

CHAPTER 1: INTRODUCTION

The Tax Expenditures Statement provides details of concessions, benefits or incentives delivered to taxpayers through the tax system. These are referred to as 'tax expenditures'. The Tax Expenditures Statement provides details of each tax expenditure provided by the Australian Government and where possible, reports the estimated value of the benefit to taxpayers.

Tax expenditures, like direct expenditures, affect the government's budget. However, unlike direct expenditures, tax expenditures once legislated become part of the tax law with a recurring fiscal impact and do not receive regular scrutiny through the budget process. The Tax Expenditures Statement publishes information to assist transparency and encourage public scrutiny, of government programs delivered through the tax system.

This statement lists around 250 tax expenditures and reports their value over the eight-year period 1999-2000 to 2006-07. The tax expenditures in this statement reflect all announced policies and legislation applying up to the date of publication of the *2003-04 Mid-Year Economic and Fiscal Outlook*.

1.1 What is a tax expenditure?

The taxation system raises revenue to fund government activities. The tax system also provides government with the opportunity to promote objectives other than revenue raising. A government can achieve this by reducing taxes in selected areas to provide incentives for economic activities or to target assistance (in the form of lower taxes) to particular groups, individuals, businesses or activities.

A tax expenditure is a tax concession that provides a benefit to a specified activity or class of taxpayer. A negative tax expenditure occurs when these arrangements impose an additional charge rather than a benefit. Almost all tax expenditures in this statement are positive.

A tax expenditure can be delivered as a tax exemption, tax deduction, tax offset, concessional tax rate or deferral of a tax liability.

Direct expenditures could deliver the benefits of most tax expenditures. Tax expenditures are substitutes for expenditure, delivered through the taxation system and accordingly affect the budget position.

Tax expenditures also redistribute the tax burden between taxpayers. This is because most tax expenditures result in less tax being collected from particular taxpayers. As a

result, for a given level of overall tax revenue, taxes paid by individuals and businesses that do not benefit from the tax expenditure will be higher than they otherwise would need to be to raise the same revenue.

To estimate the value of a tax expenditure, we must identify the tax arrangement that normally would apply to establish the nature and extent of the concession. The tax treatment that normally would apply is the 'benchmark'. The benchmark should neither favour nor disadvantage similar activities or classes of taxpayer. Tax expenditures are deviations from the benchmark.

Not all concessional elements of the tax system are classified as tax expenditures because some are considered structural elements of the tax system and 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 considered an integral design feature of the Australian tax system and is not identified as a tax expenditure.

1.2 Why report tax expenditures?

Publication of the Tax Expenditures Statement is a component of the Australian Government's budget reporting. The publication of detailed information on Commonwealth tax expenditures is a requirement under the *Charter of Budget Honesty Act 1998* and serves three key functions. These are to:

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

Tax expenditure reporting in the OECD

Australia is one of only a few countries in the world that reports tax expenditures. Furthermore, Australia's tax expenditure statement has a broad coverage including the majority of taxes levied by the Commonwealth.

Around half of all OECD countries currently report tax expenditures. The purpose of reporting tax expenditures in most countries is generally the evaluation of tax expenditures and to promote and assist public debate on the design of the tax system.

Nine OECD countries, including Australia, have noted the significant importance of reporting tax expenditures and made it a legal requirement. The other countries are Austria, Belgium, France, Germany, Italy, Portugal, Spain and the United States. In addition, most of these countries explicitly link tax expenditure reporting to the budget process.

Most OECD tax expenditure reporting countries, including Australia, report tax expenditures annually except for Germany, which reports every two years, and Italy, which reports less frequently.

In general 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 Belgium, France, Germany, Netherlands, United Kingdom and the United States, reports tax expenditures on the majority of central government direct and indirect taxes. Austria and Italy report tax expenditures at all levels of government.

Source: *Tax Expenditures — Shedding Light on Government Spending through the Tax System, Lessons from Developed and Transition Economies*, The World Bank, Washington DC (2004).

TRANSPARENCY AND SCRUTINY

The Tax Expenditures Statement improves tax system transparency, thereby allowing for greater public scrutiny of government policies.

In Australia, direct government expenditures are generally scrutinised during the annual budget process by the Parliament and parliamentary committees, the media and the general public. Concessional arrangements that give rise to tax expenditures often only receive consideration from Parliament at the time they are introduced. Furthermore, the cost of tax expenditures is generally not directly observable as it does not arise from a direct transaction with government. The publication of information on tax expenditures contributes to the review and assessment of tax expenditures, especially whether their objectives are being met at a reasonable cost.

SCOPE OF GOVERNMENT

The publication of tax expenditure information also allows for a more comprehensive assessment of Australian Government activity. Unless direct expenditures and tax expenditures are both reported, the apparent scope of government influences on the economy and society could be under-recognised. By reporting tax expenditures all government 'expenditure' is accounted for.

TAX SYSTEM DESIGN

Transparent reporting of tax expenditures also assists with the design of the tax system. Information in this statement assists in the evaluation, design and development of the tax system by helping to fulfil three key principles of tax system design: efficiency; equity; and simplicity. Provision of detailed information on tax expenditures allows for a more thorough assessment of the tax system in respect to:

- its effect on resource allocation, incentives for taxpayer behaviour and distortions created by tax expenditures;
- the most appropriate way to administer concessions, particularly as most tax expenditures could be delivered as direct expenditures;
- whether the policy intent to provide concessions through the tax system is achieved; and
- the impact on different entities within the economy, particularly as tax expenditures shift the tax burden to entities that are not treated concessionally.

1.3 Coverage of this statement

This statement covers these general-purpose Commonwealth taxes:

- income tax (personal and business);
- fringe benefits tax;
- capital gains tax;
- excise duties;
- wine equalisation tax;

- luxury car tax; and
- petroleum resource rent tax.

Taxes excluded from this statement are:

- customs duty or tariffs, except to the extent that the duty concerned is analogous to an excise duty that applies to similar goods produced in Australia
 - estimates of the value of assistance provided to various industries, including tariff arrangements, appear in the Productivity Commission's *Trade and Assistance Review*; and
- specific-purpose taxes, such as agricultural levies, which are generally levied for cost-recovery purposes.

The goods and services tax (GST) imposed and collected by the Australian Government on behalf of the States and Territories is not included in this statement.

1.4 Structure of this statement

The remainder of this statement is divided into the following sections.

TRENDS

Chapter 2 provides an overview of Commonwealth tax expenditures, including trends, aggregates and a comparison with direct expenditures.

METHODOLOGY AND BENCHMARKS

Chapter 3 outlines the various approaches to measuring and modelling tax expenditure estimates, and provides a guide on how to interpret tax expenditure estimates.

Chapter 4 describes the benchmarks used to identify and measure tax expenditures.

DETAILS AND ADDITIONAL INFORMATION

Chapter 5 outlines changes to the list of tax expenditures since the *2002 Tax Expenditures Statement*, new tax expenditures, modified tax expenditures and tax expenditures no longer reported.

Tax Expenditures Statement

Chapter 6 details each tax expenditure, including an estimate of the benefit taxpayers derive, a description of the tax expenditure and for more recent tax expenditures, the date the expenditure was introduced. Further information on tax expenditures appears in the relevant budget documentation when the concession was introduced.

Appendix A provides an overview of the main modelling techniques used to estimate tax expenditures.

Appendix B provides a discussion of tax expenditures related to superannuation benefits and conceptual issues relating to interpretation of the superannuation tax expenditure estimates.