Responses to questions raised in the Consultation Paper

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

The 2016 Tax Expenditures Statement (TES) issued in January 2017 listed almost 300 individual tax expenditure items whereas fewer than 10 per cent of these items are listed as large (positive or negative) tax expenditures where the revenue forgone was estimated to be more than $1 billion.

We believe this is a reasonable threshold and that the other (non-large) items should only be valued once every three or five years unless there has been a significant change to the operations of this item.

Question 2 - What is an appropriate frequency for updating these small tax expenditures?

See the previous answer.

Question 3 - What are appropriate bounds for the ranges?

We suggest that the individual items continue to be shown separately but are only updated on a rolling 3-5 year basis.

Question 4 - Do you have any concerns about the benchmarks currently used in the TES? How can they be improved?

The current benchmark based on the SHS definition of income does not present a realistic benchmark when dealing with long term savings, such as superannuation. As a result, the published tax expenditures for superannuation are misleading and lead to public debate which is unrealistic and misinformed.

In short, the current definition of income assumes that certain behaviour would be unchanged if the taxation concessions were removed. Whilst this may be an appropriate assumption for certain behaviour such as the consumption of food, it is not the case when one considers long term savings.

We do not believe that the comprehensive income tax benchmark is suitable for superannuation for the following reasons:

- Superannuation contributions from the employer and the fund's investment income are not able to be received by the individual until, at least, the preservation age. This may be years, if not decades, into the future. This is very different from normal income.

- Superannuation must be preserved and as the Henry Review noted, the tax concessions may be seen as compensation for the inability by the individual to access these savings.

- Superannuation contributions and benefits are not always allocated to particular individuals due to the pooling of longevity risk in defined benefit pension schemes and other pooled longevity products, which were recommended by the Financial System Inquiry.

In addition, there are many other savings and investment opportunities available to individuals where the investment income is not subject to full marginal tax rates. These include capital gains, geared investments and investments through a lower-income partner.

In light of these arguments, the benchmark used in the AIST-Mercer Super Tracker does not use the SHS definition of income but assumes that 60% of fund investment income should be taxed at the full marginal rate. The Henry Report also advocated a lower tax treatment of savings for two additional reasons:

1 The effective rate of tax on savings increases the longer the asset is held. Superannuation is a long term investment lasting years, if not decades.
2 Superannuation is a form of deferred income due to the preservation rules. Individuals should be taxed at the appropriate rate when they receive income. The primary purpose of superannuation is to provide income during an individual's retirement years. In most circumstances, the level of income received during retirement is lower than during the pre-retirement years. Hence the tax benchmark should acknowledge this fact.

Question 5 - What broad set of principles should be used to inform the choice of benchmark?

An important principle is that single year tax expenditures (such as on food) should have a different benchmark from multi-year tax expenditures where other factors are important. This should include, as a minimum, the publication of alternative benchmarks.

Question 6 - Should standards be developed and published for determining the benchmark tax treatment? If so, who should be responsible for their development?

Yes, standards should be developed. We believe it is reasonable that their development should be the responsibility of Treasury.

Question 7 - Should the TES report tax expenditures for income from savings against a pre-paid expenditure benchmark in addition to a comprehensive income benchmark?

As noted above, the comprehensive income tax benchmark for savings is misleading. Therefore we support the publication of a pre-paid expenditure benchmark in addition to the comprehensive income benchmark. We recognise this would require additional resources but as many of the major tax expenditures relate to savings, we believe it would represent an important step forward in developing improved community discussions and better public policy.

Question 8 - If so, should this apply to all forms of savings, or only a subset? Should reporting against this alternative benchmark be done annually, or periodically?

For the major tax expenditure items, the two benchmarks should be applied annually. Otherwise the public discussion will be distorted in some years.

Question 9 - Should the current benchmark treatment of owner-occupied housing be altered to allow deductibility of mortgage interest and capital works deductions against the CGT cost base?

We have no comment on this question.

Question 10 - What options are there to improve the visibility and accessibility of caveats in the TES?

The limitations and caveats need to have greater visibility than in the current publication. For example, Table 1.1 in the 2016 report lists the large measured tax expenditures with no caveats or footnotes. One must recognise that many readers will go straight to this table and assume that the numbers have no limitations because any limitations are not shown.

Question 11 - What options or strategies are available to mitigate or reduce the misunderstanding of figures published in the TES?

As mentioned in the previous answer, the figures should not be published separately or without relevant footnotes of caveats attached to them.

Question 12 - Would adopting a model where technical descriptions of tax expenditures are contained in a separate technical manual be appropriate?

This approach could actually lead to greater misunderstanding unless there is a strong link shown in the TES.

Question 13 - Would it be reasonable to update the technical manual with lower frequency? (Noting that a description of new and changed expenditures would still be included in the annual document.)

This may be feasible but it is vital that the actual published numbers have the relevant caveats and limitations noted.

Question 14 – Is there additional data that taxpayers can provide to the ATO to improve the estimates without significantly increasing compliance costs?

We are not aware of any.

Question 15 – Are there existing data sources external to Government that can be used to improve the reliability of existing estimates or allow estimates currently presented as unquantifiable to be reliably quantified?

We are not aware of any.

Question 16 - Would the value of the TES be enhanced by including appendices that focus in more detail on particular topics (varying each year) relevant to tax expenditures? What topics should be prioritised?

Yes. Attachment 2 discusses the need for an appendix as it relates to Recommendation 4 of the House Inquiry.

Attachment 2 – Superannuation Tax Expenditures and the Age Pension

Most tax expenditures relate to taxation concessions provided in respect of activity in a particular year or in a relatively short period. However superannuation is not an annual or short term expenditure. Indeed the Government's proposed objective for superannuation is to provide income in retirement "to substitute or supplement the Age Pension". It is noted that the supplementation of future age pension payments with superannuation income does not provide any saving to future Government budgets. On the other hand, the substitution of the age pension with superannuation benefits clearly reduces future Government expenditure on the Age Pension.

Most Australian retirees will be receiving a part age pension for many of their retirement years in the future. Taxation concessions for superannuation lead to higher superannuation benefits and therefore reduced part pension payments in the future. In effect, the taxation concessions are a long term investment by the Government for a future return through lower age pension payments.

Let's provide a simple example.

An individual aged 50, subject to a marginal tax rate of 37 per cent, receives an employer contribution rate of $25,000 and invests it in a superannuation fund for 20 years to earn a pre-tax return of 7% pa. The individual retires at age 70.

Under the comprehensive income tax model, the comprehensive income tax benchmark the retirement benefit available at age 70 would be:

$$\$25{,}000\ (1-0.37) * (1+.07*(1-0.37))^{20} = \$37{,}336$$

Assuming a superannuation tax rate of 15 per cent on both concessional contributions and investment income, the actual retirement benefit at age 70 is:

$$\$25{,}000\ (1-0.15) * (1+0.07*(1-0.15))^{20} = \$67{,}512$$

This simple example shows that the individual's superannuation benefit is $30,176 (or 81 percent) higher than the benchmark due to the concessional tax treatment. However it would be expected that in most cases, such an increased benefit would lead to a reduced part age pension, both in the first year of retirement and for several years thereafter. The omission of the age pension offset in the TES does not present a holistic perspective on Government expenditure.

As Mercer said in our evidence to the House of Representatives Standing Committee on Tax and Revenue, we need to see the current tax concessions as an investment for the future. Currently we have no measure on the return of that investment but we expect it to be in the billions of dollars over many years.

The need for this investment approach is particularly relevant as:

- Australia's compulsory superannuation system matures such that the expected retirement benefits in the future will be much larger than those currently being paid
- Australia (like many other developed economies) faces the financial and social consequences of an ageing population. Without our compulsory SG system, the costs of future age pension payments would be higher.

Therefore we strongly support Recommendation 4 of the House Inquiry that Treasury model the long run interactions between superannuation and the age pension, develop present value estimates of the future costs and benefits of superannuation and its tax concessions, and publish the results.

Although it would not be necessary to conduct this modelling every year, we agree it should be provided at least once every five years and following significant changes in policy. The Intergenerational Report may provide a suitable publication for these results.

A summary of the results of the most recent modelling should be included in an Appendix to the Tax Expenditure Statement each year, with the tax expenditure estimates for superannuation drawing attention to this material and its implications.