# CHAPTER 1: INTRODUCTION

The Tax Expenditures Statement (TES) provides details of concessions, benefits and incentives (tax expenditures) provided to taxpayers by the Australian Government. The publication of information on the Australian Government's tax expenditures is a requirement under the *Charter of Budget Honesty Act 1998*.

This statement lists around 270 tax expenditures and, where possible, reports the estimated pecuniary value or order of magnitude of the benefit to taxpayers over an eight-year period, from 2002-03 to 2009-10.

The tax expenditures in this statement reflect all announced policies and legislation applying up to the date of publication of the *Mid-Year Economic and Fiscal Outlook 2006-07*.

**Interpreting the estimates of tax expenditures**

Care should be taken when interpreting the estimated pecuniary value and order of magnitude of tax expenditures presented in this document. As outlined in Chapter 3, the estimates of reported tax expenditures are not necessarily reliable indicators of the budgetary impact of removing particular tax concessions. Nor are the aggregate estimates presented in Chapter 2 necessarily reliable indicators of the total value of tax expenditures. Where aggregates are reported, they are only presented as broad indicators of trends in the value and composition of tax expenditures.

Care should also be taken in comparing the level of tax expenditures reported in different editions of the TES, both for individual tax expenditures and in aggregate. Changes may arise without any change in the actual magnitude of tax expenditures. The reasons include revisions to data, changes in methodology, identification of formerly unidentified tax expenditures, quantification of previously unquantified tax expenditures and deletion of abolished tax expenditures.

## 1.1 What is a tax expenditure?

A *tax expenditure* is a tax concession that provides a benefit to a specified activity or class of taxpayer. A *negative tax expenditure* arises when arrangements impose an additional charge rather than a benefit. A tax expenditure can be provided in many forms, including a tax exemption, tax deduction, tax offset, concessional tax rate or deferral of a tax liability.

Alternatively, the benefits of most tax expenditures could be delivered through direct expenditures. Hence, tax expenditures are an alternative to direct expenditures as a method of delivering government assistance or meeting government objectives. Accordingly, tax expenditures have an impact on the budget position, as do direct expenditures.

Tax expenditures also redistribute the tax burden between taxpayers. This is because most tax expenditures result in less tax being collected from particular taxpayers. As a result, taxes paid by individuals and businesses not benefiting from the tax expenditure need to be higher to raise the same total revenue.

In order to estimate the value of a tax expenditure, the tax arrangement that would normally apply needs to be identified, so that the nature and extent of the concession can be established. The taxation treatment that would normally apply is known as the *benchmark*. The benchmark should neither favour nor disadvantage similar activities or classes of taxpayer. Tax expenditures are measured as deviations from the benchmark.

Not all concessional elements of the tax system are classified as tax expenditures. This is because some concessions are considered structural elements of the tax system and are incorporated in the benchmark. For example, the personal income tax system includes a progressive marginal tax rate structure, which results in individuals on lower incomes paying a lower marginal rate of income tax than those on higher incomes. This arrangement is a structural design feature of the Australian tax system and is therefore not identified as a tax expenditure.

## 1.2 Why report tax expenditures?

The publication of the TES is an integral component of the Australian Government's budget reporting. It serves three key functions:

- to allow tax expenditures to receive a similar degree of scrutiny to direct expenditures;
- to allow for a more comprehensive assessment of government activity; and
- to contribute to the design of the tax system, by promoting and informing public debate on all elements of the tax system.

**Tax expenditure reporting in Organisation for Economic Co-operation and Development (OECD) countries**

In the early 1970s, only Germany and the United States reported tax expenditures. By 1983, Australia, Austria, Canada, France and Spain were also regularly identifying them. Currently, almost all OECD member countries report tax expenditures. Most of these countries, including Australia, report tax expenditures annually.

The purpose of reporting tax expenditures is generally the evaluation of tax expenditures and to promote and assist public debate on the design of the tax system. Australia's TES has a broad coverage including the majority of taxes levied by the Australian Government.

Most OECD tax expenditure reporting countries report tax expenditures that relate to personal and business income taxes and value added taxes, where applicable. Australia (like Belgium, France, Germany, the Netherlands, the United Kingdom and the United States) reports tax expenditures on the majority of central government direct and indirect taxes. Austria and Italy report tax expenditures at all levels of government.

Of the OECD tax expenditure reporting countries, at least nine, including Australia, have noted the importance of reporting tax expenditures and made it a legal requirement. These countries include Austria, Belgium, France, Germany, Italy, Portugal, Spain and the United States. In addition, most of these countries explicitly link tax expenditure reporting to the budget process.

Source: H Brixi, C Valenduc and Z Li Swift, *Tax Expenditures — Shedding Light on Government Spending through the Tax System, Lessons from Developed and Transition Economies*, The World Bank, Washington DC, 2003.

## TRANSPARENCY AND SCRUTINY

The TES improves the transparency of the tax system, thereby allowing greater public scrutiny of government policies.

In Australia, direct government expenditures are generally scrutinised during the annual budget process by Parliament and parliamentary committees, the media and the general public.

Tax expenditures, like direct expenditures, affect the government's budget. Concessional arrangements that give rise to tax expenditures often receive consideration from Parliament only at the time they are introduced. Furthermore, the cost of tax expenditures is generally not obvious as it does not arise from a direct transaction with government. The publication of information on tax expenditures facilitates their review and assessment, and assists in determining whether their objectives are being met at a reasonable cost and in the interest of the community in general.

### SCOPE OF GOVERNMENT ACTIVITY

The publication of tax expenditure information allows for a more comprehensive assessment of Australian Government activity. Unless direct expenditures and tax expenditures are both reported, the scope of government influence on the economy and society will be understated. By reporting tax expenditures, all government 'expenditure' is transparent.

### TAX SYSTEM DESIGN

Transparent reporting of tax expenditures assists the evaluation, design and development of the tax system and helps to determine whether there has been adherence to the three key principles of tax system design – efficiency, equity and simplicity. The provision of detailed information on tax expenditures allows a more thorough assessment of the tax system in respect to:

- its effect on resource allocation, incentives for taxpayer behaviour and distortions created by tax expenditures;
- the most appropriate way to administer concessions, particularly as most tax expenditures could be delivered as direct expenditures; and
- the impact on different entities within the economy, particularly as tax expenditures shift the tax burden to entities that are not treated concessionally.

## 1.3 Coverage of this statement

This statement covers the following Australian Government taxes:

- income tax (personal and business), including capital gains tax (CGT) and income tax paid on retirement income;
- fringe benefits tax (FBT);
- excise duties;
- wine equalisation tax;
- luxury car tax;

- petroleum resource rent tax; and
- crude oil excise.

Taxes excluded from this statement are:

- specific-purpose taxes, such as agricultural levies, which are generally levied for cost recovery purposes; and
- customs duty and tariffs, except to the extent that the duty concerned is analogous to an excise duty that applies to similar goods produced in Australia.

Estimates of the value of assistance provided to various industries, including tariff arrangements, appear in the Productivity Commission's *Trade and Assistance Review*.

The goods and services tax (GST) is not included in this statement as it is imposed and collected by the Australian Government on behalf of the States and Territories.

## 1.4 Structure of this statement

The remainder of this statement is divided into the following sections:

### TRENDS

Chapter 2 provides an overview of Australian Government tax expenditures, including trends, aggregates and a comparison with direct expenditures.

### METHODOLOGY AND BENCHMARKS

Chapter 3 outlines the various approaches to measuring tax expenditures and provides guidance on how to interpret tax expenditure estimates.

Chapter 4 describes the benchmarks used to identify and measure tax expenditures.

### DETAILS AND ADDITIONAL INFORMATION

Chapter 5 outlines changes to the list of tax expenditures since the *2005 Tax Expenditures Statement* — new tax expenditures, modified tax expenditures and tax expenditures no longer reported.

Chapter 6 details each tax expenditure, including an estimate (where possible) of the benefit taxpayers derive, a description of the tax expenditure, a legislative reference, and for more recent tax expenditures, the date the expenditure was introduced.

Further information on tax expenditures appears in the relevant budget documentation from the time the concession was introduced.

Appendix A provides an overview of the various modelling techniques used to estimate tax expenditures.

Appendix B discusses tax expenditures related to superannuation and conceptual issues relating to interpretation of the superannuation tax expenditure estimates.