Department of the Treasury

# TAX EXPENDITURES STATEMENT

# 1995–96

January 1997

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# Introduction

This Tax Expenditures Statement (TES) provides details on the financial benefits that individuals and businesses derive from taxation concessions of various kinds. These concessions are usually delivered by tax exemptions, tax deductions, tax rebates or reduced tax rates. They lower the tax burden by either reducing or delaying the collection of taxation revenue.

The benefits provided by the tax concessions could equally be delivered in the form of direct expenditures (outlays). The Government can use taxation concessions to allocate resources to different activities in much the same way that it can use direct expenditure programmes. For this reason, and noting their direct impact on the underlying budget deficit, these concessions are generally called ‘tax expenditures’.

To allow for a more transparent and complete assessment of public funding, information is presented in this Statement about the magnitude of public assistance that is provided via concessional taxation treatment, and the sectors to which the assistance is provided. These figures provide information on the cost of tax concessions and hence on the level of assistance provided to various groups. Details are also provided on the trends in tax expenditures, a comparison with direct outlays assistance, and the level of tax expenditure by taxpayer affected. Additional detail on methodological issues, including a detailed discussion of the retirement income tax expenditures are presented in Appendices.

Since the publication of the last TES, there have been a number of developments which have increased the public profile of tax expenditures and promoted the need for enhanced reporting of tax expenditures in Budget documentation, including the TES.

## National Commission of Audit Report

The National Commission of Audit (NCA) reported in June 1996 on, *inter alia*, the Commonwealth's finances, expenditure and financial statements. The NCA identified a number of problems with the use of tax expenditures as a programme delivery vehicle. The NCA argued that tax expenditures were less visible than outlays programmes and therefore likely to be less critically assessed and reviewed. They also noted that tax expenditures are generally uncapped, open-ended and susceptible to cost blowouts.

In the light of these problems, the NCA recommended that the Government should comprehensively review all existing tax expenditure programmes against general principles for government involvement and examine the scope for converting tax concessions to outlay programmes. In response to this recommendation the Government announced in the 1996-97 Budget its intention to review all existing tax expenditures to ascertain the extent to which they are contributing towards the achievement of their policy goals, and whether some tax expenditures might be converted to outlays programmes to achieve a better outcome. It is intended that this review will be considered by the Government in the Budget context.

When considering a proposal for a new tax expenditure, the Government now considers whether such assistance can be more effectively provided through outlays programmes. The tax expenditure review will complement this approach and should help ensure that existing tax expenditures are subjected to the same degree of scrutiny as new proposals for tax expenditures.

The NCA also recommended that tax expenditures should be treated as much as possible like programme expenditures in all published fiscal reports and statements and in all budgetary processes.

## Charter of Budget Honesty

The Government has introduced its *Charter of Budget Honesty Bill 1996* to the House of Representatives. The Charter aims to produce improved fiscal outcomes through introducing institutional arrangements to improve the formulation and reporting of fiscal policy.

The Charter will directly enhance fiscal discipline by ensuring that fiscal policy is formulated in accordance with principles of sound fiscal management. The Charter will also enhance public scrutiny of the conduct of fiscal policy and accountability of government by requiring governments to be explicit about their fiscal policy intentions and ensuring that comprehensive fiscal information is released at regular intervals.

The need for such arrangements has been supported by independent bodies such as the National Commission of Audit and the Joint Committee of Public Accounts and the Charter incorporates many of their recommendations.

A feature of the Charter is the requirement to publish an overview of tax expenditures with the budget and a detailed statement of tax expenditures in the middle of the financial year. The budget will contain estimates of aggregate tax expenditures for the budget year and the following three financial years. The mid-year report will update the budget information and present disaggregated information on tax expenditures, through the publication of the TES.

## Major Changes to the 1995-96 TES

The content and format of the 1995-96 TES has been enhanced to provide a wider coverage and to accord tax expenditures a treatment similar to that given to outlays in published reports. The main changes to this year's TES are discussed further below.

### Improved coverage of tax expenditures

In this year's TES coverage of tax expenditures has been increased, for example, through listing of tax expenditures associated with the wholesale sales tax (WST) system and inclusion of additional estimates for excise. The presentation of this information is consistent with the recommendations of the NCA for greater transparency in the reporting and consideration of tax expenditure issues, and the requirements of the Charter of Budget Honesty. It means that tax expenditures related to all major taxes are now represented in the TES.

- It has not, however, been possible to provide reliable estimates of the cost of tax expenditures associated with the WST system in this year's TES. It is hoped to be able to include such estimates in future years.

Tax expenditures arising from the 1996-97 Budget (including those affecting existing expenditures) and associated cost estimates are also included in this year's TES. In some cases these new measures have yet to be legislated. They have been included to ensure the tax expenditure estimates incorporate all measures included in the revenue estimates contained in the Mid-Year Economic and Fiscal Outlook.

- In the past, new tax expenditures have been included in the TES with a greater time lag (usually after they have been legislated), in part, because they only affect the out-year costs of the expenditure. These out-year costs are being incorporated in the TES for the first time this year and so it is important that all proposed tax expenditures are also included.

## Forward projections

Forward projections of individual tax expenditures are included in the TES for the first time and cover the years 1996–97 to 1999–2000. They have been provided to enable broad comparison with estimates for outlays over the next four years. This follows on from the publication of aggregate forward projections in the 1996–97 Budget papers. The inclusion of forward projections is consistent with the recommendations of the NCA and the requirements of the Charter of Budget Honesty.

The qualifications and caveats associated with costing tax expenditures (see Appendix C) assume greater importance in relation to the production of forward projections. Nevertheless, if these cautions are borne in mind, it is considered that fiscal analysis is aided by the publication of these forward projections.

The nature of tax expenditures is such that it is not possible to accurately forecast their cost (in many cases it is not even possible to provide reliable historical estimates). The forward projections presented in the TES are generally derived by extrapolating historical trends or applying broad growth factors (for example CPI); in others, such as the superannuation concessions, by more detailed modelling.

The forward projections include the effect on particular tax expenditures of measures announced in the 1996–97 Budget or subsequently (whether legislated or not at the time of writing this Statement).

## Benchmarks

There have been revisions to a number of benchmarks, which has led to either a reduction in the number of listed tax expenditures or changes in their cost estimates. This is most apparent with regard to the Capital Gains Tax (CGT), where the benchmark has been expanded to include many features, which are fundamental design features of the CGT, but which were previously identified as tax expenditures.

A new benchmark for the indirect tax system has been established to facilitate the listing, and future costing, of tax expenditures associated with the WST system.

Further details on issues associated with benchmarks, including changes to the CGT benchmark, are provided in Appendix A.

## Format changes

The presentation of information on individual items in this year's TES has been improved. Revenue estimates are now on the page facing the description of individual tax expenditures. This replaces the format introduced last year where the description and other associated material was listed in one table and the costings in a separate table, cross referenced by an index identifier.

In another change, tax expenditures associated with deferral of revenue, primarily accelerated depreciation, have been removed from the main tax expenditure list and placed in a separate table (Table 5). The cost of these measures has also been presented and aggregated separately from other tax expenditures.

This change is designed to reflect the fact that these tax expenditures affect only the time when revenue is received and not the total amount of revenue received over the life of the expenditure. In effect, the only absolute cost to the Budget (when considered over a number of years) of these expenditures reflects the time value of money, where revenue is received later than under the benchmark treatment.

These expenditures, however, do impact on actual revenue collections, and hence the Budget outcome in any given year. For example, there is a revenue cost in the early years of the tax expenditure's operation although this is usually offset in later years by a comparable revenue gain.

In order to assess the impact on a particular Budget year, the cost of the timing tax expenditures should be included. However, to obtain an indication of the absolute level of assistance provided through the tax system, they are best excluded (although for completeness you would ideally also include the Public Debt Interest costs of the timing expenditures). The new format of presenting, but separating, this information in the TES should facilitate such analysis.

The issue of tax expenditures involving deferral (rather than loss) of revenue is discussed further in Appendix C.

## Purpose and legal incidence of tax expenditures

The columns in the tax expenditure reference table in the 1994-95 TES dealing with 'Primary Purpose' and 'Taxpayer Affected' have been deleted from this year's TES. These changes were made in response to reader requests, to allow for an improved presentation of information on individual tax expenditures contained in Tables 4, 5 and 6 (as noted above).

The revenue impact by taxpayers affected is still summarised in Table 7.

## Estimates

It is generally easier for governments to estimate the cost of spending programmes than it is to estimate the revenue forgone as a result of concessional tax treatment. This has meant that many tax expenditures typically go uncosted, because the estimates are likely to be quite imprecise and only indicate broad orders of magnitude. Nonetheless, as with the publication of forward projections, tax policy decisions are better served by broad indications of the cost of a tax expenditure than none at all. Where an estimate is not available, policy decisions are made more difficult. In some cases, the cost to revenue of expenditures for which there is no tax return data has been estimated using census data or other official statistics.

This Statement continues the practice initiated in the 1990 TES of providing estimates of identified tax expenditures for the year in which the impact on revenue occurs. In Statements prior to 1990, most tax expenditures for income tax were costed on the basis of the income year in which use of the provision was made. This may differ from the year of impact on revenue because of lags in collection.

Historical data on the cost of tax expenditures has been provided for the years 1992-93 to 1995-96 and forward projections of the cost of tax expenditures for the current Budget year (1996-97) out to 1999-2000 are also provided.

## Fringe Benefits Tax Estimates

In interpreting the fringe benefits tax (FBT) estimates, it should be borne in mind that from 1 April 1994, FBT has been levied on the tax-inclusive value of fringe benefits; that is, subject to grossing up. As part of these arrangements, an income tax deduction is allowed for employers for FBT paid from 1 April 1994. However, this deduction generally impacts on employers in the following financial year. The estimates of FBT concessions for 1994-95 for taxable employers are therefore higher than the on-going level for these tax expenditures. The estimates for 1995-96 and forward projections for 1996-97 to 1999-2000 provide a better indication of the ongoing value of FBT concessions.

- Some categories of non-government, income tax exempt bodies are eligible for a rebate of FBT. Some other employers are exempt from FBT. Where tax expenditure items refer to FBT exemptions for particular categories of employers, the estimates are based on the gross cost of the exemption, not allowing for any rebate that might otherwise have been claimable.

## Revised Estimates

Some estimates of the revenue forgone for certain tax expenditures provided in Table 4 of this Statement represent significant revisions to estimates published in the 1994-95 TES. These are listed below. Index references refer to the 1995-96 TES with the 1994-95 indices in parentheses where they have changed since last year.

Unless otherwise noted, the revisions relate to the fact that more recent tax return data or other information has become available since last year's TES.

- *H6 ¾ FBT exemption for employees of State or Territory health authority who work at a public hospital.*

This has been revised downward by $40 million for 1993-94 to $60 million and downward by $85 million to $115 million for 1994-95. The change reflects a revision of the method for estimating the value of the tax expenditure.

- *SS3 ¾ pensioner and beneficiary rebates (for example, for age and service pensions, unemployment, sickness and special benefits).*

The 1992-93, 1993-94 and preliminary 1994-95 estimates have been revised downwards by $95 million, $260 million and $195 million respectively to $1215 million, $1270 million and $1365 million. The revisions reflect the adoption of an improved methodology for costing the tax expenditure.

- *SS8 ¾ Exemption of certain war-related pensions from tax.*

The estimates have been revised upwards in this Statement by $34 million for 1992-93, $38 million for 1993-94 and $41 million for 1994-95. The revisions reflect the adoption of an improved methodology for costing the tax expenditure.

- *SS9 ¾ exemption of certain social security pensions and benefits (for example, disability pensions and family allowances) and certain repatriation pensions from tax.*

The estimates for 1992-93, 1993-94 and 1994-95 have been revised downwards by $235 million, $260 million and $230 million respectively, reflecting the use of an improved method for estimating the value of the tax expenditure.

- *SS13 (SS14) ¾ superannuation and termination payment concessions.*

The estimate has been revised upward for 1992-93 by $565 million, downward for 1993-94 by $720 million and downward for 1994-95 by $1.5 billion, reflecting changes to the method used for calculating the value of the concessions. The differences relate primarily to changes in the assumed collection timetable for tax from funds, a revised approach to estimating fund earnings, and updated data. The estimates for superannuation are discussed in more detail in Appendix B.

- *SS24 (SS29) ¾ taxation of lump sum payments for unused annual and long service leave accrued after 15 August 1978.*

The preliminary 1994-95 estimate has been revised downward by $80 million.

- *SS25 (SS30) ¾ taxation of unused long service leave accrued before 15 August 1978.*

The preliminary 1994-95 estimate has been revised downward by $90 million.

- MM4 (IA18) ¾ *exemption of income from sale, transfer or assignment of certain mining rights*

The previous estimates of less than $1 million for 1992-93, 1993-94 and 1994-95 have been revised upwards to $40 million for each of these years.

- *MM6 (IA30) ¾ general investment allowance.*

The 1993-94 estimate has been revised downward by $30 million.

- *NAF13-NAF14 (NAF18-NAF19) certain interest withholding tax (IWT) concessions.*

The preliminary 1994-95 estimate has been revised upward by $81 million to $753 million.

- *OEA14 (IA69) statutory formula method for calculating the FBT taxable value of cars.*

The 1993-94 and 1994-95 estimates have been revised downwards by $100 million and $200 million respectively to $400 million and $800 million, reflecting a revised method for calculating the value of the tax expenditure.

# Trends in Tax Expenditures

Table 1 provides the estimated cost of functional category aggregates, and the total annual aggregates, for the fiscal years 1994-95 to 1995-96, and projections for the outyears 1996-97 to 1999-00. Care must be taken when interpreting these aggregates, particularly when making comparisons across time. There are several major considerations in analysing tax expenditure aggregates.

- First, many of the identified expenditures are not costed because of a lack of suitable data. In addition, those associated with the wholesales sales tax system were not able to be costed for this year's TES.

- Second, estimates have not been consistently provided over time. Some tax expenditures have been costed for only a few of the fiscal years that they have actually been part of the tax system. For example, the 1996 TES includes for the first-time estimates relating to the excise exemption applying to 'alternative' transport fuels which has been in place for some years. Changes in aggregates over time will therefore reflect both changes in the cost of individual tax expenditures, and changes in the coverage of the tax expenditures being costed.

- Third, changes over time in methodology and available data used for calculating the cost of particular expenditures means that there can be quite large revisions to tax expenditure estimates. Therefore numbers provided in previous TESs may not be strictly comparable to figures in more recent publications. This may affect the usefulness of comparing costs over a longer period of time than covered in any single TES.

- Fourth, the introduction of forward projections for the outyears adds an additional element of uncertainty when trying to draw strong conclusions on longer term trends.

## Tax Expenditures 1995-96

Table 1 shows that the net cost of aggregate tax expenditures which provide a permanent benefit or penalty to taxpayers, has remained stable at around $16.2 billion between 1994–95 and 1995–96.

- When account is also taken of so-called 'timing' tax expenditures, which merely defer tax collections to a later date, the Budget impact is around $17.3 billion in 1995-96, compared to $17.0 billion in 1994-95. This increase reflects the growth in the cost of one accelerated depreciation allowance (AD8).

The aggregates for the functional categories have remained fairly flat between 1994-95 and 1995-96, except for mining, manufacturing and construction. However, within these functional categories, there were some significant changes in individual tax expenditures. These are discussed below.

- The cost to revenue of H5, relating to non-profit health funds, declined 42 per cent from $67 million to $39 million due to a decline in the net income of health funds.

- The cost of tax expenditure SS4–SS6, dependent spouse rebate (DSR) and other rebates, declined from $1115 million to $594 million because of the introduction of the Home Child Care Allowance (HCCA) at the end of September 1994. This Allowance replaced the with-child DSR for most eligible recipients. The HCCA was incorporated in the Parenting Allowance (PA) when the PA commenced on 1 July 1995. The projected decline in the DSR and similar rebates from $594 million in 1995-96 to $354 million in 1996-97 reflects the operation of the HCCA for approximately 9 months of the 1994-95 income year compared to the operation of the PA for the whole of the 1995-96 income year.

- Tax expenditure FE1, the excise exemption for alternative transport fuels, grew by 18 per cent from $410 million to $485 million because of strong forecast growth in the use of alternative fuels for transport, particularly liquefied petroleum gas and natural gas.

- AFF5, the income tax averaging for primary producers, grew 36 per cent from $98 million to $133 million due to fluctuations in primary production income over the averaging period.

- The cost of tax expenditures associated with mining, manufacturing and construction fell modestly in 1995–96.

  – This reflected a fall in the general investment allowance (MM6), which declined 55 per cent from $445 million to $200 million due to cessation of the allowance for equipment bought after 30 June 1994. This was offset somewhat by a 17 per cent ($110 million) rise in the research and development tax concession (MM14).

- OEA4, the exemption of interest received from credit unions declined 60 per cent from $45 million to $18 million because the exemption was removed from credit unions with assets greater than $30 million from 1 July 1994. The revenue impact of this change was experienced in the 1995-96 financial year.

- The 19 per cent decline in OEA14, the FBT statutory formula for car benefits, relates to the revenue impact of FBT deductibility following the introduction of 'grossing up'. This was discussed in more detail on page 6.

## Forward projections

It is projected that the cost of tax expenditures (excluding timing measures) will rise from $16.2 billion in 1995–96 to $18.9 billion in 1999–00.

The major functional category growth in the outyears is projected to be in the area of social security and welfare. This reflects growth in the cost of superannuation and termination tax concessions, other concessions for recipients of various pensions and benefits, and measures announced in the 1996–97 Budget.

Assistance to mining, manufacturing and construction is projected to fall after 1996-97 primarily reflecting a tightening in the R&D tax concession and a winding down in the Development Allowance, which peaks in 1996-97 as eligible projects must have commenced before 1 July 1996.

The Health category is also projected to rise in future years, largely as a result of increases in the cost of the Medical Expenses Rebate and the commencement of private health initiatives announced in the 1996-97 Budget.

## Table 1: Aggregate Tax Expenditures by Functional Category 1994-95 to 1999-00[a]

| Functional Category | Revenue Cost ($m) 1994-95 | 1995-96 | 1996-97 | 1997-98 | 1998-99 | 1999-00 |
|---|---|---|---|---|---|---|
| Total General Public Services | | | | | | |
| A. Legislative and Executive Affairs | <1 | <1 | < 1 | <1 | <1 | <1 |
| B. Financial and Fiscal Affairs | nil | nil | nil | nil | nil | nil |
| C. Foreign Economic Aid | 113 | 128 | 140 | 155 | 170 | 187 |
| D. General Research | 10 | 10 | <1 | <1 | nil | nil |
| E. General Services | 4 | 5 | 5 | 5 | 5 | 5 |
| F. Govt Superannuation Benefits | nil | nil | nil | nil | nil | nil |
| Defence | 56 | 60 | 67 | 67 | 72 | 76 |
| Public Order and Safety | nil | nil | nil | nil | nil | nil |
| Education | 28 | 28 | 29 | 29 | 30 | 31 |
| Health | 482 | 427 | 545 | 607 | 744 | 812 |
| Social Security & Welfare | 10791 | 10961 | 10949 | 11578 | 12408 | 12873 |
| Housing & Community Amenities | 160 | 162 | 164 | 167 | 170 | 174 |
| Recreation and Culture | 24 | 20 | 20 | 20 | 20 | 20 |
| Fuel and Energy | 410 | 485 | 515 | 580 | 640 | 710 |
| Agriculture, Forestry and Fishing | 213 | 272 | 312 | 310 | 311 | 314 |
| Mining and Mineral Resources other than fuels; Manufacturing; and Construction | 1548 | 1425 | 1772 | 1068 | 890 | 965 |
| Transport and Communication | 40 | 25 | 25 | 25 | 25 | 25 |
| Total Other Economic Affairs | | | | | | |
| A. Tourism and Area Promotion | 65 | 60 | 70 | 75 | 80 | 80 |
| B. Labour and Employment Affairs | 21 | 19 | 19 | 19 | 19 | 19 |
| C. Other Economic Affairs, nec | 912 | 734 | 762 | 791 | 977 | 1023 |
| Total Other Purposes | | | | | | |
| A. Public Debt Interest | nil | nil | nil | nil | nil | nil |
| B. General Purpose Inter-Govt Transactions | nil | nil | nil | nil | nil | nil |
| C. Natural Disaster Relief | nil | nil | nil | nil | nil | nil |
| D. Contingency Reserve | nil | nil | nil | nil | nil | nil |
| E. Asset Sales | nil | nil | nil | nil | nil | nil |
| Not Allocated to Function | 1284 | 1335 | 1347 | 1402 | 1513 | 1623 |
| Total | 16161 | 16156 | 16741 | 16898 | 18074 | 18937 |
| Timing Measures(b) | 870 | 1108 | 1305 | 1404 | 1493 | 1601 |
| Total (including timing measures) | 17031 | 17264 | 18046 | 18302 | 19567 | 20538 |

nec Denotes not elsewhere classified.
<1 Denotes less than $1 million.
(a) Aggregate cost of tax expenditures in functional categories is derived by summing the individual tax expenditure costings provided in Table 4, excluding items listed as costed at <1 or <5, etc.
(b) Timing measures involve deferral of revenue and are described and costed in Table 5.

# Comparison with Direct Outlays

Estimates and forward projections for aggregate tax expenditures and Commonwealth outlays for the period 1992-93 to 1999-2000 are provided in Table 2. In Table 3, the costs of identified tax expenditures in 1995-96 are compared with direct outlays by functional category consistent with the presentation in Budget Statement 3 of the 1996-97 Budget Paper No. 1.

The comparisons between tax expenditures and direct outlays shown in Tables 2 and 3 are informative in broad terms, however the costings are not strictly comparable. While most tax expenditures could, in principle, be replaced by a direct outlay, the tax expenditure estimates refer to revenue forgone, which is not necessarily the size of a direct outlay equivalent. For example, where a direct outlay is taxable, the amount of the gross direct outlay required to provide net assistance to a beneficiary equivalent to that provided by a tax expenditure would have to exceed the tax expenditure by the amount of the tax liability arising on the direct outlay.

From a public policy perspective, the size of the estimated tax expenditures relative to outlays is of interest, especially as the measured aggregate is likely to be an underestimate of the actual cost of concessions in the tax system. As noted by the National Commission of Audit, tax expenditures are not normally subject to the same annual scrutiny as are outlays. They can, however, have similar economic effects as outlays, and this should be taken into consideration when formulating government policy.

Table 2 shows that the budgetary cost of total measured tax expenditures has increased by around 29 per cent between 1992-93 and 1995-96, compared to a 16 per cent increase in Commonwealth budget outlays over the same period.

- They are projected to increase a further 17 per cent between 1995-96 and 1999-2000, although these forward projections are subject to significant uncertainty.

The aggregate level of tax expenditures, presented in Table 2, differs quite significantly from the same table published in Appendix B of Budget Statement 4 in the 1996-97 Budget Paper No.1. For example, the 1995-96 aggregate is around $900 million lower than previously published, of which around half relates to a revised estimate for superannuation. This difference rises to about $1.4 billion in 1996-97, but falls to about $500 million at the end of the forward projection period.

- The differences are a result of updated data, changed costing methodologies, revised economic parameters, and the identification and costing of more tax expenditures in the 1995-96 TES.

Table 2: Aggregate Tax Expenditures and Direct Outlays 1992-93 to 1999-00

| Year | Superannuation ($m) | Other tax expenditures ($m)(a) | Total ($m) | Budget outlays total ($m) | Ratio of tax expenditures to outlays (per cent) |
|---|---|---|---|---|---|
| 1992-93 | 5780 | 6749 | 12529 | 109586 | 11.4 |
| 1993-94 | 7765 | 8144 | 15909 | 114366 | 13.9 |
| 1994-95 | 5770 | 10391 | 16161 | 121992 | 13.2 |
| 1995-96 | 6290 | 9866 | 16156 | 126661 | 12.8 |
| 1996-97 (est) | 6250 | 10491 | 16741 | 131493 | 12.7 |
| 1997-98 (est) | 6450 | 10448 | 16898 | 128876 | 13.1 |
| 1998-99 (est) | 6985 | 11089 | 18074 | 141354 | 12.8 |
| 1999-00 (est) | 7325 | 11612 | 18937 | 149592 | 12.7 |

(a) This aggregate does not include timing measures.

The estimates presented in Table 3 indicate that revenue forgone through measured tax expenditures was much less than the cost of direct outlays for most functional classifications but very significant in absolute terms. In aggregate, net measured tax expenditures are valued at about $16.2 billion or 12.8 per cent of Commonwealth Budget outlays.

Table 3 shows that most tax expenditures are classified as being related to Social Security and Welfare (this category includes the superannuation tax concessions).

- Around 20 per cent of total assistance to this area is provided through tax expenditures.

It also highlights significant assistance: in the form of tax relief; provided to the two business and industry categories Mining etc, and Other Economic Affairs. Many tax expenditures could not be classified as belonging to any of the functional categories and are aggregated in the Not Allocated to Function category.

## Table 3: Aggregate Tax Expenditures and Direct Outlays by Functional Category 1995-96

| Functional Category | Tax Expenditures Cost ($m)(a) | Direct Outlays Cost ($m) |
|---|---|---|
| Total General Public Services | | |
| A. Legislative and Executive Affairs | <1 | 594 |
| B. Financial and Fiscal Affairs | nil | 1690 |
| C. Foreign Economic Aid | 128 | 2268 |
| D. General Research | 10 | 1081 |
| E. General Services | 5 | 223 |
| F. Govt Superannuation Benefits | nil | 946 |
| Defence | 60 | 10011 |
| Public Order and Safety | nil | 927 |
| Education | 28 | 10644 |
| Health | 427 | 18634 |
| Social Security & Welfare | 10961 | 46707 |
| Housing & Community Amenities | 162 | 1205 |
| Recreation and Culture | 20 | 1416 |
| Fuel and Energy | 485 | 37 |
| Agriculture, Forestry and Fishing | 272 | 1876 |
| Mining and Mineral Resources other than fuels; Manufacturing; and Construction | 1425 | 1651 |
| Transport and Communication | 25 | 754 |
| Total Other Economic Affairs | | |
| A. Tourism and Area Promotion | 60 | 104 |
| B. Labour and Employment Affairs | 19 | 3897 |
| C. Other Economic Affairs, nec | 734 | 309 |
| Total Other Purposes | | |
| A. Public Debt Interest | nil | 9126 |
| B. General Purpose Inter-Govt Transactions | nil | 13798 |
| C. Natural Disaster Relief | nil | -4 |
| D. Contingency Reserve | nil | nil |
| E. Asset Sales | nil | -1230 |
| Not Allocated to Function | 1335 | nil |
| Total(b) | 16156 | 126661 |

nec Denotes not elsewhere classified.
<1 Denotes less than $1 million.
(a) Aggregate cost of tax expenditures in functional categories is derived by summing the individual tax expenditure costings provided in Table 4 (deferral expenditures are not included).
(b) Items may not sum to totals due to rounding.

# Tax Expenditure Tables

Information on tax expenditures including estimates of the cost to revenue — for the fiscal years 1992-93 to 1999-2000 — is presented as follows:

Table 4: Tax Expenditures Reference Table
Table 5: Tax Expenditures Involving Deferral
Table 6: Tax Expenditures — Wholesales Sales Tax
Table 7: Tax Expenditures Classified by Taxpayer Affected

## The Tax Expenditures Reference Tables

Tables 4 and 5 provide information about each identified expenditure. This information includes: the year in which each measure was introduced; a description of each expenditure; and its estimated revenue cost (where available). Revenue estimates are not yet available for expenditures associated with the wholesale sales tax system listed in Table 6.

The columns and their function are described below.

- The 'Index' column associates each expenditure with an identifier for easy reference, and cross referencing to Table 7.

- The 'Date' column provides the year that the legislation was given royal assent, which may be different from the year that the expenditure would first impact on taxpayers' tax liabilities.

- The 'Description' column describes each expenditure and, where possible, provides a legislative reference. The following abbreviations have been used in the descriptions column: capital gains tax (CGT); fringe benefits tax (FBT); dividend withholding tax (DWT); and interest withholding tax (IWT). All expenditures relate to the personal or corporate income tax system unless otherwise identified in the description (eg by CGT, FBT, IWT, DWT, or Excise duty). Legislative references for all income tax, CGT, IWT and DWT expenditures relate to the *Income Tax Assessment Act 1936*. Legislative references for FBT expenditures relate to the *Fringe Benefits Tax Assessment Act 1986*. Other Acts of Parliament are included in the descriptions where necessary.

## Deleted Tax Expenditures

Tax expenditures which were included in the 1994-95 TES, but which are not identified in the 1995-96 TES are listed below categorised by reason for deletion. A short description of the expenditure is followed, in parentheses, by its index reference from last year’s TES.

### Deleted because the CGT benchmark was expanded to include these measures:

- CGT rollover on taxpayer’s death (SS20);
- CGT rollover on marital breakdown (SS21);
- CGT exemption for motor vehicles and other personal use assets (NAF11);
- CGT averaging of tax liability (NAF12);
- CGT exemption for assets acquired before 20 September 1985 (NAF13);
- Indexation of the cost base for CGT (NAF14);
- CGT exemption for gains due to compensation or damages for injury suffered (NAF15);
- CGT exemption of gains from gambling (NAF16);
- CGT non-deductibility of net capital loss (NAF17); and
- Certain minor technical amendments to the CGT (IA63).

### Deleted because the measure has been abolished and/or its effect on revenue has ceased:

- Exemption of open employment incentive bonus for handicapped persons (SS13);
- Exemption of income of the Thalidomide Foundation (SS18);
- Home loan interest rebate (HC1);
- Restriction on negative gearing of rental property (HC3);

- Immediate deduction for fences for specific disease control (IA3);
- Special deduction for certain capital expenditures in relation to land (IA6);
- Exemption of income of Wool Testing Authority (IA13);
- Exemption of income from gold mining (IA17);
- Rebate for subscriptions to petroleum mining companies (IA19);
- Exemption of income of Phosphate Mining Company of Christmas Island (IA20);
- Immediate deduction for subscriptions for shares in Management and Investment Companies (IA43);
- Exemption of income of trustee savings banks (IA47);
- Concession for capital expenditure on buildings for eligible scientific research (IA51); and
- Concession for other capital expenditure relating to eligible scientific research (IA53).

### Deleted because Departure Tax was replaced by the Passenger Movement Charge on 1 July 1995:

- Various Departure Tax concessions (FA10; LO1; SS28; IA59; NAF38; NAF39; and NAF40).

## New Tax Expenditures

Tax expenditures identified for the first time in the 1995-96 TES are listed below with a short description followed, in parentheses, by its index reference from this year's TES.

### Added because the measure has recently been identified as a tax expenditure:

- Exemption of income of visitor representatives of educational and certain other societies (FA3);

- Exemption of income of foreign press visitors (FA4);
- Exemption from Foreign Tax Credit System of certain non-portfolio dividends and branch income (FA6);
- Exemption of some income of CFC'S and transferor trusts in listed countries (FA7);
- CGT exemption, General Practice Rural Incentives programme (H9);
- CGT exemption, disposal of a licence to occupy a unit (HC4);
- Exemption of income from Film Finance Corporation (CR8);
- CGT exemption, Cultural Bequests programme (CR9);
- Excise exemption for 'alternative fuels' (FE1);
- Excise free status of wine, cider and other alcoholic drinks (AFF13);
- Depreciation to nil rather than scrap value (MM15);
- CGT exemption, cost base of trusts (OEA9);
- Exemption of income of foreign superannuation funds (OEA11);
- IWT half exemption for notional interest of foreign bank branches (OEA15);
- DWT exemption of dividends of PDF's (OEA16);
- Apportionment of undeducted purchase price of a pension (OEA17);
- Income from segregated pension assets not taxable in the hands of a superannuation fund (OEA18);
- Exemption of income of a State/Territory body (NAF10); and
- Various exemptions associated with the Wholesale Sales Tax system (see Table 6).

Added because the tax expenditure is a measure proposed (and in some cases legislated) since the 1994-95 TES:

- Private health insurance rebates (H10);

- CGT exemption for the sale of small business where proceeds used for retirement (SS26);
- Spouse superannuation contributions rebate (SS27);
- Rebate for low income aged persons (SS28);
- Increase in tax-free thresholds for families (SS29);
- Taxation allowance for drought preparedness assets (AFF11);
- Deduction for capital expenditure, horticultural plantations (AFF14);
- Increase in FBT exemption for remote area housing for primary production employees (AFF15);
- Concessional CGT treatment of demutualisations (OEA10); and
- CGT rollover relief for sale of small business (OEA21).

# Tax Expenditure Tables

Table 4: Tax Expenditures Reference Table[a]

Table 4: Tax Expenditures Reference Table

Table 4: Tax Expenditures Reference Table (continued)

Table 4: Tax Expenditures Reference Table (continued)

Table 4: Tax Expenditures Reference Table (continued)

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Table 4: Tax Expenditures Reference Table (continued)

Table 4: Tax Expenditures Reference Table (continued)

Table 4: Tax Expenditures Reference Table (continued)

Table 4: Tax Expenditures Reference Table (continued)

Table 4: Tax Expenditures Reference Table (continued)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| na | <5 | <5 | <5 | <5 | <5 | <5 | <5 |

Table 4: Tax Expenditures Reference Table (continued)

Notes

\- Denotes the expenditure had not commenced operation.

nec Denotes not elsewhere classified.

<X Denotes revenue cost is less than X million dollars.

na Denotes estimate of revenue cost is not available.

(a) 1995-96 figures are preliminary only and are subject to revision on receipt of tax data for 1995-96. Figures for 1996-97 to 1999-2000 are projections based on currently available information.

(b) The date of effect of this tax expenditure depends on the date on which the double tax agreement takes effect.

(c) Norfolk Island is basically self-supporting. The only contributions by the Commonwealth are of a one-off nature eg a dollar-for-dollar grant for a water and sewerage scheme.

(d) In the case of living-away-from-home allowances and living allowances paid to Defence Force personnel, the benchmark is defined to be compensation for the actual additional costs faced by employees in living away from their homes. On this view, the tax expenditure relates solely to any excess over such a component.

(e) Denotes item referring to Australian-source income of non-residents.

(f) Includes invalid relative rebate, parent or parent-in-law rebate and superannuation pension or annuity rebate.

(g) Includes invalid relative rebate and parent or parent-in-law rebate.

(h) The Medicare levy in 1996-97 has been raised from 1.5 to 1.7 per cent to fund the costs associated with the gun buyback scheme (the gun levy). It is assumed the revenue impact of exemption from the gun levy is experienced in 1997-98.

(i) Recent measure, yet to be legislated.

(j) Revised estimates- see Attachment B.

(k) Figure represents maximum possible cost of the concessional tax treatment of the schemes.

(l) The tax expenditure element here refers to the exemption of income not related to the application of the mutuality principle; ie, from trading with non-members and investment income.

(m) Based on estimates and projections of fuel use for road transport published by ABARE in *Australian Energy Consumption and Production* (February, 1995). Calculated on equivalent unit of energy basis. All natural gas used assumed to be liquefied natural gas.

(n) The tax expenditure element relates to the difference between the standard specified values and market value.

(o) Equal to annual average value of the tax expenditure for the period 1994-95 to 1996-97.

(p) Revised estimate.

(q) The IED scheme allows primary producers to make deposits that are tax-deductible upon deposit but assessable on withdrawal. A negative expenditure may thus occur in a year when farmers make a net withdrawal from the scheme. The main effect of this scheme is to allow a tax deferral, but tax will be reduced to the extent that deposits are made in high income, high marginal tax rate years but withdrawn in years of low income and low marginal tax rates. In the long run, the real value of the concession for farmers will be the sum of each year’s estimate.

(r) The method of estimating the cost to revenue of the Infrastructure Borrowing tax expenditure is currently being reviewed.

(s) The general (that is, non-syndicated) R&D tax concession provides both immediate deductibility of capital expenditure and premium deductions over 100 per cent for eligible expenditures. The tax expenditure estimates provided relate only to the revenue cost of premium deductions for R&D under the general concession. No estimate is made of the cost of the bring forward of capital deductions. As a result, the estimates provide a lower limit to the revenue cost of the tax expenditure on R&D against a benchmark of amortisation of eligible expenditures over time.

(t) This exemption was removed from the beginning of the 1994-95 income year for credit unions with gross balance sheet assets of $30 million or more and for other credit unions from the 1995-96 income year. Taxation will be at the concessional rate of 20 per cent until the beginning of the 1997-98 income year at which time the full corporate rate will apply. Concessional rates of taxation will be provided for credit unions with low levels of notional taxable income.

(u) The term 'declared rate' (also referred to elsewhere as the 'benchmark rate') is used to refer to the rate declared by the Commissioner of Taxation for the purpose of determining FBT liability for loan benefits.

(v) This estimate is derived from donations claimed on individuals' returns only. Donations made by companies, partnerships and trusts are not included. This estimate will therefore significantly understate the true cost to revenue of the concession.

Sources: Unless otherwise specified, Australian Taxation Office, Australian Customs Service, or the Treasury.

Table 5: Tax Expenditures Involving Deferral[(a)]

Table 5: Tax Expenditures Involving Deferral

## Table 5: Tax Expenditures Involving Deferral (continued)

na Denotes estimate of revenue cost is not available.

(a) 1995-96 figures are preliminary only and are subject to revision on receipt of tax data for 1995-96. Figures for 1996-97 to 1999-2000 are projections based on currently available information.

(b) It is not possible to provide estimates for these expenditures. Figures published in previous TESs cannot be continued into the outyears because of data limitations.

(c) The revenue impact does not include any clawback from reducing the cost base for CGT purposes by the amount of the concession claimed.

(d) Revised estimate.

Table 5: Tax Expenditures Involving Deferral (continued)

Table 6: Tax Expenditures — Wholesale Sales Tax

| Index | Description[(a)] |
|---|---|
| WST1 | Goods ordinarily used as raw materials in the construction or repair of buildings, fixtures or structures or other works that are attached to land, other similar materials and electrical fittings (Items 39-49). |
| WST2 | Piping, tubing, channelling and guttering for use by a person mainly for the purposes of irrigation, water supply, drainage or sewerage, other associated materials and water tanks (Items 50-54). |
| WST3 | Hydraulic power and electric current, goods for purifying or compressing natural gas, and goods for generating or storing gas or electricity in residential premises (Items 56, 57A and 58). |
| WST4 | Certain transportation related items including ships, aircraft, public railways, passenger buses and public transport authorities as specified (Items 59-64). |
| WST5 | Primary products derived directly from prescribed activities in Australia that have not been subject to any process or treatment resulting in an alteration of their form, nature or condition (Items 65-67). |
| WST6 | Food and drink for human consumption or as ingredients of such food, including tea, coffee and milk products. (Items 68-74). |
| WST7 | Clothing and footwear for human wear including fastners and materials for repair of such goods (Items 75-77). |
| WST8 | Goods related to human health and hygiene. These include, drugs and medicines, surgical and dental instruments, ambulances, spectacles, cotton wool, bandages, toothbrushes, contraceptives, sunscreens, sanitary pads, nappies and goods for the use of disabled persons (Items 78-99). |
| WST9 | Books, printed matter and paper, including pamphlets, leaflets periodicals, magazines, newspapers, manuscripts, stamps and goods made from recycled paper (Items 100-108). |
| WST10 | Scientific and educational goods for use by a school, university or associated bodies (Items 109-114). |
| WST11 | Works of art, museum exhibits, and imported collector pieces, paintings, sculptures and antiques (Items 115-119). |
| WST12 | Public monuments and memorials, defence service honour boards, tombstones, imported trophies, and miniatures of specific awards (Items 120-124). |
| WST13 | Goods for use by Commonwealth, State, Territory and Local Governments, including authorities completely controlled by them. Imported goods used for official purposes by the Governor-General, State Governors and their families. Goods for the use of state libraries, museums, art galleries, and grain storage authorities (Items 125-130). |
| WST14 | Goods for the use of foreign Governments (excluding goods for the use of diplomatic missions, consular posts and trade commissioners). Goods produced by a foreign tourist promotion agency. Certain goods used by armed forces serving in Australia (Items 131-139). |

Table 6: Tax Expenditures — Wholesale Sales Tax (Continued)

| Index | Description[(a)] |
|---|---|
| WST15 | Goods for use by a public or non-profit hospital, a public benevolent institution or a public body established and maintained principally for the relief of unemployed persons including associated fund raising bodies. Goods for the use of medical research bodies, accident prevention bodies, exempt child care bodies, zoos and armed forces support bodies (Items 140-147). |
| WST16 | A wide range of miscellaneous goods as specified in the *Act*, including wedding rings, prams, coffins, coth on the roll, leather, fertilisers, solar energy equipment, water, ice, national flags, goods for donation and loan to an always-exempt person or a foreign Government. (Items 148-184, 186-187, and 189-195). |

(a) Item references refer to Schedule One of the *Sales Tax (Exemptions and Classification) Act 1992*.

## Tax Expenditures by Taxpayer Affected

This section provides a broad indication of the recipients of assistance through tax expenditures. Despite the difficulties in determining the final beneficiary of the assistance, the purpose of this analysis is to provide an overall picture of the direction of tax expenditures.

For the purpose of this analysis the classification of 'Taxpayer Affected' is by the legal incidence of the tax. Legal incidence should not be confused with the economic incidence of a tax measure. Legal incidence refers to the taxpayer upon whom the tax is levied. In contrast, the economic incidence of a tax relates to the taxpayer who bears the economic impact of the tax, that is, whose behaviour is changed by the imposition of the tax or concession. Economic incidence will differ from legal incidence if the group bearing the legal incidence transfers the tax expenditure to someone else.

- For instance, the legal incidence of a tax expenditure may be on the manufacturer of a product. However, the economic incidence may actually fall on consumers of the product via a change in price.

The taxpayer aggregates in Table 7 consist of the expenditures listed below, covering those items for which costings are available (excluding deferral expenditures). Descriptions and costings of each expenditure are provided in Table 4.

**Businesses** (GR1, CR2-3, AFF12, OEA2, OEA8, OEA21, MM1-6, MM12, MM14, FE1);
**Defence force personnel, including veterans and their families** (D1-D2, D6, D10, SS8);
**Donors to approved organisations** (NAF11);
**Employees** (SS24-SS25);
**Employers** (LE3, TC1, TAP1, AFF15, OEA14, NAF22);
**Financial Institutions** (OEA3-5);
**Government** (NAF9);
**Hospitals and State and Territory Authorities** (H6);
**Superannuation beneficiaries** (SS13, SS26-27, OEA26);
**Non-profit organisations** (H5, NAF15, NAF17, SS21);
**Personal income taxpayers** (FA8, GS1, H1-3, H10, SS1-7, SS9, SS14-15, SS28-29; HC1);
**Property owners** (OEA1);
**Primary producers** (AFF1, AFF3-5, AFF7-9, AFF11, AFF14);
**Students** (E1);
**Miscellaneous** (H8-9, NAF13-14, FA9-10, OEA15).

## Table 7: Tax Expenditures Classified by Taxpayer Affected

| Taxpayer | 1992-93 $m | 1993-94 $m | 1994-95 $m | 1995-96 $m | 1996-97 $m | 1997-98 $m | 1998-99 $m | 1999-00 $m |
|---|---|---|---|---|---|---|---|---|
| Businesses | 952 | 1165 | 2020 | 1975 | 2344 | 1701 | 1785 | 1946 |
| Defence | 355 | 349 | 361 | 394 | 417 | 421 | 436 | 448 |
| Donors | 0 | 160 | 169 | 184 | 196 | 206 | 216 | 227 |
| Employees | 584 | 580 | 380 | 370 | 360 | 355 | 345 | 340 |
| Employers | 14 | 502 | 956 | 774 | 804 | 849 | 884 | 914 |
| Financial institutions | 111 | 91 | 86 | 50 | 55 | 58 | 11 | 11 |
| Government | 0 | 0 | 130 | 125 | 145 | 150 | 160 | 165 |
| Hospitals | 0 | 60 | 115 | 120 | 125 | 130 | 135 | 140 |
| Superannuantion beneficiaries | 5780 | 7765 | 5770 | 6290 | 6250 | 6450 | 7000 | 7340 |
| Non-profit organisations | 73 | 191 | 339 | 336 | 335 | 355 | 365 | 385 |
| Personal income taxpayers | 4006 | 4259 | 4987 | 4613 | 4737 | 5218 | 5633 | 5819 |
| Property owners | 2 | 3 | 4 | 5 | 6 | 6 | 7 | 7 |
| Primary producers | 85 | 193 | 207 | 266 | 306 | 294 | 300 | 303 |
| Students | 19 | 21 | 28 | 28 | 29 | 29 | 30 | 31 |
| Miscellaneous(a) | 548 | 570 | 609 | 626 | 632 | 676 | 767 | 861 |
| Total(b) | 12529 | 15909 | 16161 | 16156 | 16741 | 16898 | 18074 | 18937 |

(a) Expenditures included in the 'Miscellaneous' category are those for which the 'Taxpayer Affected' does not belong to any of the other identified categories.

(b) Totals do not include any contribution from items which were costed as being 'less than' in Table 4 (eg <1, <5).

# Conceptual Issues

The decision as to the appropriate benchmark for determining tax expenditures is a matter for judgement: benchmarks may vary across countries and within countries over time. The principal criterion of benchmark design is that it should represent the neutral taxation treatment of similarly placed activities or classes of taxpayer (that is, neutral taxation treatment neither favours nor disadvantages similarly placed activities or classes of taxpayer).

This typically implies a taxation system with a comprehensive base. Because the tax bases relevant to the vast majority of Australian taxes are based on a definition of income which refers to an accretion in economic wealth (rather than, say, a consumption derivative) the Schanz-Haig-Simons definition of income is used as a starting point for the ideal benchmark. This essentially defines income as the increase in net economic wealth between two points of time plus consumption during that period, where consumption includes all expenditures except those incurred as a cost in the earning or production of income.

In Australia we also adopt the individual as the tax unit for income tax and this feature is adopted as part of the benchmark.

Departures from the ideal benchmark would be a practical necessity under any operational income tax system. Such departures involve taxing income derived from particular activities in a manner which departs from the conceptual ideal (such as the taxation of realised as opposed to accrued capital gains) or excluding certain types of income from the income tax base altogether (for example, the non-taxation of imputed rent from consumer durables and the non-deductibility of expenses incurred in earning that income) because it would not be feasible administratively to tax them. In addition, certain provisions relating to the taxation of foreign source income (such as the quarantining of foreign losses) are necessary to prevent the erosion of the domestic tax base and to protect the integrity of the Australian tax system. Accordingly, provisions which are intrinsic to the operation of the tax system but which nevertheless may depart from the ideal income tax benchmark have been incorporated into the benchmark for this Statement.

In some instances adherence to the ideal benchmark may be ruled out on pragmatic grounds and a comprehensive and achievable alternative to the existing taxation system may not be available. In such cases an interim benchmark which accepts the existing system and identifies deviations from it as tax expenditures has been adopted. For example, prior to 1987-88 when the classical system of company taxation operated, no tax expenditures were identified in relation to the treatment of distributed and undistributed income even though it departed significantly from the ideal benchmark. With the introduction of the imputation system of company taxation from 1 July 1987, imputation was incorporated into the benchmark from the 1987-88 income year.

It follows that benchmarks may change over time. This approach recognises that the treatment of ideal tax benchmarks needs to be tempered to ensure that the analysis of tax expenditures remains relevant.

Practical difficulties inevitably attach to the definition of a benchmark tax structure. It is difficult to ascertain whether some tax provisions should be part of the benchmark structure or listed as tax expenditures. This Statement generally lists as tax expenditures items for which such a categorisation is judged to be marginal.

Although the above discussion focuses upon the income tax benchmark, the broad issues of benchmark design identified are equally relevant for the other heads of Commonwealth taxation such as wholesale sales tax, fringe benefits tax and excise duty.

## Income Tax Benchmark

The benchmark adopted has the following characteristics:

- The legislated progressive personal income tax rate scale, including the tax-free threshold is part of the benchmark.

- The individual is the tax unit under the income tax system and this feature is adopted as part of the benchmark. Tax expenditures are thus deemed to arise where taxpayers' liabilities are modified according to their dependant-care responsibilities.

- A single tax year is adopted as the accounting period under the benchmark structure. Accordingly, averaging provisions available only to selected classes of taxpayer are regarded as tax expenditures. However, carry-forward loss provisions are considered to fall within the benchmark.

- Consistent with practice in Australia, a nominal income benchmark is adopted in this Statement with some ad hoc adjustments for inflation. (Adoption of a real income benchmark would require the identification — as (generally negative) tax expenditures — of all aspects of the tax system which do not adjust the measurement of income for inflation.)

- An exception to this is in relation to capital gains tax, where the taxation of real gains on assets held for more than 12 months is an intrinsic feature of the capital gains tax system and is therefore included in the benchmark. The following intrinsic features are also included in the benchmark:

  – CGT exemption for gains on the disposal of motor vehicles, and on each other personal-use asset with disposal value of less than $10,000;

  – CGT exemption for gains on assets acquired prior to 20 September, 1985;

  – CGT exemption for gains received by way of compensation or damages for any wrong or injury suffered by a taxpayer;

  – CGT exemption of gains or winnings from gambling;

  – CGT rollover reliefs on the death of a taxpayer, the involuntary disposal of an asset, or the transfer of assets between spouses upon breakdown of marriage; and

  – CGT averaging of tax liabilities.

- Although assessment of income on an accruals basis is the general benchmark, those provisions where income is assessed on a realisation basis (eg under the capital gains provisions of the income tax) are considered to be essential features of the tax system and hence are incorporated into the benchmark.

- Under the benchmark adopted, expenses incurred in earning assessable income are deductible:

  – the substantiation rules, which apply to employment-related expenses incurred on or after 1 July 1986, generally conform to this benchmark. However, tax expenditures are deemed to arise where taxpayers are allowed to claim on the basis of statutory formulae which yield a larger deduction than the actual cost incurred;

- deductions for depreciation are identified as tax expenditures if they provide more generous treatment than effective life depreciation; and

- provisions which defer deductions are identified as negative tax expenditures. The restrictions on the deductibility of interest on borrowings used to finance rental property investments acquired after 17 July 1985 (the restriction being repealed from 1 July 1987) gave rise to a negative tax expenditure.

- For the 1987-88 income year and beyond, the imputation system of company taxation is the benchmark for identifying tax expenditures arising under the provisions of the income tax law relating to company income. It replaces the classical company tax system. The imputation system of company taxation — which has applied since 1 July 1987 — allows resident shareholders credit for company tax paid. This effectively frees company dividends from the double taxation which existed under the classical system where tax was imposed at both the company and shareholder level, reducing the effective tax rate on distributed profits derived by Australian residents through business entities covered by imputation.

- Under imputation, the value of concessions is offset to some degree since such concessions reduce company tax paid. The subsequent taxation, in the hands of shareholders, of dividends paid out of tax-preferred income (as also occurred under the classical system) is not costed in this Statement because of the practical difficulties in doing so. This needs to be considered in relation to the cost to revenue of company tax expenditures. While this subsequent taxation may reduce the value of the concessions to shareholders, the shareholders can still benefit through the tax-preferred income being retained in the company for long periods before being distributed.

- The taxation rules applying to sole traders, partnerships and trusts, which are not separate taxable entities, are regarded as design features of the tax system and are included in the benchmark. The taxation treatment of co-operative companies departs from the taxation of companies under the imputation system. Tax expenditures arise where the income and distributions of co-operative companies receive concessional treatment.

- The separate income tax rates scale applicable to non-residents (in the case of individual taxpayers) is taken as part of the benchmark structure, as are design features such as dividend withholding tax and interest withholding tax which apply to non-residents generally. The allocation of taxing rights in Australia's double tax agreements is included in the benchmark.

- As part of a Government policy to encourage multinationals to establish regional-headquarters in Australia, certain foreign source dividends paid on or after 1 July 1994 by a resident company to non-resident shareholders will be exempt from withholding tax. As this particular exemption reflects the view that Australia does not have a strong claim for taxing that income, on either a residence or source basis, it is not considered to be a tax expenditure. For the same reason, the exemption from interest withholding tax for interest paid to non-residents by an offshore banking unit is now considered to be part of the benchmark.

- The benchmark for foreign source income is taken to be assessment on a world-wide basis, with a limit on foreign tax credits, on a source-by-source basis, to the amount of Australian tax payable in respect of the foreign income. Under the benchmark passive income such as interest, royalties and dividends, and highly mobile forms of active income are assessed on an accruals basis while most active foreign source income is assessed on a repatriation basis with a credit for any foreign tax paid (ie the foreign tax credit system (FTCS) is applied).

  – An exemption from the operation of the FTCS is provided for branch income and certain non-portfolio dividends derived in a listed country (sections 23AH and AJ). It was intended that this list of countries should only include those that consistently impose tax on a comparable basis to Australia. To the extent that the total foreign company tax plus dividend withholding tax is less than the Australian tax payable, there is a tax expenditure, but this has not been costed.

  – Most passive income and highly mobile active income derived by controlled foreign companies (CFCs) and transferor trusts in listed countries is exempt from accruals taxation on the presumption that it has been comparably taxed. To the extent that foreign company tax paid on a current basis is less than would have been payable in Australia, there is a tax expenditure, but this has also not been costed.

  – The measures for taxing Australian residents' interests in foreign investment funds (FIFs) are taken to be consistent with the benchmark.

- Foreign employment income is exempt from Australian tax where it is derived by a taxpayer during a period of continuous service of 91 days or more, other than in certain cases where the income is exempt from tax in the source country. The income may otherwise be exempt if derived from continuous service of 91 days or more on an 'approved overseas project'. Both circumstances constitute a tax expenditure, the magnitude of which is likely to be small.

- The untaxed imputed rent from owner-occupied housing (and the non-deductibility of expenses incurred in earning that income) and the income received from an inheritance would both fall within the Schanz-Haig-Simons definition of income, but the non-taxation of these items is considered part of the benchmark for the purposes of this statement.

- Many types of capital receipts not representing a return to investors of their initial capital have not been taxed in Australia in the past, eg some capital gains realised on the sale of property; payments received by professional sportspersons in consideration for giving up a permanent asset such as their amateur status; and receipts in consideration of a restrictive covenant whereby the recipient undertakes not to use specified assets or to trade only with the other party to the covenant. Policy has moved over recent years, however, to bring many classes of capital receipts into the income tax base, particularly with the introduction in 1985 of the capital gains tax provisions in the income tax law. This Statement identifies as tax expenditures capital receipts which are specifically exempt under the capital gains tax provisions.

- Certain receipts of organisations such as non-profit associations and societies are exempt from Australian income tax on the basis of the 'mutuality principle', which asserts that a person cannot derive income from dealings with himself or herself and is applied notwithstanding that the club or society with which persons are associated may be incorporated. Such organisations are generally assessed only on their investment income and on income from trading with non-members. The application of the mutuality principle is not considered to involve a tax expenditure. The global income tax exemptions for the income of specified non-profit organisations (eg trade unions, cultural and sporting societies), which extend, for example, to investment income and income from business activities in competition with taxable entities, go beyond the justification afforded by the mutuality principle. To this extent, they are treated as tax expenditures.

- The income tax benchmark includes sovereign immunity exemptions and international taxation right exemptions. This practice is justified by the fact that these exemptions reflect standard international practices of long-standing inter-governmental taxation agreements, and thus lack the element of policy discretion usually attributed to tax expenditures.

- The income tax rebate for low income earners has been excluded from the benchmark, and therefore identified as a tax expenditure, on the grounds that it provides assistance to a distinct class of taxpayer and could be replaced by a direct outlay (a criterion used to identify expenditures in other OECD countries).

- For 1996-97 only, the Medicare levy was increased from 1.5 per cent to 1.7 per cent to fund the costs associated with the gun buyback scheme. This temporary levy increase is treated as part of the benchmark.

## Retirement and Other Employment Termination Benefits[1]

The benchmark for retirement and other employment termination benefits is the general taxation treatment of remuneration and savings. This benchmark has the following features:

- remuneration in respect of employment is deductible to taxable employers and fully taxed to the employee;

- savings are normally financed out of after-tax income;

- investment income on savings is normally taxed in the income year it is derived; and

- dissaving of amounts (including interest) accumulated and already taxed is not taxed again.

1 A detailed discussion of departures from this benchmark was provided in the 1989 Statement.

## Fringe Benefits Tax (FBT) Benchmark[2]

The benchmark adopted has the following characteristics.

- The role of the FBT in supplementing the personal income tax structure is the starting point in determining the benchmark. Accordingly, under the benchmark FBT would apply to all benefits provided to all employees or associates (except where their wage or salary income is exempt from personal income tax) and hence all employers providing such benefits would be liable for FBT.

- Reflecting the role of the FBT in supplementing the personal income tax structure, it is accepted as part of the benchmark that the FBT is levied at the maximum personal tax rate, including the Medicare levy. Negative tax expenditures arise where employees who receive fringe benefits face marginal personal tax rates below the maximum because the FBT paid by the employer is higher than the tax which employees would pay if the benefit were assessable in their hands. However, as the effective administration of the FBT requires that it be levied at a single rate, this feature is accepted as part of the benchmark.

- The benchmark value of a fringe benefit to an employee is taken to be its market value less any consideration paid by the employee. In some cases statutory formulae are available to calculate the benefit derived. As for the substantiation rules, tax expenditures are deemed to arise where the formulae provide a concession to taxpayers.

- The non-deductibility for income tax purposes of FBT on fringe benefits provided up to 31 March 1994 reduced the tax advantage of receiving remuneration in the form of fringe benefits and, accordingly, is treated as part of the benchmark.

- These characteristics were altered from 1 April 1994 when FBT was applied to the tax inclusive value of the fringe benefits and FBT became income tax deductible for employers. A special rebate applies to non-government entities that are exempt from income tax but subject to FBT and this rebate is treated as a tax expenditure.

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2 A more detailed discussion was provided in the 1987 Statement.

## Wholesale Sales Tax Benchmark

The benchmark adopted has the following characteristics:

- Tax is levied at the final wholesale transaction on goods that enter domestic consumption.

- The tax is a single stage tax. Cases where goods are taxed more than once would give rise to a negative tax expenditure.

- Services are not taxed directly. However, services are input taxed. Business input exemptions for service providers would give rise to tax expenditures.

- The existence of multiple rates of tax is considered an essential part of the design of the existing system and is part of the benchmark. The exception to this is certain exempt items contained in Schedule 1 of the *Sales Tax (Exemptions and Classifications) Act 1992*. These items provide preferential treatment to activities or classes of taxpayers and so give rise to tax expenditures.

- Business input exemptions for goods producers contained in Schedule 1 of the *Act* are part of the benchmark. This reflects the design feature of the system that it is a single stage tax.

## Excise Duty Benchmark

The benchmark for the excise taxes has the following characteristics:

- The benchmark includes excises for alcohol, tobacco and fuels.

- The benchmark has no exemptions for classes of taxpayers or activities.

- The benchmark rate for alcohol is the excise rate on beer. Beer is the highest selling alcoholic product in Australia. To allow for the different alcohol contents of beverages the excise rate is expressed as an excise per unit of alcohol.

- The benchmark rate for fuels is the excise on unleaded petrol (which is also the rate for diesel). To allow for differences in the energy output of different fuels the rate is expressed as an excise per unit of energy. The tax on leaded petrol is a negative tax expenditure.

- The benchmark rate for tobacco is the current excise rate on tobacco. Treasury is unaware of any tax expenditures for tobacco.

# Retirement and Other Employment Termination Benefits

This Appendix sets out the estimated tax expenditures on retirement and other employment termination benefits for 1992-93 to 1995-96 and forward projections for the following four years. It also briefly examines some conceptual issues relating to the interpretation of these estimates. The estimates are presented in Table B1 according to the forms of departure from the benchmark taxation treatment of these benefits.

A brief discussion of the savings benchmark is included in Appendix A. A discussion of how the actual taxation of retirement and other employment termination benefits depart from this benchmark is provided in Appendix B of the 1994 *Tax Expenditures Statement*. The 1994 Statement also outlines the difference between these estimates and estimates of the longer term budgetary impact of superannuation concessions provided by the Retirement Income Modelling Task Force (RIM) models.

The method of estimating superannuation and other termination payment concessions has been revised for this Statement. The revised method:

- uses RIMGROUP projections of contributions in their entirety and has regard to RIMGROUP projections of earnings (RIMGROUP is the population model used by RIM to project superannuation fund contributions, earnings and payouts as well as related retirement income, social security and taxation aggregates);

- removes the assumed year delay in the collection of tax from superannuation funds, reflecting changes in the collection timetable (this produces a more stable series); and

- incorporates a revised approach to estimating earnings, which leads to a higher estimated earnings figure.

These changes in method together with updated figures account for the revisions to the estimates published for this tax expenditure in the 1994-95 TES and referred to earlier in this year's Statement.

**Table B1: Estimated Tax Expenditures Through Retirement and Other Employment Termination Tax Concessions 1992-93 to 1999-00**

| | | 1992-93 ($m) | 1993-94 ($m) | 1994-95 ($m) | 1995-96 ($m) | 1996-97 ($m) | 1997-98 ($m) | 1998-99(a) ($m) | 1999-00(a) ($m) |
|---|---|---|---|---|---|---|---|---|---|
| *Costs (b)* | | | | | | | | | |
| 1 | Under taxation of employer contributions | 2310 | 2990 | 2870 | 3280 | 3150 | 3240 | 3630 | 3840 |
| 2 | Deduction for self-employed/unsupported | 460 | 170 | 180 | 150 | 160 | 170 | 150 | 150 |
| 3 | Under taxation of fund earnings | 2260 | 3620 | 1940 | 2060 | 2160 | 2270 | 2390 | 2510 |
| 4 | Under taxation of unfunded lump sums | 1050 | 1200 | 1110 | 1120 | 1120 | 1130 | 1140 | 1160 |
| 5 | Superannuation rebate - low income earners | 35 | 55 | 45 | 35 | 35 | 35 | 45 | 55 |
| 6 | Superannuation rebate - low income spouse | | | | | | | 35 | 35 |
| | *Sub-total* | *6115* | *8035* | *6145* | *6645* | *6625* | *6845* | *7390* | *7750* |
| *Less Offsets* | | | | | | | | | |
| 7 | Tax on funded pensions | (c) | (c) | (c) | (c) | (c) | (c) | (c) | (c) |
| 8 | Tax on funded lump sums before 1/7/83 | 85 | 90 | 85 | 45 | 45 | 45 | 35 | 35 |
| 9 | Tax on funded lump sums from 1/7/83 | 250 | 280 | 290 | 310 | 330 | 350 | 370 | 390 |
| | *Total Offsets* | *335* | *370* | *375* | *355* | *375* | *395* | *405* | *425* |
| **Tax Expenditure** | | **5780** | **7665** | **5770** | **6290** | **6250** | **6450** | **6985** | **7325** |

(a) The estimates for 1998-99 and 1999-00 do not include the revenue impact of the government contributions to employee superannuation accounts. The Government has announced that it intends to review the mechanism for the delivery of the co-contribution. It is therefore not practicable to include detailed information on the impact of the co-contribution at this stage.

(b) Includes the revenue impact of measures announced in the 1996-97 Budget, including the surcharge on superannuation contributio ns for high income earners. The measures have yet to be legislated.

(c) Indeterminate but unlikely to be significant.

Source: Australian Taxation Office.

## Interpretation

The cost estimate for the tax expenditure measures the amount by which tax revenue is reduced by the provisions for taxing retirement and other employment termination benefits in a particular year. The estimate of the tax expenditure in the forward projections is not necessarily indicative of the cost of the superannuation concessions in future years:

- the taxes on superannuation pensions and lump sums could be expected to provide a greater offset to the cost of the under-taxation of contributions in future years when there are larger numbers of taxpayers drawing down their superannuation savings relative to the numbers in the accumulation phase; and

- the current superannuation tax concessions will have an (intended) impact on certain direct budgetary outlays in future years. In particular, consideration of the ongoing cost of the superannuation concessions would need to take account of the offsetting effect on future age pension outlays.

Even aside from these factors, the estimates in Table B1 cannot be interpreted as a time series of the ongoing revenue savings that could be obtained if the superannuation concessions were eliminated. This is because the increase in tax arising from the elimination of the tax expenditures with respect to a particular year would cause the superannuation tax base to be smaller for the next year. For example, if contributions and fund earnings in 1995-96 were taxed according to the savings benchmark, superannuation fund assets, and hence fund earnings, would be lower in 1996-97 than if the concessional tax treatment had applied the previous year. The cost of taxing fund earnings concessionally in 1996-97 will, in these circumstances, be lower than if the superannuation concessions had applied in 1995-96.

In addition, the estimated cost of the tax expenditure on retirement and other employment termination benefits assumes no behavioural change; so the level of superannuation savings would not be affected by the removal of the concessions. To the extent that this is an unrealistic assumption the cost of the concessions will be overestimated.

Notwithstanding these caveats, the methodology used to cost tax expenditures in this Statement is considered to provide the best measure of the budgetary impact in *any given year* of removing existing tax concessions *in that year.*

## Estimates

The earnings of superannuation funds are not readily predictable, the major reason being that it is a matter for the discretion of a fund manager when the accrued capital gains of a fund are to be realised. For example, growth in the cost of the tax expenditure in 1993-94 was primarily due to stronger than expected growth in superannuation funds' taxable income. The increase in the taxable income of funds was driven primarily by large increases in net capital gains and, to a lesser extent, employer contributions. The decrease in the 1994-95 estimate, compared to the 1993-94 estimate, is in large part due to the decline in capital gains being realised by superannuation funds.

Fund earnings have been 'smoothed out' for the forward projections as this is considered to provide a better indication of the cost of the tax expenditure over time.

# Cost Measurement Issues

The cost estimates provided in this Statement for positive tax expenditures measure the amount by which tax revenue is reduced (or increased), in a particular year, by the tax provision in question relative to the benchmark. Estimates are costed on the basis of the year of impact on revenue rather than the income year in which use of the provision was made.

## Aggregation of Cost Estimates

For a number of reasons the aggregation of costings for individual tax expenditure items presented in the TES will not provide an accurate estimate of the total level of assistance which is provided through tax expenditures.

These considerations suggest that although the concept of revenue forgone may overstate the revenue which might accrue from removal of individual tax expenditures, in aggregate the costings understate the total level of preference provided through tax expenditures.

- The listing of tax expenditures while much broader, with the inclusion of those associated with the wholesales sales tax , may not be exhaustive.

- Because of the unavailability of data, estimates are not available for many items which are listed. Further, considerable conceptual and data difficulties surround the costing of many tax expenditures. For retirement and other employment termination benefits this problem is particularly acute.

- Under a progressive income tax the removal of a positive tax expenditure may push the taxable income of some taxpayers into a higher marginal tax rate bracket and thereby increase the estimated revenue forgone by virtue of remaining tax expenditures, with the reverse true for negative tax expenditures.

- The costings assume, often unrealistically, that taxpayers would not alter their behaviour following the removal of a tax expenditure. However, the removal of one tax expenditure may induce greater usage of another. This caveat also applies to direct budgetary expenditures.

## Tax Expenditures Involving Deferral

As noted at the beginning of the TES, a major change to the format of this year's publication was the separation of the information on timing (or deferral) expenditures into a separate table. It is argued that such a separation allows the reader to decide if they wish to include these estimates when assessing tax expenditures. This will depend on why they are interested in analysing tax expenditures; to determine the revenue impact in a particular year or to consider the level of assistance provided through the tax system.

This section provides more information on these deferral expenditures and provides a practical example of the operation of an accelerated depreciation provision.

The accelerated depreciation provisions of the income tax law permit tax to be deferred by allowing deductions to be brought forward. The taxpayer pays less tax in early years but more tax later. This does not mean that the aggregate revenue losses in the early years will be made up later. Accelerated depreciation provisions usually result in revenue losses over a number of years, but the losses are not offset by revenue gains in future years unless the provisions are removed. The size of the revenue effects can differ markedly from year to year, particularly during the transitional period following the introduction or removal of the concession. Thus the ongoing revenue implications of such provisions cannot be adequately summarised by 'first' or 'full' year costs to revenue. Nevertheless, reflecting the 'annual cost to the Budget' basis of tax expenditure estimates, these tax expenditures are costed in terms of their impact on revenue in individual years.

A positive tax expenditure arises in the years in which capital is being depreciated rapidly, followed by revenue gains in the years in which no deductions, or comparatively smaller deductions, can be claimed because the capital has already been written down relative to an effective life depreciation schedule, which is the benchmark. The removal of the 5/3 accelerated depreciation provisions, announced in the May 1988 Economic Statement, resulted in a revenue gain in both the 1993-94 and 1994-95 income years.

Table C1 presents calculations demonstrating how a negative tax expenditure may arise over time as a consequence of a change from an effective life regime to an accelerated depreciation regime[3]. The accelerated depreciation regime used in this example is a 5/3 depreciation regime.

The calculations are based on the following assumptions:

- Eligible expenditure of $10 billion in the first year of the introduction of 5-year depreciation under which all new equipment attracts a 5-year write off.

- Prior to the introduction of accelerated depreciation, the cost of all eligible equipment is written off using the diminishing-value method on the basis of an effective life of 9 years, giving a depreciation rate of 16.67 per cent. (The diminishing-value method automatically applies unless the taxpayer specifically elects to adopt the straight-line method, and therefore has been used in this example.)

- Under the 5/3 regime, depreciation is at an annual rate of 20 per cent over 5 years.

- Purchases are spread evenly throughout the year. Therefore, deductions allowed in respect of the first year average half a year's depreciation.

- The 1994-95 company tax rate of 33 per cent applies to all businesses.

- Factors such as past and current year losses are ignored.

Columns (2) to (4) of the table present the calculations for depreciation under effective life and the associated tax saving. Columns (5) to (7) contain the same information for 5/3 depreciation. The 'Tax Saving' is the value of the depreciation deduction to the taxpayer.

3 The calculations are based on information and methodology presented in Attachment A of the 1986 Tax Expenditures Statement, which also provides a discussion of the cost to revenue of the accelerated write-off of capital expenditure.

Column (8) gives the year-by-year cost to revenue of accelerated write-off, assuming a zero discount rate.[4] Positive tax expenditures occur in the earlier years but are offset in latter years by negative tax expenditures. With the assumption of a zero discount rate, cumulative tax expenditures are zero. However, in the real world case where the discount rate is positive, cumulative tax expenditures would also be positive, thus conferring an accumulated benefit to investors and an accumulated loss to government.

Table C1: Accelerated Depreciation Tax Expenditures

| | Effective Life | | | 5/3 Depreciation | | | Tax Expenditure | |
|---|---|---|---|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
| Year | Opening Balance $m | Depreciation $m | Tax Saving $m | Opening Balance $m | Depreciation $m | Tax Saving $m | (7)-(4) Cost $m | Cumulative Cost $m |
| 1 | 10000 | 834 | 275 | 10000 | 1000 | 330 | 55 | 55 |
| 2 | 9167 | 1528 | 504 | 8000 | 2000 | 660 | 156 | 211 |
| 3 | 7638 | 1273 | 420 | 6000 | 2000 | 660 | 240 | 450 |
| 4 | 6365 | 1061 | 350 | 4000 | 2000 | 660 | 310 | 760 |
| 5 | 5304 | 884 | 292 | 2000 | 2000 | 660 | 368 | 1129 |
| 6 | 4420 | 737 | 243 | 0 | 1000 | 330 | 87 | 1215 |
| 7 | 3683 | 614 | 203 | 0 | 0 | 0 | -203 | 1013 |
| 8 | 3069 | 512 | 169 | 0 | 0 | 0 | -169 | 844 |
| 9 | 2557 | 426 | 141 | 0 | 0 | 0 | -141 | 703 |
| 10 | 2131 | 2131 (a) | 703 | 0 | 0 | 0 | -703 | 0 |

(a) Includes balancing adjustment.

4 The Tax Expenditures Statement estimates are intended to be comparable and complementary to other Budget estimates, therefore the assumption of a zero discount rate is appropriate.