Submission from the Centre for Policy Development to the Australian Treasury on Australia's future tax system Taxation Review

In response to the call for submissions on Australia's future tax system, we would like to offer the following analysis and suggestions on Australia's system of tax expenditures. The following pages are drawn from research presented in the CPD Occasional Paper 'Reforming Australia's Hidden Welfare State'. Although the main example drawn upon in our paper is the concessional rate of taxation for superannuation, the major points and recommendations of our paper are more broadly applicable to tax expenditures in general.

For further information, please see the attached paper or view it online at http://cpd.org.au/paper/reforming-australias-hidden-welfare-state

Major Points and Recommendations

- Tax expenditures are a rapidly expanding form of government spending that has roughly doubled as a proportion of the Budget since 1984/85.
- Tax expenditures are far less likely to be closely examined than direct spending programs.
- Tax expenditures that are uncapped, and that affect the marginal tax rate, are of most benefit to higher earners and are more likely to be inequitable than other forms of public spending.
- The persistence of relatively inequitable and inefficient tax expenditures is directly related to their low visibility – social and political support for direct spending programs with the same redistributive effects as many tax expenditures is unlikely.
- Where there is a public benefit to maintaining this type of subsidy, the equity and efficiency of tax expenditures – as well as their visibility and accountability – could be improved by converting them into direct spending programs (along the same lines as the conversion of the First Home Saver Accounts scheme from tax concessions to direct subsidies).
- As an example, the inequity of current superannuation tax concessions could be ameliorated by converting the concessional taxation of superannuation contributions and earnings (the tax expenditure for compulsory super contributions) into a direct subsidy program.
- Two models are proposed to convert the super tax concessions into a direct spending program: (1) a flat rate subsidy of 15%; and, (2) a benefit of 20% for those earning up to $80 000 per annum, tapering off to a zero benefit for those earning over $100 000 per annum.

Introduction

Since the 1980s Australia has significantly altered its system of social assistance by substantially increasing the number and size of hidden subsidies through tax expenditures. Some of the increases in tax spending have undermined the equity of the retirement income/tax-transfer system and are poorly targeted as mechanisms for promoting socially desirable behaviour. The lack of questioning of these poor policy outcomes can partly be explained by the relatively low visibility and transparency of tax spending measures. By limiting tax expenditures and converting useful subsidies into direct social spending, these programs could be better evaluated and targeted. Some, such as the Health Insurance Rebate and childcare tax rebate also focus on subsidising costs at the individual level rather than directly subsidising the services to reduce costs. If no measures are taken to limit service costs, such subsidies may simply allow providers to increase their prices - counteracting the subsidy's intended impact on 'affordability'.

Reforming Tax Expenditures

Tax expenditures are now widely acknowledged as a form of government allocation of resources. Unlike a tax cut, tax expenditures are targeted to certain categories of taxpayers, or more often, tax payers undertaking certain forms of activity. Tax expenditures impose a cost on the budget that must be financed in a similar way to spending initiatives Here we focus on some of the social tax expenditures, those measures that are focused on the traditional areas of social assistance such as health, education, housing and helping families.

While data limitations make it difficult to estimate the exact cost of tax expenditures, it appears that the total cost of these measures has roughly doubled since 1984/85 as a proportion of government spending. In many cases these schemes do not seem to meet their objectives, either in terms of providing social assistance in an equitable manner or in promoting particular forms of behaviour in an efficient manner.

Some tax expenditures are based on rebates at the marginal rate of income tax. As Australia's income tax system is progressive, these types of tax expenditures tend to allocate larger benefits to those on higher incomes. This is particularly the case where the claimable amount is not capped, or the tax expenditure is a concessional rate of tax, as with superannuation.

Many social tax expenditures are aimed at subsidising private spending on (or savings for) types of community services such as health, child care, housing and retirement incomes. In some areas the amount claimable is capped in cash terms (such as in the child care rebate) or is proportional (such as the private health insurance rebate). In most cases access to these services remains limited to those with ability to pay the rest of the fee. As the ability to purchase these services increases with income, so higher income earners also tend to receive greater benefits from these schemes. If the payment increases purchasing power but is not made conditional on price controls, such as in child care, it allows providers to raise fees when subsidies are raised.

The result is that many tax expenditures are highly inequitable and far less efficient as policy instruments for achieving social policy goals than direct spending initiatives. The level of inequity is most dramatic in uncapped schemes, such as the tax expenditure on superannuation contributions.

Some of these measures also tend to be inefficient when they provide the greatest incentives to groups who already undertake the desired behaviour, or where a change in behaviour would have relatively low social benefits. As the level of benefit tends to increase with the purchase price, so does the incentive for redirecting spending into tax-exempt areas. However, those on higher incomes are those most likely to already commit private spending in these areas, such as top-up health insurance, substantial saving for retirement or quality chid care.

The growth of tax expenditures despite their relative inequity and inefficiency compared to other policy instruments is partly explained by their low levels of visibility and accountability. Tax expenditures are not subject to the same budgetary review processes as government spending, the same data gathering exercises nor are they exposed to the same public scrutiny. It is much more difficult to estimate the effectiveness of these measures, and much less likely their effectiveness will be routinely questioned as part of normal budgeting processes.

This appears to have directly contributed to the growth of these programs, as their low visibility may reduce political resistance to public subsidies to those who do not need them, compared to increased government spending. However, this has perverse effects by reducing the efficiency and equity of the tax and transfer system as a whole.

Prospects for Reform

The recent experience of the First Home Savers Account scheme offers some insight into the potential for more equitable reform. The scheme, which was based on a 2007 election promise, was initially proposed as a tax expenditure, similar to the system of superannuation concessions. It would therefore have effectively benefited individuals in proportion to their marginal tax rate.

However, during the development and implementation of the scheme it was restructured into a spending initiative, with support coming through a payment designed to return an individual's tax. This highlighted the inequity of this form of social assistance, leading to political resistance and expert outcry, and the further restructuring of the scheme to provide a flat-rate level of support per dollar contributed. While in broader policy terms, this is still a somewhat inequitable subsidy to those who are more likely to be able to buy a home regardless, it is an improvement on the original design.

By increasing the visibility and transparency of tax expenditures such schemes can be more easily reformed to ensure more equitable and efficient outcomes. This can be achieved by simply transforming tax expenditures into direct social spending.

As an example, we propose alternative models for a possible reform to the system of tax expenditures on compulsory superannuation contributions. In the first model we replace the current system with a flat rate subsidy of 15%. In the second model we replace the current system with a 20% subsidy for those earning up to $80,000 per annum, with a taper phasing out to a zero benefit for those earning above $100,000 per annum. This second model would increase the benefits received by 85 per cent of workers. Both models are budget neutral.

As these benefits accrue to compulsory contributions there are no behavioural effects of the two models resulting from altered incentives. This reduces the complexity of estimating the cost of the measures. However, we argue that a similar logic can be applied to voluntary contributions as the change in incentives is likely to both reduce costs while increasing incentives for the bulk of wage earners, particularly those likely to receive a full or part public pension.

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