1 Introduction

1.1 Background

The *Tax Expenditures Statement* (TES) provides a detailed list of tax expenditures provided by the Commonwealth to individuals and businesses.

This Statement identifies around 260 tax expenditures and, for many of these, reports estimates of the financial benefits derived by the recipients over the period 1998-99 to 2005-06. The publication of detailed information on Commonwealth tax expenditures is a requirement of the *Charter of Budget Honesty Act 1998.*

The tax expenditures in this Statement reflect all announced policies and legislation applying up to the date of publication of the *2002-03 Mid-Year Economic and Fiscal Outlook* (MYEFO).

1.2 What is a tax expenditure?

A tax expenditure is a tax concession that is designed to provide a benefit to a specified activity or class of taxpayer. (A negative tax expenditure occurs when such arrangements impose a higher charge rather than a benefit. Almost all of the tax expenditures in this Statement are positive.) Tax expenditures can be delivered in a variety of ways: by a tax exemption, tax deduction, tax offset, reduced tax rate or by deferring a tax liability.

The benefits of most tax expenditures could be delivered equally by direct expenditures. Hence, tax expenditures are an alternative to direct expenditures as a method of delivering government assistance or meeting government objectives. This explains the use of the term *tax expenditures* — they are substitutes for expenditure, delivered through the taxation system. Accordingly, tax expenditures have an impact on the budget position, as do direct expenditures.

In order to estimate the value of a tax expenditure, it is necessary to identify the taxation arrangement that would normally apply, so that the nature and extent of the concession can be established. The taxation treatment that would otherwise apply is referred to as the *benchmark*. Benchmark taxation treatment should neither favour nor disadvantage similarly placed activities or classes of taxpayer. Tax expenditures are then defined as deviations from the benchmark.

Not all tax concessions are necessarily classified as tax expenditures. This is because some concessions are considered to be structural features of the taxation system and hence are incorporated in the benchmark.

For example, people on lower incomes pay a lower marginal rate of income tax than people on higher incomes. While this could be construed as a concessional rate of taxation, progressive marginal tax rates are considered to be an integral design feature of the Australian tax system. On that basis, lower marginal tax rates are not identified as tax expenditures.

There is an element of judgement involved in identifying which elements of the tax system constitute tax expenditures and which elements are structural features, given the diversity of taxation arrangements. For this reason, international comparisons of tax expenditures can be difficult to interpret. A discussion of the assumed structural features (that is, benchmarks) of the Australian tax system is provided in Chapter 3.

1.3 Purpose of this Statement

This Statement serves two broad objectives:

- to describe the benchmarks of the tax system and the extent to which the tax system differs from these, to inform the public debate, and/or to contribute to the discussion of the design of the tax system; and

- to facilitate assessing tax expenditures alongside direct expenditures.

In respect of the second objective, the publication of tax expenditure data enables tax expenditures to be reviewed and assessments made as to whether objectives are being met at reasonable cost. It facilitates a comparable degree of scrutiny for tax expenditures as occurs for direct expenditures.

Direct government expenditures are generally subject to a considerable amount of scrutiny from within the public sector (during the annual budget process) and by the Parliament and Parliamentary committees, the media and the general public. In part, this scrutiny stems from the need to gain Parliamentary approval each year for the level and composition of a substantial proportion of government expenditure. In contrast, concessional arrangements that give rise to tax expenditures usually only require approval from Parliament at the time they are introduced. Furthermore, the cost of tax expenditures is generally not directly observable because the Government does not receive the forgone tax revenue from concessionally-taxed activities.

Finally, the publication of tax expenditure data allows for a more comprehensive assessment of Commonwealth government activity. As noted above, tax expenditures are often a substitute for direct expenditures. Accordingly, unless both direct expenditures and tax expenditures are considered, the apparent size of government could be reduced simply by pursuing the objectives of expenditure programs through tax expenditures.

1.4 Interpretation of tax expenditure estimates

Some caution should be exercised when using the estimates in this Statement for wider purposes, such as estimating the amount of taxation revenue forgone as a result of tax provisions. Tax expenditure estimates identify the financial benefits derived by individuals or businesses that receive concessions. However, it does not necessarily follow that there would be an equivalent increase to Commonwealth revenue from the abolition of a tax expenditure. This is because of behavioural responses by the recipients of tax expenditures.

Concessionally-taxed activities tend to expand in response to the introduction of a concession. Accordingly, the same activity would be expected to contract should the related tax expenditure be abolished, with consequent implications for potential revenue flows from the taxation of this activity. Other responses may follow, in that:

- the removal of one concession may result in increased use of other concessionally-taxed activities, lowering tax revenue elsewhere; and

- under a progressive income tax system, the removal of a tax expenditure may result in some taxpayers moving into a higher marginal tax bracket — providing a boost to tax revenue.

In most cases, the net effect of these influences on revenue is likely to be unclear.

Furthermore, in cases where the level of activity is highly sensitive to the existence of the concession, the increase in revenue from removing this tax expenditure could be very small. In these cases, reporting tax expenditure estimates as the cost to revenue would give the impression that the tax expenditure has little material effect when in fact the financial benefits derived by the recipients could be quite large.

Therefore, for the purposes of this report, it is neither practical nor desirable to incorporate potential responses to the removal of a tax expenditure into the estimates.

Finally, tax expenditure estimates may, in some cases, differ from Budget estimates, because tax expenditures are estimated relative to designated benchmarks. For example, the tax expenditures for the capital gains tax (CGT) discounts applying to individuals are measured relative to a benchmark of full taxation of capital gains. The estimates reflect the projected level of capital gains realisations following the introduction of the concession on 1 October 1999. In contrast, the Budget estimates for implementing these measures take into account the offsetting impacts on revenue of removing CGT indexation and averaging and the revenue dividend arising from increased realisations.

1.5 Structure of this Statement

Chapter 2 provides an analysis of tax expenditure aggregates, including a discussion of trends in tax expenditures and a comparison with direct expenditures.

Chapter 3 contains a description of the benchmarks that are used to define tax expenditures in this Statement.

Chapter 4 provides an outline of the changes to the list of tax expenditures since the *2001 Tax Expenditures Statement*, outlining new tax expenditures, those that have been modified and those that are no longer reported.

Chapter 5 provides estimates of the cost of each tax expenditure.

Appendix A provides further detail on each tax expenditure, including legislative references, a brief discussion of some of the estimates and, for more recent tax expenditures, the date the expenditure was introduced. Generally, tax expenditures are described in greater detail as policy measures in the relevant Budget paper or MYEFO announcing their introduction.

Appendix B provides further discussion of tax expenditures related to superannuation benefits and disaggregated superannuation estimates.