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Submission to the Treasury review of the Tax Expenditures Statement

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Introduction

On 18 September 2017, the Treasury issued a consultation paper and called for submissions on the Tax Expenditures Statement (TES) in response to a House of Representatives Committee on Tax and Revenue inquiry into the TES. The consultation paper contained a number of focus questions for the review which stakeholders in the TES were invited to address.

This submission addresses those questions and provides some general comments on the usefulness and interpretation of the TES from the perspective of the Parliamentary Budget Office (PBO) and adds to our comments from our earlier submission to the above Committee.[1]

General comments

From the PBO's perspective, the TES is an extremely important resource which should continue to be produced. Its most important contribution is as a comprehensive list of concessions (which adds a great deal to budget transparency), where they arise from and their relative values.

The production of a tax expenditures statement is regarded as best practice from a number of world economic bodies, including the Organisation of Economic Cooperation and Development, the International Monetary Fund and the World Bank.[2] As noted in the discussion paper, the concept of tax expenditures dates back to 1967 when the concept of a tax expenditure was first put by Stanley Surrey of the United States Treasury.

The rationale for reporting on tax expenditures is based on the proposition that providing assistance to taxpayers through the tax system is equivalent to providing the same value of assistance through budget expenditure. Identifying and keeping track of tax concessions is critical for budget transparency and accountability because it ensures that assistance provided through the tax system is identified and can be reviewed in a similar manner to assistance provided through the expenditure side of the budget.

A major contribution made by the TES is that it provides a complete catalogue of the concessions provided through the Australian taxation system. This provides an important starting point for any review of the taxation system. From a PBO perspective, the estimates provided in the TES are a useful plausibility check for a wide range of analyses that we perform. The estimates provided in the TES are also valuable as a guide to the relative importance of the various tax expenditures, in terms of the value of those concessions to taxpayers.

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1 PBO Submission to the House of Representatives Standing Committee on Tax and Revenue inquiry into the Tax Expenditures Statement, 17 September 2015. Available from the PBO website.

2 For instance, see the IMF 'The Fiscal Transparency Code' which recommends that fiscal reports should include 'Coverage of Tax Expenditures' (item 1.1.4). The IMF code is referenced by the World Bank and OECD.

Users of the TES need to be careful, however, in how they interpret the estimates. The TES provides estimates on a 'revenue foregone' basis of estimation, which estimates the value of the concessions on the basis of the existing tax base with no allowance for behavioural effects or flow-ons to expenditures. The TES benchmark is a hypothetical tax system that does not correspond to the actual tax system, against which actual tax revenues are assessed. Not including behavioural effects means that the estimates are not estimates of the revenue that would be gained from abolishing the concessions concerned, rather they provide an estimate of the value of the benefit that is provided to the taxpayer from the reduction in tax on the transactions they engage in. The lack of behavioural impacts and potential interactions between tax expenditures means that you cannot sum the individual tax expenditure estimates so the TES does not provide the aggregate budgetary impact of concessions. Movements in the total value of tax expenditures from year to year are also not particularly meaningful.

It has been suggested in the past that the TES should provide more 'revenue gain' estimates of tax expenditures that incorporate behavioural effects.[3] The TES includes estimates of a small number of representative tax expenditures presented on this basis (10 items in the 2016 Tax Expenditures Statement). More comprehensive reporting of tax expenditures on this basis, while possible, would be a significant increase in the complexity of estimating tax expenditures and require more resources. Revenue gain estimates raise a further set of issues regarding interpretation of the estimates:

- They are not definitive estimates of the gain from abolishing individual tax expenditures as they require the exercise of some judgement regarding how the government would abolish each tax expenditure
- The revenue gain estimates derived for individual tax expenditures would still not be additive due to interactions, so could not be used to derive meaningful aggregate estimates
- These interactions between the behavioural effects of different tax expenditures can make a significant difference to the aggregate cost of concessions and attribution of those interactions is complicated by the order in which the analysis assumes the concessions are removed.

3 See Australian National Audit Office report 32 of 2007–08, Preparation of the Tax Expenditures Statement, recommendation 5.

PBO responses to the focus questions

The following sections provide the PBO's responses to the individual focus questions put in the consultation document.

What is an appropriate annual threshold below which expenditures could be updated less frequently and reported as ranges?

This question raises several issues, whether some estimates should be updated less frequently, the threshold for determining which estimates should be updated less frequently and whether these estimates should be reported as ranges of values rather than as point estimates.

In the 2016 TES, estimates were not available for 142[4] tax expenditure items out of 289 identified tax expenditures. The PBO accepts that production of the remaining 147 tax expenditure estimates is a highly resource intensive task, with many of the smaller estimates showing little variation from one edition of the TES to the next. This is because in many cases, the change in the base and growth of the smaller TES estimates is insufficient to change the magnitude of the previous estimate by enough to move the estimates beyond the threshold of rounding.

Estimating small tax expenditure less frequently has the potential to free up resources to undertake other analysis, such as increasing the number of revenue gain estimates or undertaking investigations into particular tax concessions as discussed in responses to later discussion questions.

The PBO considers that it would be acceptable for small tax expenditures to be updated less frequently than each TES publication on the basis that there is likely to be little meaningful variation in the magnitude of the estimates.

An appropriate threshold for this less frequent updating that balances reliability in reporting with resource constraints would be estimates with an absolute value less than $100 million in each of the current budget year (as at the time of the publication of the TES) and the forward estimates years.

Reporting the value of small tax expenditure items as range values rather than point estimates raises the question of how the ranges are presented and how they are likely to be interpreted. All of the estimates in the TES are already range estimates in the sense that the point estimates shown are the outcome of an uncertain calculation process that produces uncertain values which could all be presented as being a value plus or minus a standard error (if sufficient information is available to calculate a confidence interval). Producing estimates that present values as a confidence interval (i.e. from a lower value to an upper value) will tempt users to just split the difference to get to the central estimate. Given the imprecise

4 2016 Tax Expenditures Statement, page 7.

way that many costing parameters, assumptions and data are used to produce estimates, producing statistically meaningful confidence interval[5] estimates is unlikely to result in any resource saving.

Reporting the value of small tax expenditure items as whether they fall into broader fixed ranges of values, while addressing the temptation to estimate the central value of a range, still requires the value of the tax expenditure to be calculated from time to time to confirm which range it falls into. It also risks losing a degree of fidelity in the tax expenditure estimates in that it means that it becomes harder to determine the rank order of tax expenditure items, with this being harder the wider the fixed ranges are set.

The PBO considers that it would be preferable to continue presenting small tax expenditure items as point estimates.

What is an appropriate frequency for updating these small tax expenditures?

The frequency at which small tax expenditure estimates should be updated, as discussed above, is a question of balancing the resource implications of regularly updating estimates with the loss of reporting reliability that arises from less frequent updates. Updating the small tax expenditure items on a four year rolling cycle would have the advantage of ensuring that tax expenditure updates occur for all TES items within a budget forward estimates period.

The PBO considers that an appropriate frequency for updating small tax expenditures would be once every four years on a rolling basis (i.e. one quarter of small estimates updated each year) and that the information presented with each expenditure item should include the year the estimate was last updated.

Exceptions to this approach would need to apply where the tax expenditure item has been subject to a policy change since the last TES publication, for tax expenditure items that are subject to significant period to period volatility (for example, A28 Exemption of disaster relief payments) or which are of special interest.

What are appropriate bounds for the ranges?

As set out above, the PBO considers that range values for estimates in the TES would not be a positive innovation.

Instead, consideration should be given to the appropriate rounding factors for values of all tax expenditure items, so that the rounding factor used reflects the level of uncertainty of the estimates as indicated by the 'estimate reliability'.

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5 For instance a 90 per cent confidence interval, which is the range over which there are nine chances in ten that the actual value of the item being estimated will occur.

If, however, ranges were to be implemented for small estimates (e.g. those under $100 million), ranges $10 million wide would be the PBO's preference.

Question 4: Do you have any concerns about the benchmarks currently used in the TES? How can they be improved?

The benchmarks for tax expenditures are important both as determinants of the magnitude of tax expenditures and in determining which provisions of the tax legislation are identified as tax expenditures.

The design of the tax expenditure benchmark means that some items which are commonly regarded as concessional are not identified as tax expenditures, while some identified tax expenditure items are items which some people consider should be part of the benchmark.

Examples of items of interest that are not tax expenditures are:

- negative gearing deductions
- tax exemption for imputed rent
- work related deductions
- interest deductions
- mutual income.

The PBO considers that the general principle should be that the design of the tax expenditure benchmark should conform to the broad principles on which the various elements of the tax system are based, as elaborated below.

In relation to those elements of the tax system that are not tax expenditures on account of the design of the benchmarks, such as those in the list above, consideration could be given to having TES appendices from time to time (i.e. not in every issue) that explore these issues.

Income tax benchmark

The income tax benchmark currently employed which employs a Schanz-Haig-Simons definition of income is an appropriate benchmark for measuring income tax expenditures. While some commentators have argued for an alternative consumption tax benchmark on the basis that such a tax would be more economically efficient and would not show provisions designed to address the bias against saving under the income tax as concessions, moving to that benchmark would not reflect the design principles on which our income tax system (warts and all) has been built.

There could be scope for the TES to include, from time to time, additional information on some tax items as memorandum items which explore issues of common concern in the tax system[6]. These could include information on items such as the value of negative gearing and the value of the retirement income provisions measured against a consumption tax benchmark.

The PBO considers that the current income tax benchmark is the appropriate benchmark to use for personal income tax, company tax, the capital gains tax and retirement income concessions.

Indirect taxes

There are several 'sub-benchmarks' in the indirect tax benchmark. Given the divergent nature of the tax bases covered, it would be difficult to see how a single benchmark design could adequately identify the concessions inherent in each.

The PBO considers that the appropriate benchmark for indirect tax should be to base the sub-benchmarks on tax levied on 'activities in common', where the activity to be taxed is defined and a benchmark rate of tax applied. There is scope for some indirect tax benchmarks to be revised, particularly the alcohol benchmark.[7]

Under this approach:

- For general household consumption, the benchmark would be a value added tax levied on all final household consumption expenditure at a rate of 10 per cent.
- For excises, the benchmark would be a tax on the production or import of particular goods that pass the relevant point of taxation:
  - for alcohol, the activity being taxed is the consumption of alcohol and the benchmark should be excise at a single benchmark rate (rather than the multiple rates now used) imposed on the volume of pure alcohol and the base covered should be all alcoholic beverages including wine (with the wine equalisation tax collected allowed as an offset item).
  - for fuel, the activity being taxed is the consumption of energy used in internal combustion engines and the benchmark should be the volume of fuel times an excise rate set equal to the per litre excise on petrol, adjusted for the energy content of the fuel (on the basis that the activity concerned is the consumption of energy).
  - for tobacco, the activity being taxed is the consumption of tobacco and the benchmark should be the rate of excise per stick for cigarettes or the per kilo equivalent of the per stick rate for other products.

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6 See the PBO Submission to the House of Representatives Standing Committee on Tax and Revenue inquiry into the Tax Expenditures Statement, 17 September 2015.

7 See PBO Report no. 01/2015 *Alcohol taxation in Australia* and the PBO Submission to the Senate Select Committee on Red Tape inquiry into *the effect of red tape on the sale, supply and taxation of alcohol*, 9 March 2017.

- For wine equalisation tax (WET), the benchmark should be the WET rate of tax on the wholesale value of wine, for all wine sold.
- For the luxury car tax (LCT), the benchmark should be the LCT rate of tax on the value of all cars that is in excess of the LCT threshold.

The TES treats all customs duties, other than for excise equivalent goods, as negative tax expenditures, in full. The basis for this is that domestically produced goods are not subject to customs duties. This approach is consistent with an approach that treats the benchmark as free trade and uses the taxation of domestic production as the benchmark.

The main drawback with this approach is that it does not show the impact of free trade agreements and other trade preference provisions on the level of customs duty collected.

The PBO supports the current customs duty benchmark but considers that there would be value in the production of estimates of the impact of trade concessions and free trade agreements as a memorandum item to the TES.

Question 5: What broad set of principles should be used to inform the choice of benchmark?

See the response to question 4.

Question 6: Should standards be developed and published for determining the benchmark tax treatment? If so, who should be responsible for their development?

The general principle behind the TES benchmarks should be that they are representative of a broad 'standard' treatment of the transactions concerned. This standard treatment should be representative of the tax base covered by the benchmark concerned. The most important aspect of the benchmarks is that the benchmark being used should be clearly outlined and published in the TES, as is currently the case.

There is no common international standard or accounting standard for tax expenditures estimates. While other countries use similar benchmarks to the Australian TES, approaches vary. The tax expenditures concept is an economic concept rather than an accounting one and it is difficult to see that an accounting standard could usefully be developed or what it would be based on.

The PBO considers that the most useful approach to benchmark development would be for the benchmarks used in the TES to be fully transparent by being set out in each TES (as is currently the case) but that the Treasury review the benchmarks from time to time in consultation with interested parties (e.g. academic institutions, parliamentarians and agencies such as the PBO) to ensure they are kept up to date and are subject to external scrutiny.

Question 7: Should the TES report tax expenditures for income from savings against a pre-paid expenditure benchmark in addition to a comprehensive income benchmark?

As noted in response to question 4, the PBO supports the use of the current income tax benchmark as the principal benchmark for assessing tax expenditures for personal income tax, company tax, capital gains and retirement incomes because this is the design principle on which the current tax system is based. That said, there is scope for analysis of tax expenditures to be done against alternative benchmarks to highlight issues within the tax system and as part of the process for developing tax reform options. The issue this raises is, however, is to ensure that the production of these estimates does not detract from the process of producing the main TES estimates.

The PBO considers that the estimates of tax expenditure against the income tax benchmark should remain the main focus of the TES (unless there is a fundamental change in the nature and design of the tax system).

The PBO considers that while reporting tax expenditures for income from savings against an expenditure tax benchmark has merit in broadening the discussion of tax policy, this should only be done if it does not detract from producing the income tax benchmark estimates.

Question 8: If so, should this apply to all forms of savings, or only a subset? Should reporting against this alternative benchmark be done annually, or periodically?

As noted in the discussion paper, applying the expenditure benchmark to all forms of savings would be more resource intensive than looking at the treatment of particular types of income under the benchmark. If the objective of the analysis is to identify which provisions in the tax system introduce a bias against savings/towards debt in the tax system, reporting against a broader benchmark would be more appropriate.

On the other hand, if the objective is to identify the extent to which particular tax treatments that are shown as tax expenditures against an income tax benchmark overcome the double taxation of savings in the income tax system, a more focussed approach would be more appropriate. For instance, if we wanted to analyse how effective the retirement income tax concessions were in overcoming the income tax bias against saving, an approach that focussed on the superannuation and retirement savings systems would be appropriate.

Given that applying these alternative benchmarks is likely to be resource intensive and the conclusions of the analysis are unlikely to change significantly unless there has been policy change, the timing of the analysis should be periodic. The frequency of the periodic analysis would depend upon factors like the rate of policy change in the area. For instance, given the changes to the superannuation system in recent years and changes in contribution rates that are in prospect, analysis of the retirement income system would be a candidate for more frequent analysis than, for example, dividends or rents.

On balance, the PBO considers that, if an alternative expenditure tax benchmark analysis were to be included in the TES, it should be limited to specific types of savings, with the treatment of different types of savings considered in rotation on a periodic basis.

The choice of which savings types to examine, and the relative frequency of that examination should be determined by the extent to which the taxation treatment of those types of saving changes.

Question 9: Should the current benchmark treatment of owner occupied housing be altered to allow deductibility of mortgage interest and capital works deductions against the CGT cost base?

Currently, the capital gains tax (CGT) exemption for owner-occupied housing is the only tax expenditure identified in the TES for owner-occupied housing. The discussion paper indicates that a criticism of the current TES benchmark treatment is that the capital gains on owner-occupied housing are taxable income but the benchmark excludes allowances for expenses associated with earning that income such as mortgage interest and capital works from the capital gains cost base.

The current benchmark treatment of owner-occupied housing is at best a partial analysis. While including the CGT exemption of owner-occupied housing as a tax expenditure item under the capital gains tax was an advance, that inclusion is only a partial analysis of the tax concessions for investments in owner occupied housing. A fuller consideration of the tax concessions for owner-occupied housing, relative to other taxable investments, should consider not only expenses such as mortgage interest and capital works, but the investment return that is derived from investing in owner-occupied housing. Indeed, it would be a mistake to include the deduction items in the benchmark unless imputed rent was also included on the other side of the ledger. If imputed rent is incorporated into the benchmark, consideration should also be given to allowing other dwelling related expenses, such as local government rates, as deductions under the benchmark in line with the standard tax treatment of landlords.

The PBO considers that there is a case for broadening the current benchmark for owner-occupied housing.

However, the benchmark should only be broadened to include mortgage interest and capital works deductions if imputed rent on dwellings is also included in the benchmark.

If this is done, the benchmark treatment should be to offset mortgage interest, capital works and other relevant deductions against imputed rent first, with any excess incorporated into the CGT cost base.

Question 10: What options are there to improve the visibility and accessibility of caveats in the TES?

Chapter 1 of the TES already sets out the caveats around use of tax expenditure estimates in some detail. These caveats could be improved by drafting them in plainer language and in a more summary form up front. Currently, the caveats are embedded within the text of Chapter 1 and are difficult for a reader to find. An up-front summary of just the caveats without the reasoning, with reference to the reasoning in the chapter that follows, may be more effective.

For instance, some of the main caveats could be set out as follows:

- **Tax expenditures are not estimates of how much particular tax concessions cost the budget or of how much would be gained by removing them**
- **Tax expenditures cannot be added up**
- **Comparing tax expenditures from one year to the next can be misleading**
- **The reliability of the estimates varies widely, many estimates are only an indication of the magnitude of the concession.**

While the caveats could be made plainer and more explicit in a summary up front in the publication, the proverb about leading a horse to water still applies.

The PBO considers that the caveats in the TES could be drafted in plainer language and summarised in a box at the start of the document as a way of making them more visible and accessible.

For those tax expenditure items for which estimates are prepared on a revenue gain basis, the revenue gain estimates could be incorporated into the individual tax expenditure tables in the main part of the report to facilitate the comparison of estimates prepared on a different basis.

Question 11: What options or strategies are available to mitigate or reduce the misunderstanding of figures published in the TES?

As with the TES caveats, reducing the misunderstanding of the TES estimates is difficult as many of those who quote TES estimates have not read the text of the document. The most effective way to reduce misunderstanding of the TES document would be to include an easy to read executive overview that sets out the key messages in each edition of the TES that provides readers with some take out messages and which would provide a guide to the media and commentators regarding key developments in the estimates. Such a section should focus on the estimates, be drafted in plain language and address themes like:

- The largest tax expenditure
- The most changed tax expenditure

- The effect of measures announced over the last year on tax expenditures (increase/decrease). For instance, whether the budget includes more reductions in tax concessions than increases in concessions.
- Reasons for changes in the number of tax expenditure items identified.

The PBO considers that the best strategy for reducing the scope for misunderstanding of the TES estimates would be for the Treasury to include an easy to read executive overview in the TES that would give some direction to commentary on the document.

Question 12: Would adopting a model where technical descriptions of tax expenditures are contained in a separate technical manual be appropriate?

The descriptions of the tax expenditures contained in the TES are an important part of the TES as a reference document. The technical descriptions provide a brief outline of what gives rise to the tax expenditure. If the technical descriptions of tax expenditures and details such as the TES benchmarks and the data and methodology used to estimate tax expenditures were contained in a separate technical manual, it would put the this explanatory material at a distance from the estimates and increase the likelihood of misinterpretation of the estimates.

Until the 2002 edition of the TES, the tax expenditure estimates were contained in a separate table from the technical descriptions in the document which made the TES much more difficult for users. The current presentation, where each tax expenditure is presented in a self-contained description makes it easier to use the TES as a reference source.

It is also not clear that moving the technical detail of the TES into a separate document would achieve much saving in the production of the TES. The largest input to the TES is the calculation of the estimates and drafting of text for the items that have changed. While it is the case that many of the technical descriptions of items and benchmarks are carried over unchanged from year to year, it is not clear that this imposes a great editorial burden in the production of the document.

The PBO does not support separating the technical details and descriptions of tax expenditures from the tax expenditure estimates because this would increase the risk of misinterpreting estimates and make the TES harder to use as a reference document.

Question 13: Would it be reasonable to update the technical manual with lower frequency? (Noting that a description of new and changed expenditures would still be included in the annual document.)

See the response to question 12.

Question 14: Is there additional data that taxpayers can provide to the ATO to improve the estimates without significantly increasing compliance costs?

This recommendation relates to tax expenditure estimates that are shown as unquantifiable. These unquantifiable estimates generally arise either due to lack of data or because the transactions involved are particularly volatile and uncertain.

Where the reason for estimates being unquantifiable is a lack of tax return data, there would be scope to go beyond tax data in order to quantify the tax expenditure. It would need to be acknowledged that such estimates could be very low reliability indicators of the order of magnitude of the tax expenditure involved.

Question 15: Are there existing data sources external to Government that can be used to improve the reliability of existing estimates or allow estimates currently presented as unquantifiable to be reliably quantified?

See the response to question 14.

Question 16: Would the value of the TES be enhanced by including appendices that focus in more detail on particular topics (varying each year) relevant to tax expenditures? What topics should be prioritised?

As indicated in earlier responses, the PBO considers that there is scope for the TES to be enhanced by appendices that set out additional information on tax expenditure issues.

Areas that could be included in this are:

- examination of elements of the tax system that are frequently considered as concessional but are not included as tax expenditures including:
  - negative gearing
  - work related expenses
  - the tax exemption for the member sourced income of mutual organisations
- examination of alternative tax expenditure benchmarks, such as:
  - the treatment of savings under an alternative expenditure tax benchmark
  - a uniform benchmark for alcohol taxation

- examination of conceptual issues such as the difference between tax expenditure estimates and measurement of the 'tax gap', given that many commentators look on tax expenditures as a form of de facto tax gap analysis
- more detailed examination of particular tax expenditures, such as owner-occupied housing and superannuation (which have been the subject of appendices in the past)
- analysis of tax expenditures that grow disproportionately in scale, for instance because they are in a transitional phase and not yet 'mature'. Superannuation is an example of such a tax expenditure.