Productivity Commission Interim Report - Creating a more dynamic and resilient economy
Response to Information Request 1.2

UNSW SYDNEY

The Commissioners
Productivity Commission

Via online upload
11 September 2025

Dear Commissioners

Thank you for the opportunity to make this submission, the limited purpose of which is to respond to Information Request 1.2:

> The PC is interested in views on the most appropriate way to tax financial services in a manner that is consistent with the proposed changes and induces additional capital expenditure in a similar manner to the net cashflow tax.

A cash flow method is not suitable for taxing financial services

The starting point is to observe that a cash flow method is simply not suitable for taxing financial services. There are two significant problems.

First, the method relies upon the use of explicit interest charges for borrowers and depositors. However, not all financial transactions rely upon explicit interest charges (derivatives trades and foreign exchange transactions, for example). A cash flow method, therefore, cannot provide a complete solution to taxing financial services.

Second, the method would affect assets already financed by debt. For a bank, interest payments would become taxable in the hands of the bank after the introduction of the tax but no credits would have been available for the original loan. Complex transitional arrangements would be necessary which would 'severely undermine' the simplicity of the tax (Report on Australia's Future Tax System, ('the Henry Report', 'Henry 2009'), Part 2, 281).

An adjusted profit method would be effective in taxing financial services

There is a link between taxing income and taxing consumption.

The Henry Report considered the case for taxing the consumption of financial services as an alternative to GST input taxation (Henry 2009, Part 2, 303ff). In short, an 'addition method' of taxation would be effective in fully taxing the consumption of financial services as an alternative to the GST's partial taxation of inputs. In broad terms, the addition method calculates liability by taking the sum of an entity's labour and profit for a tax period and multiplying this by the prevailing tax rate. In this context, 'labour plus profit' is a shorthand description of the more accurate 'factor payments plus economic rent'.

There is of course a difference between the base for income tax and the base for consumption tax. However, as noted in Schenk, a direct tax such as an income tax can be imposed on a consumption base by removing returns to capital, such as interest, dividends and capital gains (Schenk, Thuronyi and Cui, 'Value Added Tax: A Comparative Approach', Cambridge University Press, 2nd ed, 2015, 7).

Since it is possible to tax the consumption of financial services using an addition method, it is possible to tax the income derived from financial services using the same method, but with adjustments to reflect the income tax base. The starting point would be economic rent which, as the Henry Report observed, could be calculated by reference to existing income tax concepts (Henry 2009, Part 2, 309).

This is essentially an 'adjusted profit' method. One adjustment that could easily be made is to exclude depreciation from the profit calculation, thus aligning the method with the PC's desire to allow companies to deduct their investment costs in full.

Thus, the most appropriate way to tax financial services in a manner consistent with the PC's proposed changes, is to use an 'adjusted profit' method, building on the work done for the Henry Report.

The consumption of financial services should also be fully taxed

In addition to taxing income derived from financial services, the consumption of financial services in Australia should also be fully taxed. I have more fully made the case for this in a published article (O'Rourke, K, 'Taxing Financial Services under Australia's GST', International VAT Monitor, March/April 2024, 65). The taxation of consumption is essentially achieved using the addition method described above. To the economic rent component would be added the labour component. This, too, would use existing concepts, such as from the PAYG withholding regime and the fringe benefits tax.

Fully taxing the consumption of financial services has significant revenue implications. The net under-taxation of financial services under Australia's GST comes at a cost of over $4.5b per annum to the Australian revenue base (refer Treasury, '2024-25 Tax Expenditures and Insights Statement', using FY26 estimates, 187, 188). Moreover, it is economically very efficient to fully tax the consumption of financial services. Murphy has estimated the marginal excess burden for removing the financial services GST concession to be just 1% (Murphy, C, 'Corporate Tax Reform Modelling Scenarios: First Stage Report', June 2025).

On a 'high level' basis, I have estimated that it is possible to compensate the bottom 40% of the income distribution at a total cost of just over 20% of the revenue raised (O'Rourke, 72).

The PC should consider recommending fully taxing the consumption of financial services in Australia.

Conclusion

The most appropriate way to tax financial services in a manner consistent with the PC's proposed changes, is to use an 'adjusted profit' method, building on the work done for the Henry Report. By parity of reasoning, this should be extended to fully taxing the consumption of financial services in Australia by use of an addition method.

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Please feel free to contact the writer direct if I can assist further in any way.

Yours sincerely

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