Hidden dangers of a duel over tax cuts

The dependence on the ATO is reaching new heights

Budget19

JAMES KIRBY
WEALTH EDITOR

Tax is set to become the battlefield in the federal election: the Coalition will flatten taxes and offer inducements to high-salary earners, while Labor will cut taxes too and offer inducements to lower-paid workers.

Regardless of who wins, the dependence on the tax office will be elevated to new levels, and that in turn is where trouble — not just for the next government but for every taxpayer — might just begin.

In a world where investors struggle to get 5-10 per cent a year, the return on investment at the ATO remains spectacular — in the budget this week the built-in expectation is that the government would make an extra $3.60 for every $1 spent on tax collection.

Here's how: the government will now give another $1 billion to the ATO over the next four years this time to chase multinationals, public and private groups and so-called "high-wealth" individuals — a classification that appears to be unique to the tax office.

As the official Treasury papers put it: "This measure is estimated to have a gain of $3.6bn over the forward estimates period."

It is the single biggest revenue item in the budget.

Perhaps as investors we might look for the best in this situation and console ourselves that it is, after all, our money — taxpayer funds ultimately finance this rolling money-making machine.

But you do wonder what is the real cost when so much is expected of tax collectors. And how far can the ATO be pushed to drive more revenue?

Two key issues are emerging. First, the ATO does not bring in as much as it used to. Second, the data the ATO promotes to achieve its objectives are under question.

As non-specialists in this area, investors might stand wide-eyed at the ability of the ATO to bring in those remarkable numbers, but in fact the law of diminishing returns has been making its presence felt in Canberra.

Grant Wardell-Johnson, a partner at KPMG's Tax and Economics Centre, says that until recently the ATO worked on the basis of $6 coming in for every dollar invested in their activities.

This week's budget saw the ratio move down to one to 4.6 (that's spending $1bn and raising $4.6bn, creating a "gain to the budget of $3.6bn" in the so-called tax integrity measures).

"I wouldn't be surprised to see the ratio drop further," says Wardell-Johnson, who points out that the "gap" between what the ATO thinks it should get and what it actually brings in is shrinking.

And while the returns from the ATO diminish, there is continuing evidence that it may be trying too hard to get its numbers. The recent reports of overzealous use of garnishee notices in South Australia are a case in point (garnishee orders let the ATO take money out of bank accounts without consent). The questions raised over the ATO's claims that nine out of 10 investment property deductions contained "errors" are valid, too. There are 8 million people involved in this area and the ATO cited a survey of 300 people.

The ATO's focus on tax professionals is also under scrutiny: in the measure to furnish the ATO with an extra $1bn this week the usual targets of multinationals and wealthy individuals were flanked by what Treasury describes as "specialist tax advisers and intermediaries that promote tax avoidance schemes and strategies".

Earlier this week the Inspector General of Taxation brought up the integrity of the ATO's own data again — this time in the area of work-related expenses following a recent barb from ATO chief Chris Jordan that overclaiming was "actually worse in agent-prepared returns".

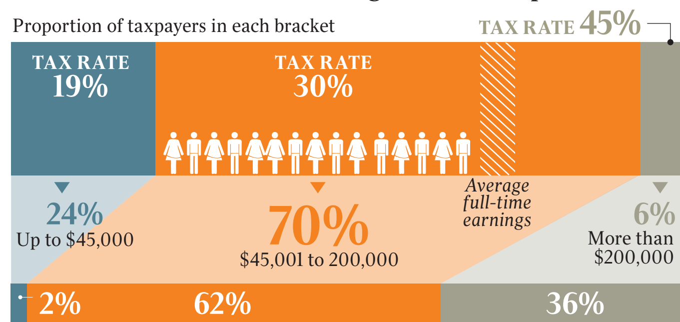
Everyone and every company must pay tax. Crucially, every company must also pay superannuation liabilities. But there must now be concerns on how far the government can push this methodology of endlessly cranking up funds for the tax office in the hope of endlessly raising tax receipts.

Though this week's headlines are about tax cuts and offsets, the reality is that the tax take is already rising twice as fast as income.

A successful tax system is the backbone of a successful economic system. Australia's works relatively well. But there is evidence now to suggest the ATO is already under pressure to get its numbers, and this is before the Coalition or Labor start cutting taxes further.

2024-25 tax brackets with the government's plan

Proportion of taxpayers in each bracket



Key changes to super, offsets and small business write-offs

JAMES GERRARD

If you were expecting a big spending federal budget with generous cash handouts this week, you would have been severely disappointed.

For a pre-election federal budget, it was unusually sensible with some minimal structural changes to taxation and superannuation law, albeit with a couple of tweaks that put a few more dollars in voters' back pockets.

For investors, attention has now turned to the sharemarket and analysing which stocks were winners and losers.

Also, with the federal election looming in little more than a month, investors are thinking about what election policies will affect them and to what extent do they matter.

The key take-outs from the budget from an investment perspective were some selective but important changes in relation to super contributions, which were:

● From July 1 next year, Australians aged 65 and 66 will be able to make voluntary superannuation contributions, both concessional and non-concessional, without meeting the work test.

Currently, people in this group can only make voluntary contributions if they work a minimum of 40 hours over a 30-day period.

The rule change is to align the work test with the eligibility age for the Age Pension, scheduled to reach 67 from July 1, 2023.

Similarly, the government will extend access to the bring-forward arrangements, which allow those aged under 65 to make three years' worth of non-concessional contributions to super in a single year. Those aged 65 and 66 can now access these arrangements.

Also the age limit for receiving spouse contributions is to go up from 69 to 74. Currently, those aged 70 and over cannot receive contributions made by another person on their behalf.

● The Low to Middle Income Tax Offset (LMITO) doubles to a maximum of $2160 per household.

● The small business instant tax write-off program is widened to allow medium-sized businesses to participate and the write-off limit is increased to $25,000 per financial year.

LIAM KIDSTON

Consumer discretionary stocks are expected to be among the main benefactors of the budget

Equity markets reacted mildly positively to the budget, with several ASX sectors benefiting from the above changes, mainly due to an increase in forecast consumer spending.

Looking at the different ASX sectors, the main benefactors are consumer discretionary stocks such as JB Hi-Fi, Harvey Norman and Super Retail Group due to the personal income tax cuts and increased business write-offs.

Healthcare and infrastructure stocks are beneficiaries from the increase in government spending, but the impact on earnings for ASX-listed companies will be minimal and also staggered, meaning the federal budget will not act as a catalyst for these stocks to boom.

The value of financial stocks have already taken a hit throughout the banking royal commission last year. The increase in government spending on financial market regulation comes as no surprise and financial stocks are unaffected by the budget.

For the SMSF investor, the main consideration is still the likely loss of cash refunds on excess imputation credits should Labor win.

Given the uneven way Labor intends to implement this policy, many financial planners are already positioning clients to run multiple super funds, with assets yielding unfranked income to remain in the SMSF, while assets with franking credits to be transferred over to industry and retail super funds, to bypass the change.

Other SMSF investors are looking to reshape their portfolios and flush out investments with franking credits and rebalance to unfranked investments such as bonds, listed property trusts and international shares.

And in a separate issue, SMSF investors who have been considering borrowing to purchase property inside of the fund are also fast-tracking plans as Labor has flagged a ban on SMSF lending.

Individual property investors have been thinking about the changes to capital gains tax and negative gearing, with some evidence of cashed-up investors rushing to secure loan approvals so they can acquire more property assets before Labor's planned January 1, 2020 start date of the negative gearing changes.

Other property investors are now pivoting their portfolios and searching for high-yielding, cash flow-positive investments, which are not affected by a removal of negative gearing benefits.

The likely impact is that we're going to see property prices in regional and smaller capital cities rise as investors come knocking looking for the higher rental yields on offer in these locations.

In fact, this may already be a factor in cities such as Canberra, Adelaide and Hobart which all reported positive growth in property prices over the past 12 months.

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Leaning on home support to contain costs of caring for the aged

JOHN RAWLING

Many people who were expecting big things for aged care from Tuesday night's budget were sorely disappointed, particularly after the federal government launched the royal commission into aged care with so much fanfare.

The key funding for the sector was in the form of more support for the Commonwealth Home Support Program, which provides lower value services to a larger number of people than home care.

Three key initiatives emerged in the latest budget measures:

● First, there were increases to residential care subsidies and residential care places.

The government is providing a $320 million general boost in 2018-19 for residential aged care, via the Temporary Subsidy Increase, and 13,500 new residential care places. This is in direct response to industry calls that funding addresses the financial sustainability of the industry; it will run over the next 18 months as the royal commission takes place.

However, this temporary boost is well short of restoring the 2015 cuts. The expectation is that something permanent will be put in place after the royal commission ends.

● Second, the government announced a release of additional home-care packages.

The government has allowed $282.4m over five years from 2018-19 for the release of an additional 10,000 home-care packages across the four package levels, bringing to 40,000 the number of new packages announced over the past 18 months.

Many older Australians will receive thousands of dollars a year for in-home services.

The Association of Independent Retirees was particularly supportive of this initiative, describing it as "one bright spot in the budget for retirees".

"This has been a key policy in the AIR's pre-budget submission to the government as the demand for home care has escalated," Wayne Strandquist, the association's acting president, said.

Total government aged-care funding is on the rise

"AIR had sought a substantial increase in funding for level three and four home-care packages and a new level five home-care package to support higher care needs in the home."

This continues the push of the Living Longer, Living Better reforms in 2012, aiming to keep people living at home longer, which requires less government funding. While the release of new packages is a positive, the number of people on the waiting list has been steadily increasing — from 105,000 to 130,000 during the past year.

● Third, the government announced a trial for an alternative residential funding tool.

After the 2017 ACFI review of the government funding model found the model was "no longer fit for purpose", the government recently received a recommendation for an alternative.

The government has announced that it will run a two-year trial of this model to determine whether it will achieve the objective for a more stable, contemporary, efficient and effective funding system to provide greater financial stability to both the residential aged-care sector and the government.

Importantly for a government desperately trying to deliver a budget surplus in the lead-up to an election, the provision of basic home support keeps many people out of more expensive home-care programs and also out of aged-care accommodation, which requires even greater government funding.

Total government funding to aged care grows from an estimated $20 billion in 2019-20 to nearly $24bn in 2022-23.

The aged-care industry has been under the microscope since the government's decision in the December 2015 mid-year economic and fiscal outlook to hold back on funding increases of $472m as a punishment after audits identified perceived systematic rorting of government funding.

Then, in 2017, the government commissioned several aged-care related reports including the Tune review of the aged-care legislation and the ACFI review of the government funding model.

Since then there has been a steady stream of initiatives to implement recommendations from these reports.

The Aged Care Quality and Safety Commission was established on January 1 this year and the aged-care royal commission began in February. As serious issues have been identified, the government has made a string of announcements to address them and there may be more after the royal commission wraps up with a final report in April next year.

John Rawling is an aged-care expert at Joseph Palmer & Sons.

Beaten by a curve ball: are we reading bond market signals the wrong way?

ROGER MONTGOMERY

There's been a lot of talk of inverted yield curves in the US and whether they signal a recession or a stockmarket crash.

Currently, about 60 per cent of the US yield curve is inverted. To put that in perspective, the last three occasions that that occurred — in 1990, 2000 and 2006 — the US went into a recession within a couple of years. Of course, stocks tend to collapse ahead of recessions, so presumably the fear on investors' minds is that the market is going to crash some time ahead of any forthcoming recession.

But before jumping at shadows, keep in mind the data above is hardly enough to be statistically significant.

The inversion follows a more dovish stance (meaning a pause on rate hikes) taken by the US Federal Reserve.

Earlier in the year, when US treasury bonds dropped across the board and US 10-year bonds fell to 2.42 per cent and two-year bonds to just above 2.3 per cent, the tech-heavy Nasdaq plunged more than 2 per cent. So, there's merit even for equity investors in watching developments in the bond market.

Importantly, the three examples listed earlier, where more than 60 per cent of yield curves were inverted, were all prior to the global financial crisis. Since 2008, the world's economy and its financial system is vastly different not only from just prior to the GFC but since the end of WWII.

It could be that the inverted yield curves are signalling expectations of a sharp decline in inflation.

If investors believe goods will be cheaper in the future than they are today, then dollars today are worth less than dollars in the future. In other words, the time value of money turns positive and an inverted curve may not be the harbinger of a recession.

The important thing here is not the inversion itself, but whether it persists. And so far the period of the inversion can be counted in days on just two hands.

It's interesting at this point to bring in another indicator of a pending recession — unemployment. Since 1965, whenever US unemployment rose more than 50 basis points above its trailing-year low, a recession followed. Of course, you'd expect rising unemployment to lead to a slowing economy, especially if it's not accompanied by an offsetting increase in productivity.

Whichever way you look at it, the lower long-term bond yields reflect the fact that the market believes the Fed has raised rates too quickly and/or too much.

In other words, the market currently believes the Fed has made a mistake by lifting rates eight times. And if you add the balance sheet reduction, you could throw in another two or three pseudo rate hikes.

When the first yield curves began inverting late last year, the markets seemed to be saying, if not screaming, that the Fed must stop tightening immediately. But now that the Fed has committed to pausing, the failure of the inverted yield curves to normalise suggests the market thinks the Fed went too far. Indeed, US bank-lending growth appears to be slowing.

There can be no doubt that the Fed is more optimistic about the future than the market.

Without a crystal ball we cannot know whether the Fed has effectively raised rates just enough to slow global growth and normalise rates in time to be able to cut any recession off at the pass — in turn, stabilising markets — or whether their actions will cause a violent end to the asset bubbles we see everywhere.

What I am reasonably sure about is that the inversion suggests that *if* a recession does transpire, the Fed will adopt a very different policy response than during past recessions.

Perhaps instead of looking at yield curves we need to remember that with rates so low for so long, the desperate search for yield has, without doubt, resulted in systemic risks associated with a misallocation of resources. You only have to look at the massive multi-billion-dollar valuations being ascribed to a loss-making company, such as the recent IPO of ride-sharing company Lyft, to be certain of that.

For stockmarket investors, watching yield curves may not be as important as focusing on valuations. Instead of watching yield curves, keep an eye on valuations as your indicator of future returns.

When profitless prosperity seems normal, you have to remember these companies cannot survive without funds.

When they are unlisted they turn to private equity and venture capital for their funding, but after they list, they'll turn to the stockmarket for additional funding. And stockmarkets are much less patient than bond markets.

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