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Submission to the Commonwealth Parliament, Standing Committee on Tax and Revenue

# Inquiry into the Tax Expenditures Statement (TES)

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# Contents

Submission and recommendations.....	1
Submission .....	1
Recommendations.....	3
References .....	4

## Submission and recommendations

This submission offers the following comments on the Tax Expenditures Statement (TES), encompassing recommendations by the ANAO reports of May 2008 and May 2013, the JCPA in its report of June 2009, and the AFTS Review of December 2009 regarding integration into the budget process, systematic review and evaluation of tax expenditures on an ongoing basis, and improvements to the tax expenditure estimates over time.

### Submission

#### *Tax expenditures, transparency, accountability and the budget process*

Treasury has been preparing tax expenditures statements since the mid-1980s, and these are valuable tools for public policy analysis that are important for promoting transparency and accountability of governments for their fiscal policies. They expose the 'twilight zone' of public spending.

A study I prepared for the Parliamentary Research Service in 2003 (Smith 2003) canvassed the key issues in tax expenditure analysis, and made recommendations for increasing transparency and widening the scope of tax expenditures estimates. It also reported available information on state government tax expenditures which are substantial.

The preparation of tax expenditure statements was subsequently required by the Charter of Budget Honesty from 2007, however, the recommendations in that Charter for tax expenditures to be treated comparably with direct outlays has not been implemented.

Tax expenditures may facilitate transfers to groups of taxpayers on a scale and with equity effects that would not be tolerated if they were made as direct outlays. In this sense, tax expenditures can be a form of stealth budgeting that misleads the public and undermines accountability of governments for their policies.

#### *Revenue gain vs revenue foregone*

It is important that tax expenditures statements are accessible and easily interpreted and understandable to the general public and in particular parliamentarians, and do not become mainly the preserve of technical 'experts'.

Many other countries now provide such tax expenditures estimates, and most use estimates on a revenue foregone basis which does not adjust for behavioural effects. Including behavioural effects may not add substantially to the usefulness of the estimates, but absorbs considerably resources to conduct robust modeling based on parameters for behavioural changes.

Improving the conceptual framework and accuracy of the tax expenditures statements is important, but absorbs scarce resources, and excess focus on defining the benchmark and

related issues risks becoming an academic exercise that distracts from their main purpose of supporting democratic scrutiny and decisionmaking on public policy.

Some tax expenditures are not reported because information is not available, which according to the Henry Tax Review can be particularly the case for exempt income. It is important the information on such areas be improved where there is a possibility that lack of scrutiny is facilitating the cash economy or other tax evasion activity.

Hence priority should generally be on ensuring tax expenditures are better integrated into budget processes, rather than on requirements for Treasury and the ATO to devote substantial additional resources to refining the accuracy of estimates to include behavioral effects. Nevertheless, addressing information gaps is important to maintaining tax integrity.

### *The politics and policy of tax expenditures*

It has been pertinently observed regarding tax expenditures that

*'Tax incentives are popular because they represent a way of increasing Federal support for social policy, while seeming to be tax cuts rather than increases in spending. Compared to direct outlay programs with similar goals, they better meet the need of politicians to appear to favour spending restraint and in some circumstances can be financed at a lower political cost.'*

Tax concessions may have a legitimate role as a tool for implementing government policy.

Tax expenditures have long been an element of the redistributive role of the Australia's tax system, and the treatment of Commonwealth income taxpayers with children was for many years considered part of the 'benchmark' for income taxation (Smith 2002).

However, the policy process does not include adequate scrutiny of tax expenditures, in particular as part of preparing the annual Budget. This means that many tax expenditures are poorly scrutinized when introduced and are not adequately monitored or evaluated.

As a consequence, tax expenditures are popular with governments that purport to advocate spending restraint, and tax cuts whilst providing fiscal support to causes that would be unpopular if provided as direct government funding. Tax expenditures are allowed to rise to an extent that more visibly and better monitored direct outlays are not.

Public policy is less well monitored, less evaluated, less cost effective, and less coherent as a result, as is well illustrated in the case of retirement incomes policies where different standards are applied to the use of public revenues for subsidizing the retirement of higher income earners contributing to non-compulsory superannuation compared to those on lower incomes whose retirement is mainly supported by Australia's aged pension. A recent study of tax expenditures taxes retirement incomes as an example (Xynas and Jaynes 2012).

A contrasting example where there has been greater transparency is in the case of private health insurance, where the public subsidy to this part of the finance industry has been made more transparent and its opportunity cost to the health budget more apparent by

converting it from a tax rebate to a direct subsidy reported in the budget papers (Smith 2001). (The substantial industry assistance provided through the Medicare surcharge has been less commented on but remains substantial (Smith 2001).

An important gap in tax expenditures reporting is in states' tax expenditures. Improved reporting in the area of tax concessions for gambling, land and payroll taxation would enhance democratic accountability and provide greater transparency about industry subsidies in these areas although the politics is difficult (Smith 1998; Smith 2000). (Strangely, the Tax Expenditures Statement includes the GST, yet is purportedly not a Commonwealth tax.)

Likewise, the excise treatment of some forms of alcohol warrants closer investigation to enhance public policymaking in this area, and tax expenditure reporting on excises contributes importantly to such discussions (Smith 2004 (1993)).

### *The way forward*

It is important to public confidence and trust in the tax system and fiscal politics that tax expenditures be monitored and reviewed individually on their merits in achieving their stated purposes at least cost to the public.

However, in the apparent absence of political commitment to strong fiscal management of individual tax expenditures, it has been suggested that parliaments might set rules to limit the expansion of tax expenditures. For example, US experts in this field (Toder, Rosenberg et al. 2013) have suggested setting limits such as through requiring converting tax concessions into refundable tax credits, an approach which appears worthy of examination in Australia. This could contribute to improve the progressivity of tax expenditures, which are notably inequitable in their incidence, as well as to improve the ability to evaluate such expenditures in a way comparable to direct outlay programs.

These points are elaborated in further detail in the attached publications.

## **Recommendations**

1. The Commonwealth Parliament focus on ensuring tax expenditures are better integrated into budget processes as required by its legislated Charter of Budget Honesty
2. Consideration be given as in the United States to introducing rules to limit the unmonitored growth of tax expenditures
3. State governments be encouraged through COAG and other processes to compile tax expenditures statements or contribute information to the Tax Expenditures Statement on their key taxes
4. Addressing information gaps on tax expenditures to assist with maintaining tax system integrity is a priority area for resources, compared to compiling comprehensive revenue gain estimates

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