CHAPTER 1: INTRODUCTION

A tax expenditure arises where the actual tax treatment of an activity or class of taxpayer differs from the benchmark tax treatment.

- Tax expenditures typically involve tax exemptions, deductions or offsets, concessional tax rates and deferrals of tax liability.
- A positive tax expenditure reduces tax payable relative to the benchmark. A negative tax expenditure increases tax payable relative to the benchmark.

Benchmarks represent a standard taxation treatment that applies to similar taxpayers or types of activity.

- Benchmarks may also incorporate structural elements of the tax system; for example, the progressive income tax rate scale for individual taxpayers.
- The benchmarks used in the 2014 TES are outlined in Appendix A.

Determining benchmarks involves judgment. Consequently, the choice of benchmark may be contentious and benchmarks may vary over time.

- To facilitate discussion and understanding of the impact of using different benchmarks, the 2013 TES included an illustrative case study which showed the differences in the estimates for superannuation tax expenditures if an expenditure tax benchmark was used rather than the usual income tax benchmark – see Appendix A, *2013 Tax Expenditures Statement*. Although that exercise has not been repeated for this year's TES, the conceptual points that were discussed last year remain.

The Tax Expenditures Statement

The annual TES provides a description of Australian Government tax expenditures and, where possible, the estimated value or order of magnitude of the tax expenditure.

The TES is intended to facilitate scrutiny of tax expenditures by Parliament and parliamentary committees, the media and the general public. Transparent reporting of tax expenditures also helps inform debate on the efficiency and equity of the tax system.

This TES reflects Australian Government policy up to and including the 2014-15 *Mid-Year Economic and Fiscal Outlook*.

Estimating tax expenditures

Consistent with most OECD countries, estimates of the size of tax expenditures in the TES reflect the existing utilisation of a tax expenditure, similar to Budget estimates of outlays on demand-driven expenditure programmes. This is known as the 'revenue forgone' approach.

- For example, Budget Paper No.1, Budget Statement 6 – Expenses and Net Capital Investment, reports expenditure on the age pension. Broadly, the amount reported reflects the number of age pension recipients and the amount of pension each receives. Budget Paper No.1 does not provide any estimate of the hypothetical saving to the Budget should the expenditure cease.
- Similarly, the estimated size of a tax expenditure reflects the number of taxpayers utilising the tax expenditure and the notional amount of tax expenditure each receives. Revenue forgone estimates do not indicate the hypothetical saving to the Budget should the tax expenditure cease.

In practice, the revenue forgone approach involves estimating the difference in revenue between the existing and benchmark tax treatments, but importantly assuming taxpayer behaviour is the same in each circumstance.

This approach can be illustrated using the GST exemption for water, sewerage and drainage services (H6).

- By definition, no GST revenue is raised under the existing tax treatment. The benchmark treatment is the imposition of GST on water, sewerage and drainage services. The estimated value of the tax expenditure is therefore the amount of GST revenue that would be raised on water, sewerage and drainage services assuming that consumption of these services remained unchanged under a GST.

An alternative approach involves estimating the impact of abolishing a tax expenditure taking account of the potential changes in taxpayer behaviour, unlike revenue forgone estimates. This is known as the 'revenue gain' approach. Because of this, revenue gain estimates are often lower than revenue forgone estimates.

- 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 may cause a corresponding change in taxpayer behaviour.

In particular, taxpayers may make greater use of other tax expenditures if a particular tax expenditure were to be (hypothetically) abolished.

- For example, a revenue gain estimate for the concessional treatment of employer superannuation contributions would take account of the potential for voluntary employer contributions to be redirected to other tax-preferred investments.

Revenue gain estimates should be treated with particular caution.

- They assume that a tax expenditure is abolished, which may be implausible in many cases.

- In practice, the revenue gain can be difficult to estimate as there is usually little, if any, information on how taxpayers might react to the removal of a tax expenditure. Assumptions about taxpayer behavioural responses therefore need to be made, and these assumptions can be difficult to meaningfully substantiate.

- Judgments also need to be made about likely policy settings – for example, whether it is realistic to assess the abolition of a single tax expenditure (for example, a particular GST exemption) while keeping other tax expenditures unchanged (for example, other GST exemptions).

Consistent with a recommendation of the Australian National Audit Office in its 2007-08 performance audit of the TES, the TES reports revenue gain estimates for 10 large tax expenditures.[1]

Interpreting tax expenditure estimates – additional caveats

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.

Readers should exercise care when comparing tax expenditure estimates with direct expenditure estimates.

- Tax and direct expenditure estimates may measure different things. For example, the tax expenditure estimate for the Private Health Insurance Rebate (A17) relates to the tax exemption for the rebate, not the rebate itself.

- 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.

Tax expenditure estimates are not additive, particularly because the removal of one tax provision will often affect the utilisation of others.

1 ANAO Audit Report No. 32, 2007-08, *Preparation of the Tax Expenditures Statement*, Recommendation 5.

Large tax expenditures

Table 1.1 lists the largest measured tax expenditures for 2014-15.

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 attempts to take 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 assumed to be relatively insensitive to a tax expenditure.

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 (B11);
- off-market share buy-backs (B28);
- philanthropy — income tax exemption for registered charities, public educational, scientific and community service entities (B56); and
- quarantining of capital losses (E27).

Table 1.1: Large measured tax expenditures for 2014-15

Tax expenditure		Estimate $m	
		Revenue forgone	Revenue gain
Large positive tax expenditures			
E6	Capital gains tax main residence exemption — discount component	25,500	n/a
E5	Capital gains tax main residence exemption	20,500	n/a
C3	Concessional taxation of employer superannuation contributions	16,300	15,550
C6	Concessional taxation of superannuation entity earnings	13,400	11,750
H28	GST — Food	6,400	6,300
E11	Capital gains tax discount for individuals and trusts	5,800	n/a
H16	GST — Education	3,950	3,550
H2	GST — Financial supplies - input taxed treatment	3,550	3,550
H19	GST — Health - medical and health services	3,550	3,500
C5	Concessional taxation of non-superannuation termination benefits	2,700	2,700
A38	Exemption of Family Tax Benefit payments	2,220	2,220
B73	Statutory effective life caps	1,945	n/a
B14	Exemption from interest withholding tax on certain securities	1,860	1,310
A19	Medicare levy exemption for residents with taxable income below the low-income thresholds	1,710	n/a
A17	Exemption of the Private Health Insurance Rebate	1,570	n/a
D10	Exemption for public and not-for-profit hospitals and public ambulance services	1,400	n/a
D14	Exemption for public benevolent institutions (excluding public and not-for-profit hospitals)	1,360	n/a
F8	Concessional rate of excise levied on aviation gasoline and aviation turbine fuel	1,230	n/a
H20	GST — Health - residential care, community care and other care services	1,110	n/a
A54	Philanthropy — deduction for gifts to deductible gift recipients	1,100	n/a
H5	GST — Child care services	1,090	n/a
B80	Research and development — non-refundable tax offset	1,070	n/a
H6	GST — Water, sewerage and drainage	1,050	n/a
B75	Capital works expenditure deduction	960	n/a
H3	GST — Financial supplies - reduced input tax credits	900	n/a
Large negative tax expenditures			
F24	Customs duty	-2,550	-2,550
F12	Higher rate of excise levied on cigarettes not exceeding 0.8 grams of tobacco	-1,840	n/a

Compared to the list of large tax expenditures in the 2013 TES, the biggest change in estimates are to the two tax expenditures relating to the main residence exemption from capital gains tax (E5 and E6). These have increased significantly between the 2013 TES and 2014 TES as a result of the higher than expected increase in housing prices in 2013-14.