NOTES

- The Tax Expenditures Statement (TES) is published annually, as required by the *Charter of Budget Honesty Act 1998*.
- A tax expenditure results from a provision of the tax law that causes a deviation from the standard tax treatment that would apply to an activity or class of taxpayer; that is, from the benchmark tax treatment.
  - The choice of benchmark unavoidably involves judgment and may therefore be contentious in some cases.
  - This choice should not be interpreted as indicating a view on how an activity or class of taxpayer ought to be taxed.
  - The level of the tax expenditure estimates the difference in tax liabilities relative to the benchmark. Consistent with most OECD countries, the standard methodology (the 'revenue forgone' approach) used to estimate tax expenditures is based on the existing level of activity utilising a tax provision.
  - These estimates therefore do **not** indicate the revenue loss to the Australian Government budget of specific tax expenditures, as there may be significant changes in activity were tax expenditures to be removed.
  - The potential revenue losses associated with some of the largest tax expenditures have been estimated (see Table 1.3).
    - These estimates are subject to significant caveats.
- Previous editions of the TES have stated that tax expenditure estimates are not strictly additive. Tables aggregating tax expenditures have therefore been removed from the 2013 TES. This issue will be reviewed for the 2014 TES.
- Care is required when comparing tax expenditures with direct expenditures as they may, for example, measure different things.
- The 2013 TES reflects Australian Government policy, as announced, up to and including the 2013-14 *Mid-Year Economic and Fiscal Outlook*.
- Estimates from previous editions of the TES should not be compared to estimates in the current edition because, for example, benchmarks may have changed.
- Currently, the benchmark for the tax treatment of savings is the comprehensive income tax benchmark. Experimental estimates for superannuation using an expenditure tax benchmark are reported at Appendix A.

CHAPTER 1: TAX EXPENDITURE FRAMEWORK

1.1 Introduction

The Tax Expenditures Statement (TES) is published annually, as required under the *Charter of Budget Honesty Act 1998*.

This TES provides a description of the tax expenditures provided to taxpayers by the Australian Government and, where possible, the estimated value or order of magnitude of the tax expenditure.

This TES reflects Australian Government policy up to and including the 2013-14 *Mid-Year Economic and Fiscal Outlook*, including measures that are yet to be enacted.

Purpose

Direct government expenditures are scrutinised during the annual budget process by Parliament and parliamentary committees, the media and the general public.

The TES enables tax expenditures to also receive scrutiny by making transparent their existence and, where possible, their magnitude.

Transparent reporting of tax expenditures also assists and informs debate on the design and development of the tax system as a whole, including its effect on resource allocation and incentives for taxpayer behaviour.

What is a tax expenditure?

A tax expenditure results from a provision of the tax law that causes a deviation from the standard tax treatment that would apply to an activity or class of taxpayer — that is, from the benchmark tax treatment. The level of the tax expenditure estimates the difference in tax liabilities relative to the benchmark.

Positive tax expenditures reduce tax liabilities relative to the benchmark. Negative tax expenditures increase tax liabilities relative to the benchmark.

Tax expenditures typically involve tax exemptions, deductions or offsets, concessional tax rates and deferrals of tax liability. Tax expenditures do not arise from, for example, the exercise of administrative discretion.

In the case of fringe benefits tax, tax expenditures may also be delivered through a reduction in taxable value, discounted valuation or record keeping exemption.[1] Certain tax expenditures relating to depreciation allow for the accelerated write-off of depreciable assets.[2]

New and modified tax expenditures arise each year as a result of changes in Australian Government revenue policy. Tax expenditures are deleted because of changes in policy or where they no longer have a financial impact in the years for which estimates are reported in the TES.

1.2 Estimating the value of tax expenditures

Benchmarks

Tax expenditures are defined and measured as deviations from the relevant tax benchmark.

- Benchmarks should represent the standard taxation treatment that applies to similar taxpayers or types of activity. Consequently, a benchmark taxation treatment should neither favour nor disadvantage similar taxpayers or activities.

- Benchmarks may also incorporate *structural elements* of the tax system; for example, the progressive income tax rate scale for individual taxpayers.

Applying these criteria typically involves judgment. In particular, there may be different views on which structural elements to include in a benchmark. Consequently, the choice of benchmark may be contentious; benchmarks vary over time and across countries and can be arbitrary.

The choice of benchmark should not be interpreted as indicating a view on how an activity or taxpayer ought to be taxed.

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1 A reduction in taxable value is a tax expenditure that arises where the taxable value of the fringe benefit is reduced by some factor. A discounted valuation describes provisions where a valuation other than the actual value of the benefit is used as a basis for calculating the tax. Record keeping exemptions arise where an employer is not obliged to maintain current records of benefits to calculate the tax.

2 In the early years of an asset's life, accelerated write-offs allow larger deductions than the benchmark depreciation treatment, which is based on the effective life of an asset. In the later years of an asset's life when the accelerated write-off is complete, deductions that would be allowed under the benchmark are no longer available. Thus, accelerated write-offs act like tax deferrals.

Each benchmark will generally consist of the following elements:

- the tax base — the activities or transactions subject to the tax;
- the tax rate — the rate of tax that applies to the base;
- the tax unit — the entity liable to pay the tax; and
- the tax period — the period in which the activities or transactions are undertaken.

The benchmarks used in this TES are outlined at the beginning of each set of tax expenditures in Chapter 2 and are explained in detail in Appendix B.

The tax treatment of savings

The current benchmark applied for the income tax treatment of savings is the comprehensive income tax benchmark. There is, however, a question about whether using an expenditure tax benchmark, either in addition to the income tax benchmark or as a replacement, would be appropriate, given the tax treatment of assets held by Australian households.

- Under a comprehensive income tax benchmark, income from capital is taxed at marginal rates. Under an expenditure tax benchmark, income from capital is exempt from tax.

Most household savings is concentrated in property and superannuation — both of which are taxed concessionally against the income tax benchmark. According to the Australian Bureau of Statistics, the principal assets of Australian households are their own home (43 per cent of household assets), other property including rental property (17 per cent), superannuation (15 per cent), personal use assets (10 per cent), shares and interests in trusts (8 per cent), bank accounts (5 per cent) and other assets (1 per cent) (ABS 2013).

The tax treatment of various types of savings is outlined below.

- Owner occupied housing is purchased with after tax income, but returns are not subject to income tax (consistent with an expenditure tax benchmark).
- Rental properties are purchased with after tax income, but benefit from the 50 per cent capital gains tax discount. Net rent is taxed at marginal tax rates.
- Superannuation contributions are generally made out of pre-tax income, but are subject to a 15 per cent tax. Fund earnings in the accumulation phase are taxed at a 15 per cent rate and are eligible for a one third capital gains tax discount. Funds are also entitled to refunds of excess imputation credits. Earnings derived from assets which are used to meet current pension liabilities are exempt from

tax. Benefits for individuals aged 60 and over are tax free (where taxed in the fund).

- Personal use assets are purchased with after tax income, but returns are not subject to income tax.
- Shares are generally purchased using after tax income. Domestic investors generally benefit from refundable imputation credits, thereby avoiding double taxation, and from the 50 per cent capital gains tax discount.
- Interest bearing deposits are funded from after tax income. Interest earned is taxed at marginal rates.

Given owner occupied housing is the largest form of savings held by Australian households, and is taxed consistently with an expenditure tax benchmark, arguably this benchmark could be used for savings rather than the current comprehensive income tax benchmark.

To help facilitate discussion and understanding of the impact of utilising different benchmarks, experimental estimates for superannuation using an expenditure tax benchmark are reported at Appendix A.

Estimating tax expenditures

Consistent with most OECD countries, estimates of the value of tax expenditures in the TES are derived primarily using the 'revenue forgone' approach. This approach compares the tax treatment of a specified activity or class of taxpayer with the benchmark treatment, assuming taxpayer behaviour would not change under the benchmark treatment.

Revenue forgone estimates differ in principle from estimates of the financial impact of new revenue measures in the Australian Government budget. Budget estimates use the 'revenue gain' approach, which takes account of factors such as taxpayer behaviour if the tax expenditure was abolished (that is, if the benchmark treatment prevailed), and taxpayer compliance with the tax law. In addition, assumptions must be made about other policy settings relevant to changes in taxpayer behaviour.

Tax expenditures and taxpayer behaviour

Introducing a tax expenditure may create incentives for taxpayers to change their behaviour to utilise (or avoid) the new tax provision. Removing the tax expenditure (so that the benchmark tax treatment prevailed) would remove this incentive and cause a corresponding change in taxpayer behaviour.

While the revenue gain approach takes account of this likely change in taxpayer behaviour, the revenue forgone approach does not. As a result, it is important to note that revenue forgone tax expenditure estimates should not be interpreted as the budget impact of removing a tax expenditure. Rather, they represent the value of the tax concession under the current (or projected) level of utilisation.

The revenue forgone approach is preferred primarily because the revenue gain approach requires information about the behavioural responses of taxpayers to policy changes for each estimate. In most cases reliable information is not available and assumptions need to be made to arrive at an estimate.

The revenue forgone approach also provides estimates that are similar to the way the ongoing cost of demand driven outlays are recorded in the budget based on the total demand for a program.

In addition, where taxpayer behaviour is relatively insensitive to a tax expenditure, revenue gain and revenue forgone estimates are likely to be similar.

Conversely, where taxpayer behaviour is highly sensitive to, or solely motivated by the existence of a tax expenditure, the increase in revenue from removing the tax expenditure could be very small, as this could also remove much of the related activity. In these cases, reporting tax expenditure estimates using the revenue gain approach would give the impression that the tax expenditure has little material effect when, in fact, taxpayers make significant use of it.

To illustrate the difference between the revenue forgone and revenue gain approaches, the values of ten of the largest tax expenditures have been estimated using both approaches. The results are set out in Table 1.3. Chapter 3 provides further detail on the revenue gain estimates.

Interpreting tax expenditure estimates

The following caveats apply to tax expenditure estimates reported in the TES.

- Tax expenditure estimates in different editions of the TES are generally not comparable. Estimates may change between editions as benchmarks are modified, new tax expenditures are identified, revised or new data becomes available, or changes in modelling methodology are made.

- Care is required when comparing tax expenditures with direct expenditures.
  - Tax and direct expenditure estimates may measure different things. For example, the tax expenditures relating to the Private Health Insurance Rebate (A20) and Childcare Rebate (A29) relate to the tax exemption for the rebates, not the rebates *per se*.
  - Direct expenditure estimates of non-taxable transfer payments effectively include the value of the tax exemption for the payments. Summing the direct and tax expenditure estimates would therefore overstate the cost of the government support to the budget.
- Unless otherwise indicated, tax expenditure estimates are calculated on an individual basis and do not take account of potential overlaps with other tax expenditures.

Previous editions of the TES have stated that tax expenditure estimates are not strictly additive, for example, because the removal of one tax provision will affect the utilisation of other provisions for accounting and behavioural reasons. Tables aggregating tax expenditures have therefore been removed from the 2013 TES. This issue will be reviewed for the 2014 TES.

The tax expenditure estimates in the TES comprise:

- projections for the forward estimates period — that is, for 2013-14 until 2016-17; and
- estimates for the four years preceding the forward estimates period — that is, for 2009-10 until 2012-13. The estimates for 2012-13 are preliminary and subject to revision upon receipt of further tax data.

Consistent with Australian Government budget procedures, tax expenditure estimates are in nominal dollars. Consequently, for example, 2013-14 estimates are in 2013-14 dollars and 2012-13 estimates are in 2012-13 dollars.

Tax expenditure estimates are prepared on an accruals basis (see Appendix B.6).

Reliability of estimates

Tax expenditure estimates vary in their reliability depending upon the quality, detail and frequency of the underlying data, the extent to which calculations are based on assumptions, the sensitivity of the results to those assumptions and whether future taxpayer behaviour is reasonably predictable. In addition, unexpected changes in economic conditions or volatility in markets may influence the future value of tax expenditures, thus impacting the reliability of tax expenditures projections.

The reliability of each tax expenditures estimate (where quantified) has been assessed by separately scoring:

- the reliability of the data;
- the underlying assumptions; and
- other relevant factors (for example, the volatility of growth rates over time).

Scores range from 0 (very low) to 3 (high). The three scores are then summed to give an overall reliability rating as set out below.

Score	**Rating**
0	Very low
1	Low
2	Low
3	Low
4	Medium-low
5	Medium
6	Medium
7	Medium
8	Medium-high
9	High

The reliability of quantified tax expenditures in the 2013 TES is shown in Table 1.1.

Table 1.1: Reliability of quantified tax expenditures for 2013-14

Reliability rating	Number of tax expenditures
High	4
Medium — High	22
Medium	83
Medium — Low	27
Low	51
Very Low	8
Total	195

Several tax expenditure estimates given a low reliability rating are significant in size. The number of tax expenditures given other reliability ratings is broadly in proportion to the value of those tax expenditures.

Unquantifiable tax expenditures — orders of magnitude

In many cases there is insufficient data to produce a reliable estimate for a tax expenditure item. In these cases the estimate will be shown as being unquantifiable or 'not available'. In the 2013 TES, estimates are not available for 2013-14 for around 43 per cent of tax expenditures — that is, 154 out of 355 expenditures.[3]

Where tax expenditures are not quantifiable, an order of magnitude is provided using the categories set out in Table 1.2.

Table 1.2: Orders of magnitude

Order of magnitude range	
Category	**Expected tax expenditure ($m)**
0	0 on average over reporting period
1	0 — 10
2	10 — 100
3	100 — 1,000
4	1,000 +
NA	not available

Category classifications are provided as a broad guide only. They are based on assumptions and judgment and should be treated with caution.

The category classification also indicates whether a tax expenditure is positive or negative. For example, '1+' indicates a positive tax expenditure. Where a tax expenditure could be positive or negative, a '+/-' order of magnitude is assigned.

The category assigned to a tax expenditure refers to the year the tax expenditure is considered to be most significant.

3 The estimates for six tax expenditures were incorporated into related tax expenditures.

1.3 Major changes from 2012

The major changes in the 2013 TES from the 2012 TES are:

- the carbon pricing mechanism benchmark has been set at zero from 2014-15 reflecting the Government's policy to repeal the carbon tax, with the result that the carbon pricing mechanism tax expenditures revert to zero from that year;

- the natural resources benchmark has been modified to reflect the Government's policy to repeal the minerals resource rent tax (MRRT) from 1 July 2014 with the result that the MRRT tax expenditures revert to zero from 2014-15; and

- a new methodology for assessing the reliability of tax expenditure estimates has been adopted (as outlined above).

Appendix C lists all new, modified and deleted tax expenditures in the 2013 TES.

1.4 Large tax expenditures

Table 1.3 lists the largest measured tax expenditures for 2013-14.

The table includes revenue gain estimates for several of the largest tax expenditure items. These estimates illustrate the points made above that:

- significant differences can arise between revenue forgone and revenue gain estimates, particularly because the latter takes account of behavioural change by taxpayers; and
- conversely, in some cases, revenue gain and revenue forgone estimates are identical or very similar as taxpayer behaviour is relatively insensitive to a tax expenditure.

As discussed above, unquantified tax expenditures have been assigned an order of magnitude, rather than an estimate of their value. The largest such tax expenditures are as follows:

- income tax exemption for Commonwealth, State and Territory public authorities, and State and Territory entities (B3);
- exemption for foreign branch profits from income tax (B13);
- off-market share buy-backs (B29);
- philanthropy — income tax exemption for charitable, religious, scientific, and community service entities (B67); and
- quarantining of capital losses (E30).

Table 1.3: Large measured tax expenditures for 2013-14

Tax expenditure		Estimate $m Revenue forgone	Revenue gain
Large positive tax expenditures			
E6	Capital gains tax main residence exemption — discount component	16,500	n/a
C6	Superannuation — concessional taxation of superannuation entity earnings	16,100	14,100
C5	Superannuation — concessional taxation of employer contributions	16,000	13,550
E5	Capital gains tax main residence exemption	13,500	n/a
H29	GST — Food; uncooked, not prepared, not for consumption on premises of sale and some beverages	6,200	6,100
E16	Capital gains tax discount for individuals and trusts	4,300	n/a
H16	GST — Education	3,700	3,300
H19	GST — Health; medical and health services	3,400	3,350
H2	GST — Financial Supplies; input taxed treatment	3,300	3,300
C3	Concessional taxation of non-superannuation termination benefits	2,450	1,800
I6	CPM uncovered sectors — Agriculture	2,090	n/a
A42	Exemption of Family Tax Benefit, Parts A and B	2,080	2,080
B16	Exemption from interest withholding tax on certain securities	1,800	1,270
B88	Statutory effective life caps	1,720	n/a
A20	Exemption of the private health insurance rebate, including expense equivalent	1,450	n/a
D11	Philanthropy — Exemption for public and not-for-profit hospitals and public ambulance services	1,400	n/a
D14	Philanthropy — Exemption for public benevolent institutions (excluding public and not-for-profit hospitals)	1,340	n/a
A19	Exemption from the Medicare levy for residents with a taxable income below a threshold	1,320	n/a
B101	Small business — simplified depreciation rules	1,265	n/a
I1	CPM uncovered sectors — Deforestation	1,210	n/a
A62	Philanthropy — Deduction for gifts to deductible gift recipients	1,150	n/a
H21	GST — Health; residential care, community care and other care services	1,050	n/a
F8	Concessional rate of excise levied on aviation gasoline and aviation turbine fuel	1,010	n/a
B98	Research and development — non-refundable tax offset	1,000	n/a
H5	GST — Child Care Services	940	n/a
H6	GST — Water, sewerage and drainage	910	n/a
B90	Deduction for capital works expenditure	890	n/a
H3	GST — Financial Supplies; reduced input tax credits	830	n/a
D20	Application of statutory formula to value car benefits	810	n/a
Large negative tax expenditures			
F25	Customs duty	-3,000	-3,000
F12	Higher rate of excise levied on cigarettes not exceeding 0.8 grams of tobacco	-1,885	n/a