CHAPTER 2: THE TAX EXPENDITURE FRAMEWORK

This chapter provides background on tax expenditures, outlining what they are and how they are measured, and provides guidance for interpreting the estimates reported in the Tax Expenditures Statement (TES).

2.1 What is a tax expenditure?

A tax expenditure is a provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the 'standard' tax treatment that would apply. A negative tax expenditure arises when arrangements impose an additional charge rather than a benefit. Tax expenditures can be provided in many forms, including tax exemptions, tax deductions, tax offsets, concessional tax rates or deferrals of tax liability.

Tax expenditures are often an alternative to direct expenditures as a method of delivering government assistance or meeting government objectives. Tax expenditures, like direct expenditures, have an impact on the budget position, although the tax expenditure estimates presented in this statement are not directly comparable to budget revenue estimates.

Tax expenditures may also redistribute the tax burden between taxpayers, as most tax expenditures result in less tax being collected from particular taxpayers. As a result, taxes paid by individuals and businesses not benefiting from the tax expenditure need to be higher to raise the same total revenue.

Not all concessional elements of the tax system are classified as tax expenditures. Some concessions are considered structural elements of the tax system and are incorporated in the benchmark. For example, the personal income tax system includes a progressive marginal tax rate structure, which results in individuals on lower incomes paying a lower marginal rate of income tax than those on higher incomes. This arrangement is a structural design feature of the Australian tax system and is therefore not identified as a tax expenditure.

Tax expenditures do not include the impact of the exercise of administrative discretion or the impact of taxpayer non-compliance with the tax law. While these may result in a benefit to certain taxpayers, they do not arise from any policy intent on the part of the government. The magnitude of some tax expenditures may also be affected by factors such as interpretation of the law by the courts and tax administrators.

2.2 Why report tax expenditures?

In addition to meeting the requirements of the *Charter of Budget Honesty Act 1998*, the TES is an integral component of the Australian Government's budget reporting. It serves three key functions:

- to allow tax expenditures to receive a similar degree of scrutiny as direct expenditures;
- to allow for a more comprehensive assessment of government activity; and
- to contribute to the design of the tax system, by promoting and informing public debate on all elements of the tax system.

Tax expenditure reporting in Organisation for Economic Co-operation and Development countries

In the early 1970s, only Germany and the United States reported tax expenditures. By 1983, Australia, Austria, Canada, France and Spain were also regularly identifying them. Currently, almost all Organisation for Economic Co-operation and Development (OECD) member countries report tax expenditures. Most of these countries, including Australia, report tax expenditures annually.

The purpose of reporting tax expenditures is generally the evaluation of tax expenditures and to promote and assist public debate on the design of the tax system.

Most OECD tax expenditure reporting countries report tax expenditures that relate to personal and business income taxes and value added taxes, where applicable. Australia, like many OECD countries, reports tax expenditures on the majority of central government direct and indirect taxes. Some OECD countries report tax expenditures at all levels of government.

References:
H Brixi, C Valenduc and Z Li Swift, *Tax Expenditures — Shedding Light on Government Spending through the Tax System, Lessons from Developed and Transition Economies*, The World Bank, Washington DC, 2003.
Tax Expenditures in OECD Countries, OECD, 2010.

TRANSPARENCY AND SCRUTINY

The TES improves the transparency of the tax system, thereby allowing greater public scrutiny of government policies.

In Australia, direct government expenditures are generally scrutinised during the annual budget process by Parliament and parliamentary committees, the media and the general public.

Tax expenditures, like direct expenditures, affect the Government's budget. It is important, therefore, that tax expenditures are reviewed on a regular basis and receive similar scrutiny to that given to direct expenditures. The publication of information on tax expenditures facilitates their review and assessment, and assists in determining whether their objectives are being met at a reasonable cost and in the interest of the community in general.

SCOPE OF GOVERNMENT ACTIVITY

The publication of Australian Government tax expenditure information allows for a more comprehensive assessment of Australian Government activity.[1] Unless direct expenditures and tax expenditures are both reported, the scope of Government influence on the economy and society will be understated. By reporting tax expenditures, all Government assistance is transparent.

TAX SYSTEM DESIGN

Transparent reporting of tax expenditures assists the evaluation, design and development of the tax system and helps to determine whether there has been adherence to three of the key principles of tax system design — efficiency, equity and simplicity.[2] The provision of detailed information on tax expenditures allows a more thorough assessment of the tax system in respect to:

- its effect on resource allocation and incentives for taxpayer behaviour;
- the most appropriate way to administer concessions, particularly as most tax expenditures could be delivered as direct expenditures; and

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1 Tax expenditures applying to State and Territory law are not reported in the Australian Government TES.

2 For further discussion of tax and transfer system design principles, see AFTS Review Panel 2009, *Australia's future tax system Report to the Treasurer*, Part One Overview, p 17.

- the impact on different entities within the economy, particularly as tax expenditures shift the tax burden to entities that are not treated concessionally.

2.3 Approaches to measuring tax expenditures

There are three main methods used to measure tax expenditures.

- The revenue forgone approach — this approach measures the difference in tax paid by taxpayers who receive a particular concession relative to similar taxpayers who do not receive that concession. It compares the current/prospective treatment to the benchmark treatment, assuming taxpayer behaviour is unchanged. Accordingly, revenue forgone tax expenditures measure the impact of a concession in terms of the benefit taxpayers derive from the concession given their behaviour once it is in place.

- The revenue gain approach — this approach measures how much revenue could increase if a particular tax concession was removed. Accurate estimation of this cost requires estimates of the behavioural effects associated with such a change. (This approach is used when preparing new policy proposal estimates for the budget.)

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

The three methods can yield significantly different estimates of the value of a tax expenditure.

Consistent with most tax expenditures statements published in OECD countries, Australia uses the revenue forgone approach. This is the most reliable method for estimating the level of assistance the tax system provides to taxpayers.

2.4 Treasury's approach to estimating tax expenditures

REVENUE FORGONE AND COMPARISON WITH BUDGET ESTIMATES

The estimates of tax expenditures in this statement are prepared under the 'revenue forgone' approach which calculates the benefit to the taxpayer of the tax provisions concerned, measured relative to a non-concessional tax benchmark, rather than in terms of the budgetary cost of those provisions.

Revenue forgone estimates differ from budget estimates for new revenue policy measures as they are estimated relative to different benchmarks. Estimates calculated by the revenue forgone approach identify the financial benefit of tax concessions to taxpayers receiving those concessions relative to taxpayers that do not. They do not include behavioural response impacts and so it does not necessarily follow that there would be an equivalent increase to Government revenue from the abolition of the tax expenditure.

In contrast, estimates of the cost of new policy proposals in the budget are based on the revenue that the Government expects to collect. The forward estimates and budget estimates are estimates of future tax collections and take account of factors such as taxpayer behaviour and compliance with the tax law.

The revenue forgone approach is the principal approach used to estimate tax expenditures in this statement and in the tax expenditure statements of most other countries. This approach is preferred because:

- The revenue forgone approach requires only a single consistent assumption regarding behavioural responses to removing a concession (no behavioural change) which allows the value of a tax concession to be based on the actual (or projected) level of transactions.
- The revenue forgone approach measures the total 'expenditure' on a concession, given the level of usage of the concession by taxpayers, similar to the way in which the ongoing cost of demand driven outlays are recorded in the budget based on the total take up of a program.
- The results under the revenue forgone approach can be interpreted consistently in terms of the benefit of a tax concession to the taxpayer.

REVENUE GAIN ESTIMATES

The revenue gain approach has often been proposed as an alternative to the revenue forgone approach as a way of producing tax expenditure estimates that are more comparable to budget revenue estimates.

This TES includes revenue gain estimates for several of the largest tax expenditure items for comparison purposes in Chapter 4. These estimates show that significant differences can arise between the two sets of estimates because of the impact of behavioural assumptions and the policy specified for removing the tax concessions to bring them into alignment with the benchmark.

There are, however, considerable practical difficulties in producing estimates on a revenue gain approach for all the tax expenditures identified in this statement.

- As there are no Government decisions to remove tax concessions, estimating the revenue gain from doing so requires the making of ad hoc policy assumptions. While the revenue gain estimates use a standard policy specification as far as possible, the estimates presented only represent one of a range of possible policy outcomes.

- Estimating revenue gain requires information about the behavioural responses of taxpayers to policy changes for each estimate. In most cases this information is not available and assumptions need to be made to arrive at an estimate.

- Calculating comprehensive revenue gain estimates that provide a reliable estimate of aggregate tax expenditures would require the specification of assumptions regarding the order in which tax expenditures are removed and how activity would flow to alternative concessions.

ACCRUAL ESTIMATES

The tax expenditure estimates are prepared on the same revenue recognition basis as the budget estimates. Since the 2006-07 Budget, the basis for reporting revenue in the budget has changed. The changes are outlined below and apply to estimates in the TES from 2006-07.

Revenue recognition methodology

Accrual accounting was introduced by the Australian Government in the 1999-2000 Budget. The Australian Accounting Standards and Government Finance Statistics standards for accrual accounting require that taxation revenue be recognised in the reporting period in which the taxpayer earns the income that is subsequently subject to taxation — this is known as the Economic Transactions Method (ETM). But the standards also permit government reporting using an alternative approach when the ETM approach would generate unreliable measures of taxation revenues.

Because ETM is an unreliable measure for several significant revenue heads — and these account for the majority of total revenue — all taxation revenue was recognised using the Tax Liability Method (TLM) in all accrual budget related documentation from the 1999-2000 Budget to the *Mid-Year Economic and Fiscal Outlook 2005-06*. Under TLM, taxation revenue is accounted for at the time a taxpayer makes a self assessment or when an assessment of a taxation liability is raised by the relevant authority.

Commencing with the 2006-07 Budget, the Australian Government adopted ETM revenue recognition for all revenue heads where the measurement issues are not material, but retained TLM revenue recognition where ETM measurement issues may be material. The taxation revenues that continue to be recognised on a TLM basis are:

- individuals and other withholding taxation;
- company income taxation; and
- superannuation taxation.

RELIABILITY OF THE ESTIMATES

Where estimates of tax expenditures are quantified, information on the reliability of the estimate is also provided. The reliability ratings used in the TES, as well as indicators for each rating and a summary of the tax expenditures at each rating, are provided in Table 3.1 of Chapter 3.

2.5 Interpreting the estimates of tax expenditures

Care should be taken when interpreting the tax expenditure estimates presented in this document. The estimates of reported tax expenditures are not necessarily reliable indicators of the budgetary impact of removing particular tax concessions. Nor are the aggregate estimates presented in Chapter 1 necessarily reliable indicators of the total value of tax expenditures, in particular as tax expenditures are not additive.

Care should also be taken in comparing the level of tax expenditures reported in different editions of the TES, both for individual tax expenditures and in aggregate. Changes may arise without any change in the actual magnitude of tax expenditures. The reasons include revisions to data, changes in methodology, identification of formerly unidentified tax expenditures, quantification of previously unquantified tax expenditures and deletion of abolished tax expenditures.

Great care also needs to be taken in interpreting the revenue gain estimates in Chapter 4 as they are 'stand alone' estimates that do not take account of the impact of other policy changes. Like the revenue forgone estimates they are not additive and aggregates should only be used as indicators of broad trends in the overall value of tax concessions.

2.6 Issues surrounding interpretation of tax expenditure estimates

This section provides an overview of the main issues relating to interpretation of the estimates.

Behavioural effects

The introduction of a tax expenditure tends to increase concessionally taxed activity. Accordingly, the same activity would be expected to contract should the related tax expenditure be abolished, with consequential implications for potential revenue flows. Other responses may follow. For example:

- The removal of one concession may result in increased use of other concessionally taxed activities, lowering tax revenue elsewhere.
- Under a progressive income tax system, the removal of a tax expenditure may result in some taxpayers facing a higher average tax rate, increasing tax revenue.
- As tax concessions may alter resource allocation and direct scarce resources from one activity to another, removal of those concessions may affect economic efficiency and the overall level of economic activity. This change in activity could affect tax revenues.

In most cases, the net effect of these influences on revenue is unclear. Furthermore, in cases where the level of activity is highly sensitive to a concession, the increase in revenue from removing the tax expenditure could be very small. In these cases, reporting tax expenditure estimates as the cost to revenue (that is, using the revenue gain approach) would give the impression that the tax expenditure has little material effect when actually the recipients make great use of it to derive quite large financial benefits.

Potential overlaps

Unless otherwise indicated, tax expenditure estimates are calculated on an individual basis and do not take account of potential overlaps with other tax expenditures. While aggregate tax expenditures can provide a guide to trends in tax expenditures over time, overlaps between the coverage of different 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.

Estimates and projections

Tax expenditure estimates are separated into estimates (for historical years) and projections (for future years). The estimates for 2011-12 are preliminary and subject to revision upon receipt of further tax data. Estimates in the TES may change between editions as benchmarks are modified, new tax expenditures are identified, or as a result of revised or new data becoming available.

2.7 Tax expenditure benchmarks

In order to identify and measure tax expenditures a benchmark must be specified. Tax expenditures are defined and measured as deviations from this benchmark.

The framework for defining the benchmarks used in this statement is based on two principles.

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

- The benchmark may incorporate *structural elements* of the tax system where there are difficulties adopting the standard treatment as the benchmark. Such elements could include integral design features; for example, the progressive income tax rate scale for individual taxpayers.

Reconciling these two criteria often involves an element of judgment. In particular, there may be different views on which structural elements to include in the benchmark. Consequently, benchmarks vary over time and across countries and can be arbitrary.

Each benchmark will generally consist of the following elements:

- the tax base — the activities or transactions subject to the tax;

- the tax rate — the rate of tax that applies to the base;

- the tax unit — the entity liable to pay the tax; and

- the tax period — the period in which the activities or transactions are undertaken.

The benchmarks used by Australia in the TES are outlined at the beginning of each set of tax expenditures in Chapter 3 and are explained in detail in Appendix A.