Chapter 14

Tax expenditures

Contents

14. TAX EXPENDITURES

SUMMARY

Most OECD countries estimate tax expenditures. While tax expenditure estimates provide important information for evaluating the extent of government assistance to particular taxpayers and activities, care needs to be taken in interpreting the results, especially tax expenditure aggregates. Differences in tax systems and benchmarks make international comparisons of tax expenditures particularly difficult.

As a result of these difficulties no attempt is made to compare estimates of tax expenditures across countries. Instead the focus of this chapter is to provide a comparison of tax expenditure reporting across selected OECD countries.

The Australian Treasury publishes an annual Tax Expenditures Statement (TES) summarising Australian Government tax expenditure estimates. The 2005 TES listed around 270 tax expenditures with an estimated value of around $37 billion or 4.1 per cent of GDP in 2004-05 (Treasury 2005). This level has remained broadly constant over the past five years and is projected to remain so.

Australia's approach of having a legal requirement to analyse tax expenditures, linking it to the government budget cycle, and covering a broad range of taxes appears to be in line with the approach followed by most OECD countries.

14.1 INTRODUCTION

As discussed in Chapter 2 the main objective of any taxation system is to raise 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 some of these objectives by reducing taxes in selected areas to provide incentives for economic activities and to direct 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 an additional charge is imposed rather than a benefit provided. Most tax expenditures provide a benefit to the taxpayer.

A tax expenditure can be provided in many forms, including tax exemption, tax deduction, tax offset, concessional tax rate or deferral of a tax liability.

Not all programmes delivered through the taxation system are regarded as tax expenditures. In Australia, a number of programmes which are delivered through the taxation system have been classified as direct expenditures under the Australian System of Government Finance Statistics (GFS) and are not counted as tax expenditures (ABS 2005). These include a number of refundable tax offsets, for instance, the Family Tax Benefit, the Research and Development Tax Offset and the Private Health Insurance Tax Offset.

The statistical concepts and classification principles used by the Australian Bureau of Statistics in compiling the GFS are based on an International Monetary Fund standard. Under the GFS classification, programmes delivered through the taxation system are not treated as part of the taxation system (and therefore as giving rise to tax expenditures) unless they are integral to the taxation system.

Direct expenditures could be used to deliver most tax expenditures. Tax expenditures deliver benefits through the taxation system and affect the budget position in a similar way to direct expenditures. Tax expenditures may be preferable to direct expenditures in promoting some government policy objectives. The advantages of using tax expenditures rather than direct expenditure include:

- they can influence private activity by affecting prices or returns, leaving decisions on the extent of participation to private decision makers; and
- they can reduce the extent of direct government supervision required of a policy.

The disadvantages of tax expenditures over direct expenditures include:

- there is usually a much lower level of public accountability for tax expenditures relative to direct expenditures. Expenditures through the annual budget tend to be scrutinised closely as part of the annual budgetary cycle;
- taxes affect prices, including tax concessions. There can be difficulties in setting the correct level of taxes or tax concessions to use prices to correct market failures. They may be ineffective in achieving specific objectives, including by under or overshooting the desired outcome or by offsetting the effect of other policy instruments;
- tax expenditures may be difficult to contain and may lead to erosion of the tax base over time as different groups compete for concessions;
- tax expenditures generally add to the complexity of the tax system; and
- tax expenditures make it more difficult to evaluate the size of government, both over time and in comparisons with other jurisdictions. For instance, pursuing government policies through tax expenditures can reduce both tax and direct expenditures, making government look smaller than if the same policies were pursued through direct expenditures.

Currently, the majority of OECD countries report on tax expenditures. Reporting on tax expenditures serves several functions, including:

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

The Australian Government has recognised the importance of tax expenditure reporting by making it an integral component of its budget reporting and a requirement under the *Charter of Budget Honesty Act 1998*.

14.2 MEASURING TAX EXPENDITURES

As outlined in the 2005 TES, tax expenditures can be measured in three principal ways:

- The *revenue forgone approach* which measures how much taxation revenue is reduced (relative to a benchmark) because a tax expenditure exists. It compares the current and/or prospective treatment and the benchmark treatment, assuming taxpayer behaviour is unchanged.

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

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

In addition, as indicated in Table 14.1, Australia and some other countries use an accruals framework, while other countries use a cash basis.

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

While the revenue gain approach would be most consistent with budget estimates, it also requires substantial information regarding behavioural responses and interactions with the rest of the tax system as well as assumptions regarding the order of tax expenditures. This becomes extremely complex (and arbitrary) as the number of tax expenditures in a system increases.

Australia uses the revenue forgone approach to calculate tax expenditures, which is consistent with the approach used in most OECD countries that report tax expenditures. It is the most reliable method of estimating the level of assistance the tax system provides to taxpayers. The revenue forgone approach calculates tax expenditures as the difference in tax paid by taxpayers who receive a particular concession relative to a benchmark that incorporates structural elements of the tax system and is representative of similar taxpayers who do not receive that concession.

As noted in the TES, care should be taken in interpreting estimates of tax expenditures calculated by the revenue forgone method because the estimates of reported tax expenditures are not necessarily reliable indicators of the budgetary impact of removing particular tax concessions. Furthermore, aggregated estimates of tax expenditures are not reliable indicators of the total value of tax expenditures and should only be taken as broad indicators of trends in the value and composition of tax expenditures over time.

Care should also be taken in comparing the level of tax expenditures reported in different editions of the tax expenditures statements, both for individual tax expenditures and in aggregate. Changes may arise for reasons that do not reflect any change in the actual magnitude of tax expenditures, such as revisions to data, changes in methodology, identification of formerly unidentified tax expenditures, quantification of previously unquantified tax expenditures, and deletion of abolished tax expenditures.

For similar reasons, comparisons of the level of tax expenditures between countries are difficult. Differences in tax systems, benchmarks, classification systems and coverage of estimates mean that comparisons of the value of tax expenditures between countries (in monetary or proportional terms) are unlikely to be meaningful.

For example, benchmarks could be based on either a comprehensive income approach or an expenditure approach. In turn, these can be based on a nominal approach (no account taken of the impacts of inflation) or a real approach (account taken of inflation). In addition, the base can be determined around accrued income (income is recognised as the price of assets and liabilities change) or on a realisations basis (changes in asset values recognised at the time of sale). Australia bases its tax expenditures on a comprehensive, nominal, realisation basis. Use of another tax benchmark would produce very different results in terms of the absolute magnitudes of tax expenditures and their composition.

14.3 TAX EXPENDITURE REPORTING IN THE OECD

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 tax expenditures. Currently, the majority of OECD member countries report tax expenditures; most, including Australia, report tax expenditures annually.

In general, most OECD countries that report tax expenditures do so for 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.

Of the OECD countries that report tax expenditures, at least nine have noted the importance of reporting and made it a legal requirement. These countries include Australia, 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.

Table 14.1 is reproduced from a World Bank Study (Brixi, Valenduc and Li Swift 2003) and provides details of the basis of tax expenditure reporting in 10 OECD countries (note that only five of these countries, including Australia are in the OECD-10 comparator group). Table 14.2, from the same study, provides details of what is included in the tax expenditure statements of various countries.

In summary, Australia's approach of having a legal requirement to analyse tax expenditures, linking it to the government budget cycle, and covering a broad range of taxes appears to be in line with the approach followed in most OECD countries.

Table 14.1: Tax expenditure reporting — a comparison among 10 selected OECD countries

Country	Purpose/usage	Legal requirement	Relationship with budget	Frequency	Method of estimation
Australia	Facilitating assessing tax expenditures alongside direct expenditures; contributing to the design of the tax system; informing the public debate.	Legally obliged	A separate government document with a summary in the budget.	Annually	Revenue foregone method on an accruals basis.
Austria	Tax reform and facilitating budget process.	Legally obliged	As an annex, part of 'Subsidy Report' to budget documents.	Annually	Revenue foregone method on an accruals basis.
Belgium	Assessing the impact of various tax measures on revenue.	Legally obliged	An annex to budget.	Annually	Revenue foregone method on a cash basis.
Canada	(1) Analysing federal income tax and VAT systems. (2) Pre-budget consultations.	No statutory obligation	Not linked to budget process, but for pre-budget consultation.	Annually	Revenue foregone method on cash basis.
France	Facilitating the budget process.	Legally obliged	Appended to budget bill.	Annually	Revenue foregone method on a cash basis.
Germany	Subsidies/expenditure reduction.	Legally obliged	As a part of budget, called 'Subsidy Report'.	Biennial	Revenue foregone method on a cash basis.
Italy	(1) Evaluating tax expenditure on the basis of its cost, objective criteria, and its consistency with budget. (2) Evaluating its effects for particular sectors and geographical areas, compared with their original aims. (3) Being in line with EC tax expenditure policy guidance.	Legally obliged	Not linked to budget process, nor as annex to budget document. But an independent document.	Sporadically	Revenue foregone method on an accruals basis.
Netherlands	Providing the Parliament with insight into budgetary cost of tax expenditures, and possible budgeting.	Not legally obliged	As an annex to the Budget Memorandum. Not directly linked to the budget but serves as additional background information for the Parliament.	Annually	Revenue foregone method on an accruals basis.
United Kingdom	Facilitating annual budget discussion/debate.	No statutory obligation, but as a recommendation from the Expenditure Committee	Not linked to budget process, nor as annex to budget document. But as part of statistical supplement to Autumn Statement (revenue).	Annually	Revenue foregone method, on an accruals basis.
United States	(1) Shaping tax reforms. (2) Deficit reduction.	Legally obliged	As part of annual budget documents, but is not integrated into the budget process.	Annually	Revenue foregone, outlay equivalent, and present value methods, on a cash basis.

Source: Brixi, H, Valenduc, C and Li Swift, Z (2003, pp 10-11).

Table 14.2: Coverage of tax expenditures report — a comparison of 10 selected OECD countries

		Coverage		
Country	**Definition and inclusions in Report**	**Types of taxes**	**Levels of Government**	**Classification**
Australia	A formal definition of a tax expenditure is used and the 'norm' is applied.	Personal income tax; retirement benefits tax; fringe benefits tax; business tax; and excise tax.	Commonwealth Government (Central Government)	By broad economic function; by type of taxpayer affected; and by the particular benchmark to which they relate.
Austria	Using tax norm to define tax expenditures or 'indirect subsidy'. Also using three-way classification in tax expenditures, relief in benchmarks and some in between or combination of the two.	Direct and indirect taxes.	All levels of governments	By types of taxes; and by beneficiary.
Belgium	Tax expenditure is defined as a deviation from the benchmark system resulting in a loss of revenue. The Report includes all exemptions, deductions, and allowances that affect government revenues.	Personal income tax; corporate tax; excise taxes; mortgage registry fees; value added tax; annual tax on insurance policies.	Federal Government	By whether or not it constitutes a tax expenditure; by type of taxes; by intended purpose.
Canada	Using a very narrow definition of the 'norm', in which only the most fundamental structural elements of the tax system are considered to be part of the benchmark. The Report includes both tax preferences which are structural items, non-structural items.	Personal income tax; corporate income tax; goods and service tax.	Federal Government	By (1) personal income tax: by budgetary functional category; (2) corporate income tax: by industry, then broken down by industrial sector; and (3) VAT, by four categories: zero-rated, tax-exempted, tax rebates and tax credits.
France	A formal definition of a tax expenditure is used and the 'norm' is applied.	Income tax; income tax and corporate tax; corporate tax; registry fees and stamp duty; VAT; payroll tax; internal tax on the consumption of petroleum products.	Central Government	By types of the tax; by main purposes; and by beneficiary.
Germany	Uses 'Subsidy Report,' which includes both direct subsidies and tax concessions.	Income tax; corporate tax; net worth tax; business tax; turnover tax; company tax; insurance tax; motor vehicle tax; excise taxes; betting and lottery tax; property tax; inheritance tax.	Federal Government	By industrial sector; within these sectors, a further classification by tax type.
Italy	All favourable tax treatment provisions, which include both structural and non-structural.	Personal and corporate direct taxes; value-added tax; excises; customs duties; and other indirect taxes.	Both Federal and local governments	By type of taxes; main sectors involved; the aim; beneficiaries; and their locality.
Netherlands	Formally defined as a loss or deferment of taxation revenue resulting from a tax provision insofar this tax provision is not in accordance with the benchmark tax structure. For defining the benchmark tax structure a rather pragmatic approach is used.	Wage and income taxes; corporate tax; VAT; excise taxes; energy tax; motor vehicle tax; estate and gift tax; and social insurance contributions.	Central Government	By purpose of tax expenditure (direct taxes); and by type of taxes (indirect taxes).

Table 14.2: Coverage of tax expenditures report — a comparison of 10 selected OECD countries (continued)

		Coverage		
Country	Definition and inclusions in Report	Types of taxes	Levels of Government	Classification
United Kingdom	All tax reliefs are included according to three categories: structural relief; non-structural reliefs; and reliefs on the borderline.	Income tax; capital gains tax; inheritance tax; stamp duty; national insurance contributions; and VAT.	Central Government	By ‘tax expenditures’, ‘structural relief’ or ‘relief’ with tax expenditures and structural components under each tax if possible.
United States	A tax expenditure is a preferential exception to the baseline provisions of the tax structure. Report includes all tax expenditures according to the definition. Baselines include normal tax baseline and reference law baseline.	Individual and corporate income taxes; estate and gift taxes; and social security contribution.	Federal Government	By budgetary functional category.

Source: Brixi, H, Valenduc, C and Li Swift, Z, 2003, pp 13-15.

14.4 REFERENCES

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