CHAPTER 3: MEASURING TAX EXPENDITURES

This chapter explores approaches used to measure and evaluate tax expenditures and provides a guide to interpreting the estimates reported in this statement.

3.1 Approaches to measuring tax expenditures

Tax expenditures can be measured in three principal ways. These are the revenue forgone, revenue gain and outlay equivalence approaches:

- The *revenue forgone approach* measures how much tax revenue is reduced (relative to a benchmark) because a tax expenditure exists. It is an ex-post measure of the cost of a particular tax concession that compares the current treatment and the benchmark treatment, assuming taxpayer behaviour is unchanged.

- The *revenue gain approach* measures how much revenue could increase if a particular tax concession were removed. Accurate estimation of this cost would require estimates of the secondary or behavioural effects associated with such a change.

- The *outlay equivalence approach* estimates how much direct expenditure would be needed to provide a benefit equivalent to the tax expenditure. This approach measures the expenditure required, in pre-tax dollars, to achieve the same after-tax dollar benefit as a tax expenditure where the direct expenditure receives the tax treatment appropriate to that type of income in the hands of the recipient.

The different methodologies used to measure tax expenditures can result in significantly different estimates of their value.

Consistent with most tax expenditure statements published in OECD countries, Australia uses the revenue forgone approach to calculate tax expenditures.[1] This is most reliable in estimating the level of assistance the tax system provides to taxpayers. Tax expenditures calculated by the revenue forgone approach show tax expenditures as the difference in tax paid by taxpayers who receive a particular concession relative to similar taxpayers who do not receive that concession.

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1 The approaches adopted by selected OECD countries to measure tax expenditures are reported in *Tax Expenditures — Shedding Light on Government Spending through the Tax System, Lessons from Developed and Transition Economies*, The World Bank, Washington DC (2003).

3.2 Interpretation of tax expenditure estimates

Readers should be cautious when using the estimates in this statement for wider purposes, such as estimating the budgetary impact of tax concessions and tax provisions. Tax expenditure estimates calculated by the revenue forgone approach identify the financial benefit of tax concessions to individuals receiving those concessions relative to individuals or businesses that do not. However, it does not necessarily follow that there would be an equivalent increase to government revenue from the abolition of a tax expenditure. This is because of behavioural responses by the recipients of tax expenditures and because of overlaps in the coverage of different tax expenditures.

Concessionally-taxed activities tend to expand in response to a concession's introduction. Accordingly, the same activity would be expected to contract should the related tax expenditure be abolished, with consequent implications for potential revenue flows from taxing 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, increasing 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 concession's existence, 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 actually the recipients derive quite large financial benefits. Therefore, for this statement it is neither practical nor desirable to incorporate potential responses to the removal of a tax expenditure into the estimates.

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 discount 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 since introduction of the concession on 21 September 1999. In contrast, the revenue impact of the concession is estimated against the benchmark of the revenue already included in the budget forward estimates. The budget estimates for implementing the capital gains tax discount measures take into account the offsetting impacts on revenue of removing capital gains tax indexation and averaging and the revenue dividend arising from increased realisations which formed part of the existing revenue base.

Unless otherwise indicated, tax expenditure estimates are calculated on an individual basis and do not take account of potential overlaps between different tax expenditures. While aggregate tax expenditures can provide a guide to trends in tax expenditures over time, overlaps between the coverage of tax expenditures and likely behavioural responses to their removal mean that such aggregates are not a reliable indicator of the overall budgetary impact of tax concessions.

Tax expenditure estimates are separated into estimates (for historical years) and projections (for future years). The estimates for 2002-03 are preliminary and subject to revision upon receipt of further tax data.

3.3 Accrual estimates

Consistent with budget reporting, this statement is prepared on an accrual basis using the *tax liability method* of revenue recognition. Under the tax liability method, the Australian Government is deemed to have accrued revenue the earlier of when an assessment of a tax liability is made or cash payment is received by the Australian Taxation Office or the Australian Customs Service.

Alternative methods of revenue recognition include:

- cash accounting with the Australian Government deemed to have derived revenue at the time cash is exchanged; and
- the economic transaction method, where the Australian Government is deemed to have accrued revenue at the time the relevant economic or financial transaction occurs.

In principle, the economic transaction method is generally more consistent with accrual accounting principles. However, with respect to tax revenue, the Australian Government, at this stage, considers that the tax liability method provides a more robust and reliable basis for forecasting revenue.

3.4 Technical notes

TREATMENT OF IMPUTATION

The value of some concessions reported in this statement is partially offset as a result of the imputation system. For example, concessions that reduce company tax may be 'clawed back' through the subsequent taxation of dividends in the hands of shareholders. The estimates in this statement generally make no allowance for this clawback due to the practical difficulties in doing so.

CAPITAL GAINS TAX ESTIMATES

Under the capital gains tax (CGT) benchmark nominal capital gains are fully taxable upon realisation. (This benchmark is described in full in Chapter 4.) The most significant tax expenditure against this benchmark is the 50 per cent discount for capital gains realised by individuals and trusts (E15) which affects most capital gains realised by these entities. However, individuals and trusts may also be eligible for other CGT concessions.

The revenue foregone methodology that is generally used in this statement implies that estimates for these other CGT concessions should be calculated against the benchmark of full taxation of nominal capital gains. In effect, this would double count the value of the 50 per cent tax concession for individuals and trusts in the value of these other concessions.

Unless otherwise stated, the value of tax expenditures reported for particular CGT items is reduced by the CGT discount and the discount component of the tax expenditure is allocated to the tax expenditure for the CGT discount (E15). This modification to the tax expenditure methodology provides a more realistic estimate of the value of the benefit taxpayers receive from capital gains concessions and removes the significant double counting of the CGT discount from the estimate.