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Tax Expenditures: the \$30 Billion Twilight Zone of Government Spending

This paper examines the \$30 billion in Commonwealth tax expenditures which provide tax benefits through deductions, rebates, reduced rates and deferred liabilities. While essentially the same as outlays, tax expenditures are not subject to the same scrutiny but provide the cosmetic effect of a slimmer public sector with lower outlays and taxation receipts.

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Acronyms

ACOSS	Australian Council of Social Service
ANAO	Australian National Audit Office
ANTS	A New Tax System
ASFA	Association of Superannuation Funds of Australia
ATO	Australian Taxation Offices
CDEP	Community Development Employment Project
CGT	Capital Gains Tax
DWT	Dividend Withholding Tax
GDP	Gross Domestic Product
GST	Goods and Services Tax
NCOA	National Commission of Audit
OECD	Organisation for Economic Cooperation and Development
TES	Tax Expenditures Statement

Executive Summary

A tax expenditure is a provision of Australian tax law that provides preferential treatment to certain classes of taxpayers or to particular types of activity. Examples are superannuation tax concessions and excise exemption for alternative fuels. Tax expenditures take various forms including deductions, rebates, reduced rates and deferred liabilities. In 2001–02, the cost of Commonwealth tax expenditures was estimated at nearly \$30 billion, the equivalent of 20 per cent of outlays or four per cent of Gross Domestic Product (GDP).

This paper examines trends in tax expenditures in Australia, and the implications for the efficiency of public spending and for parliamentary and public scrutiny.

There has been an underlying upward trend in the real cost and number of tax expenditures since the mid 1990s. Social tax expenditures have been growing faster than tax expenditures affecting business. Nevertheless, tax expenditures remain a greater proportion of budgetary assistance for industry than is the case for the social security, health and welfare functions of the Commonwealth.

The significance from a public policy perspective is that even though tax expenditures are *effectively* equivalent to direct government spending, and in some cases are alternatives, they largely escape the detailed parliamentary scrutiny and accountability processes associated with budgetary outlays. This is notwithstanding the 1996 National Commission of Audit recommendations that tax expenditures be subjected to the same degree of scrutiny as direct budget spending.

Indeed the only real progress that has been made in achieving greater scrutiny of tax expenditures dates back to the mid 1980s when the government of the day commenced the publication of Treasury's annual *Tax Expenditures Statement*,¹ a document the Treasurer releases typically in January. Unfortunately, these statements do not encompass some important Commonwealth tax expenditures, notably those relating to the goods and services tax (GST) concessions (for example, the zero-rating of GST on many food items).

Nor, to date, has there been any public evidence that the Commonwealth Government has met undertakings to integrate tax expenditure analysis into its fiscal management practices.

Ways to improve the transparency and parliamentary scrutiny of tax expenditures could include:

- incorporating existing tax expenditures into annual budgetary review processes
- including the Treasury's annual *Tax Expenditures Statement* in the published Budget documentation

- requiring the publication of a justification statement by the relevant portfolio minister and specifying the rationale for tax expenditures rather than direct spending—for example, a Tax Expenditure Justification Statement could be included in the Explanatory Memorandum of each Bill where applicable
- an independent body such as the Productivity Commission or the Australian National Audit Office assessing whether particular tax expenditure measures are meeting stated objectives as a delivery tool
- providing for parliamentary committee scrutiny of tax expenditures along with portfolio estimates.

The paper suggests that reform measures along these lines might be considered and developed further in the context of a parliamentary inquiry into tax expenditures policies.

Introduction

What are Tax Expenditures?

A tax expenditure is a departure from the generally accepted ('benchmark') tax structure that produces a favourable treatment of particular types of activities or taxpayers.² In the United States the Office of Management and Budget defines tax expenditures as revenue losses attributable to provisions of the federal tax laws 'which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability'.³

In Australia, the Commonwealth Treasury considers a tax expenditure as 'A tax concession that is designed to provide a benefit to a specified activity or class of taxpayer'.⁴

Emphasising the characteristic that tax preferences are similar to direct expenditures in that they are different ways of achieving the same kinds of social and economic policy goals, some commentators identify a provision as a tax expenditure only if its objective could reasonably be achieved by an expenditure program.⁵ In other words, 'a tax expenditure is a spending program and must therefore be analysed in spending terms', using analytical techniques similar to those used to evaluate direct expenditure programs⁶.

Tax expenditures can take various forms and may either reduce tax liabilities or simply defer them. Tax exemptions, deductions or allowances, rebates or 'offsets', rate reliefs and provisions for income averaging or income or tax deferral are different ways of delivering a tax expenditure.⁷ The schedule below identifies some major forms of tax expenditures with some illustrative examples.

Schedule 1. Major forms of tax expenditure

Form of tax expenditure	Illustrative examples
Tax exemptions	Exemption of disturbance allowance for Australian Defence Force members
Tax concessions	Concessional tax treatment of income of offshore banking units
Tax deductions	Deductions for gifts other than trading stock to approved donees.
Allowances	Capital gains arising from the sale of active small business assets are exempt from capital gains tax (CGT), up to a maximum lifetime limit of \$500 000, where the proceeds of the sale are used for retirement.
Rebates or offsets	Under the Infrastructure Borrowings Tax Offset Scheme (IBTOS), resident lenders receive a tax offset at the company tax rate for interest income received from loans for approved land transport infrastructure projects.
Rate relief	Brandy is subject to a lower rate of excise than other spirits.
Provisions for income tax averaging	Primary producers can elect to pay tax at a tax rate based on the average income earned over the previous five income years.
Provisions for tax deferral	Insurance recoveries from loss of timber or livestock, and net income from forced disposal of livestock, can be spread over five income years.

Measuring Tax Expenditures

A number of conceptual and measurement issues arise from the need to identify and measure tax expenditures.⁸ An important area of debate has been over the norm or 'benchmark' income tax system. The benchmark is the basic structure of the income tax system against which tax expenditures are measured.⁹ The cost of a tax expenditure depends on how the tax benchmark is defined—for example, if the family unit is considered to be the benchmark income tax unit, family payments will not be counted as tax expenditures. The benchmark may differ between countries and over time.

Differences may include:

- the definition of the tax base (for example, income or consumption), or the tax-paying unit (individual versus couple or family)
- whether it is adjusted for inflation
- what degree of integration between corporate and individual taxation is considered the norm
- which accounting period is appropriate
- whether a realisation or accruals basis is used for assessment, and
- how tax penalties and negative tax expenditures are assessed.¹⁰

An [Organisation for Economic Cooperation and Development](#) (OECD) survey of tax expenditures and benchmark tax structures found that the norm includes the rate structure, accounting conventions, the deductibility of compulsory payments, provisions to facilitate administration and those relating to international fiscal obligations.¹¹ Discussing such conceptual issues, the Treasury's view is that:

The decision as to an appropriate benchmark for determining tax expenditures is a matter for judgment: benchmarks may vary across countries and within countries over time. The principal criterion of benchmark design is that it should represent the neutral taxation treatment of similarly placed activities or classes of taxpayer (That is, neutral taxation treatment neither favours nor disadvantages similarly placed activities or classes of taxpayer).¹²

The usefulness of the tax expenditures concept as a tool in budgetary analysis has been contested by advocates of targeted tax benefits for favoured industries or constituents, who challenge the labelling of tax concessions as 'spending' because it reduces their attractiveness. Opponents of tax expenditure reporting in the United States have also criticised the effects of arbitrary measurement of some tax expenditure items on democratic decision-making, because of federal budget rules requiring that new direct spending and revenue legislation be deficit neutral.¹³

The undoubted conceptual and practical difficulties of estimating tax expenditures have not prevented their widespread adoption. As United States economic adviser and academic Professor Martin Feldstein observed two decades ago 'The fact that experts disagree about which provisions should be considered tax expenditures does not reduce the usefulness of any estimates of particular tax subsidies'.¹⁴

Surveys of legislators in the United States show a wide acceptance of the tax expenditures concept and it is now well recognised that tax benefits have an economic impact similar to a budgeted appropriation.¹⁵

Although tax expenditure analysis overseas initially focused on the income tax system, tax expenditures estimates have also been compiled for other taxes, including sales taxes and excise taxes, as well payroll taxes and land taxes such as those levied by the Australian states. That said, tax expenditures reporting so far has been most utilised within a revenue policy framework, for understanding the nature of potential tax policy problems and the impact of existing tax policies, rather than as a tool of budgetary decision-making and determining the allocation of public resources.¹⁶ This also appears to be the case for tax expenditure reporting in Australia.

Why are Tax Expenditures Important?

The most important reason for examining tax expenditures is their size. Treasury has identified 218 tax expenditures for the year 2001–02, with an estimated cost to revenue of \$29.2 billion a year. While there are significant conceptual problems in aggregating

individual tax expenditure items,¹⁷ the magnitude of tax expenditures can be gauged by the fact that the amount is equivalent to twice the size of the Defence budget and roughly equals Commonwealth spending on health. Tax expenditures account for one in five dollars of Commonwealth spending. At the state government level, tax expenditures exceed \$9.5 billion annually.

There are several consequences of tax expenditures that are of interest to public policy.

One is that overuse of the tax system for non-revenue purposes may undermine tax system integrity. Tax expenditures also have important potential implications for budget control and fiscal management because they are often open-ended and their financial cost difficult to forecast.

Other consequences of tax expenditures arise from their allocative effects. Assistance provided through tax concessions is closely akin to a direct budget subsidy. United States academic Professor Paul McDaniel, one of the architects of tax expenditures reporting in the US, highlighted what he saw as the 'secret double life' of the tax system:

The basic function of a tax system is to collect those revenues which are to be allocated to the public sector and expended for publicly determined purposes. A tax system may also be used by government as a tool to implement policies of government that require the expenditure of funds. Thus when government desires to provide a financial incentive for individuals or businesses to engage in a particular course of action or to share costs in hardship situations, it may employ either direct spending programs or special provisions in the tax system.¹⁸

Tax expenditures may work against other policy objectives or their results may be quite different from those of related direct spending programs.¹⁹ For example, tax expenditures targeting business or industry policy objectives may reduce the effectiveness of direct spending programs promoting environmental goals.

Critics of tax expenditures also emphasise that the distributive consequences of tax reliefs and tax incentives are often very regressive compared to direct spending programs.²⁰ It has been argued that the design of tax expenditures entrenches the economic disadvantage and dependent status of women because the main beneficiaries of major tax concessions such as for superannuation and capital gains—high-income earners with continuous labour force participation, and those with significant capital gains—are predominantly male.²¹ Much social security and health spending in Australia has been provided through direct outlays, often on a means-tested basis. Recent new tax expenditures such as the baby bonus, the 30 per cent private health insurance rebate, and higher tax thresholds for retirees have been criticised as a 'new welfare state', characterised by 'a steady growth in handouts to people who are far from poor'.²²

While such criticisms may stem from inappropriate design as much as intrinsic problems in using the tax system to deliver benefits, such characteristics may be more common in tax expenditure programs because they are subjected to a lesser degree of scrutiny and

evaluation than direct outlays. Unlike direct subsidies, tax expenditures traditionally have been subject to little parliamentary or public scrutiny. As the OECD pointed out: 'the concept of a tax expenditure was developed because accounting for the costs and benefits of tax measures is often less rigorous than for direct expenditures'.²³ Treasury notes that 'unless both direct and tax expenditures are considered, the apparent size of government could be reduced simply by pursuing the objectives of expenditure programs through tax expenditures'.²⁴

For this reason tax expenditures have been dubbed 'the twilight zone of public expenditures'.²⁵ It is therefore noteworthy that a Parliamentary enquiry recently initiated by the Senate Economics References Committee is examining the structure and distributive effects of the Australian taxation system. One of its terms of reference is to inquire into 'the use and efficiency of tax and expenditure incentives to influence social and economic conduct, for instance participation in the workforce'.²⁶

Some United States public choice theorists consider that tax expenditures are less susceptible to 'capture' by special interests than direct spending programs, arguing that Congressional tax committees are more broadly based and less 'captured' by special interest groups than program committees.²⁷ However, others argue that the lack of parliamentary scrutiny reduces tax expenditure transparency, making them particularly susceptible to lobbying by interest groups.²⁸ The measuring and reporting of tax expenditures is thus said to 'serve to limit the ability of the politically powerful to obtain tax relief at the expense of the less powerful'.²⁹

Purpose and Structure of the Paper

Given the importance of tax expenditures, the purpose of this paper is to assess:

- the adequacy of information about tax expenditures
- the transparency and public accountability of decision-making on tax expenditures, and
- the adequacy of the internal processes of government and of parliamentary scrutiny in examining tax expenditures and reviewing their effectiveness compared to direct expenditures.

The remainder of this paper is organised as follows:

The next section examines the pattern and trends in tax expenditures, raising issues about the adequacy of information and reporting of tax expenditures and whether tax expenditures have been underestimated.

The centrepiece of the paper is the section, 'Tax Expenditure' or 'Direct Spending—Why Does it Matter?'. This section lists and describes the various criteria that might be used to evaluate individual tax expenditures. It also examines the report of the National

Commission of Audit and issues of budgetary control. It covers matters such as preserving the integrity of the tax system and transparency, political accountability and political decision-making.

The concluding section brings things together and proposes a series of measures that could address the problems identified in this paper.

Tax Expenditures in Australia

Emergence of the Treasury's Tax Expenditures Statement (TES)

Public and parliamentary debate over Commonwealth taxation and Budget policy in the early 1980s was accompanied by several changes in the way tax expenditures are reported and examined.

In 1982, the House of Representatives Standing Committee on Expenditure expressed concern at the information base of tax concessions and their budgetary cost, and strongly recommended improvement.³⁰ The Treasurer supported this recommendation in a statement on 27 March 1985. Although since 1980–81 the Commonwealth Treasury had listed major Commonwealth income tax expenditures in an Appendix to Statement No. 4 of *Budget Paper No. 1*, these were without comprehensive costings.³¹ However, since 1986, the Commonwealth Treasury has published annual estimates of the cost of tax expenditures in Tax Expenditures Statements (TES).

The TES is now published as one of the commitments under the *Charter of Budget Honesty Act 1998*.³² The Commonwealth Government's other commitments under this Act are discussed later in this paper.

Most states also now publish tax expenditure information relating to state taxes in their annual budgets. State tax expenditures are discussed below after the examination of trends and patterns in Commonwealth tax expenditures.

Purposes of the TES

Treasury considers that the primary purpose of the TES is 'to provide estimates of the value of concessions received by individuals and businesses as a result of tax expenditures'. This in turn permits review and scrutiny as to 'whether objectives are met at reasonable cost' compared with that for direct expenditures, and 'facilitates a comparable degree of scrutiny for tax expenditures as occurs for direct expenditures'.³³

Another purpose of the TES is to allow comparison of the assistance that the Commonwealth Government provides to different sectors:

An examination of direct expenditures alone can present a misleading picture, particularly since the benefits derived from tax expenditures are for some sectors, greater than those derived from direct expenditures.³⁴

Issues in the Calculation of Tax Expenditures

The Treasury TES excludes many tax items which arguably might be considered as tax expenditures. Some of the exclusions are too difficult to estimate or are apparently not costed in the TES due to lack of relevant information, for example:

- the main residence exemption from capital gains tax (CGT)
- venture capital tax concessions
- small business CGT exemptions relating to the sale of active business assets/goodwill
- the exploration and prospecting deduction
- the deduction for horse breeding stock
- the dividend withholding tax (DWT) exemption for Pooled Development Funds
- the exemption of non-portfolio dividends from the foreign tax credit system
- exemptions from accrual taxation for controlled foreign companies and transfer or trusts, and
- recreation/childcare facilities on an employer's premises.

Some of these tax expenditures are measures for which revenue cost estimates could have been expected to form the basis of decision-making at the time the concession was introduced.

Other tax provisions can be viewed as preferential but are counted as part of the benchmark and so are not identified as tax expenditures. The more debateable exclusions are:

- concessional tax rate on interest, dividends and royalties paid to non-residents under double tax agreements
- non quarantining of negative gearing of rental properties
- taxation of capital gains on a realisation rather than an accruals basis
- non realisation of capital gains on death
- non taxation of the imputed rental income from owner-occupied housing, and

- tax rules applying to sole traders, partnerships and trusts (such as discretionary family trusts), including those that facilitate income splitting and tax avoidance.

Unofficial estimates suggest the cost of these excluded items would exceed several billion dollars annually. For example, dividends, interest and royalties paid to non-residents are generally subject to a withholding tax that is the final tax liability for these payments. The interest withholding tax is imposed at a flat rate of 10 per cent on gross interest and royalties paid to non-residents, with a 15 per cent rate generally applying to dividends.³⁵ The revenue cost of this concession compared to a standard rate of 30 per cent is around \$5.2 billion.³⁶

Likewise, the Senate Community Affairs References Committee's 1997 *Report on Housing Assistance* presented estimates of the revenue loss from negative gearing tax concessions of between \$800 million and \$900 million for the year 1994–95.³⁷ The revenue loss increased to about \$1.4 billion when the loss to partnerships, trusts and companies for similar types of investment was included. Assuming the cost of this tax expenditure has risen at least as fast as GDP since 1994–95, the concession would have cost around \$2.1 billion in 2001–02.

The general benchmark for the personal income tax is taken in the TES to be the individual. For this reason, tax credits allowed to taxpayers with responsibility for financial support of dependent children are counted in the TES as tax expenditures. Treasury's practice of counting tax rules facilitating income splitting as part of the benchmark thus raises the broader issue of whether the tax preferences that result from judicial decisions that are not then overturned by statute should be identified as a tax expenditure.³⁸

Debate over what the benchmark includes also gives rise to debate over whether the exemption from the one per cent Medicare Levy surcharge for those with private hospital insurance should be identified as a positive tax expenditure or as a tax penalty (negative tax expenditure).³⁹

Aspects of the measurement of some tax expenditures are also questionable with the effect of possibly underestimating the cost to Commonwealth revenue for tax deferral provisions such as accelerated depreciation. The TES treatment of deferral tax expenditures assumes a zero discount rate for such provisions. This understates the cost of such tax expenditures although Treasury considers that this treatment makes measurement comparable and complementary to other Budget estimates.⁴⁰ By deferring the collection of revenue, the provision means the Commonwealth net debt is greater by the amount of the interest cost of deferred taxation. Attributing a positive discount rate to the deferral of tax revenue due to accelerated depreciation would suggest a total budgetary cost of accelerated depreciation of around \$3.8 billion for the twelve-year period the provision is included in TES.⁴¹

A further debateable omission from the 2001 TES are tax expenditures relating to the GST. According to Treasury:

Only tax expenditures that relate to Commonwealth taxes are reported in Table 5.1. As the GST is imposed and collected by the Commonwealth on behalf of the States, and the proceeds of the GST are not reported as Commonwealth revenue, this Statement does not cover GST.⁴²

However, neither the Australian Bureau of Statistics nor the Commonwealth Auditor-General treat the GST as a state tax under existing statistical or accounting conventions.⁴³ Tax expenditures relating to the GST, such as exemptions for certain foods, rent, and health or education services, and input taxing of the financial services and building industries, might justifiably be reported as a tax expenditure. The magnitude of these exclusions is likely to be large. For example, exempting food from the GST was estimated to cost \$3.1 billion in 1999–2000.⁴⁴

Likewise, the TES no longer reports customs duty concessions as tax expenditures, although this would be consistent with the treatment of excise duties.

In addition, since the 2001 TES and the 2002–03 Budget were prepared, a number of major new tax expenditures have been announced. These include additional concessions for superannuation (estimated cost around \$142 million for 2004–05),⁴⁵ the first child tax rebate (\$390 million in 2004–05),⁴⁶ and the national excise scheme for low alcohol beer (\$69 million in 2003–04).

There are other aspects of the TES data which make their interpretation difficult, especially in examining trends over time. Aggregating estimates of individual tax expenditures is particularly problematic. These issues are discussed in more detail in various editions of the TES but include:

- changes in data coverage and methodology over time; for example, the expansion of TES to include excise duties and sales taxes, and the later inclusion of previously identified but uncoded tax expenditures
- the questionable assumption that taxpayers would not alter their behaviour following the removal of a tax expenditure, and
- the effect of interactions between one tax concession and another or with a progressive income tax scale; for example, introducing or removing one concession may alter the revenue cost of another.

It is also worth noting that the progressive personal income tax scale is considered part of the 'benchmark' for income taxation. This means that reductions in personal tax rates reduce the measured costs of some tax expenditures such as tax deductions or exemptions. On the other hand, the benchmark does not include any particular personal income tax

scale so that, for example, cuts in tax rates that favour particular income brackets, or increases in tax rates in other brackets, are not counted as tax expenditures.

The data used below have attempted as far as possible to adjust for the effects of revisions and changing coverage of the TES, but for the reasons discussed above, care must be taken when interpreting these aggregates, particularly when making comparisons over time. In particular, these aggregates include only those tax expenditures costed in the TES, thus excluding uncosted tax expenditures and those that Treasury does not identify as tax expenditures.

Patterns and Trends in Commonwealth Tax Expenditures

Commonwealth measured tax expenditures totalled \$29.2 billion or about 4.5 per cent of GDP in Australia in 2001–02. By comparison, Commonwealth outlays are around 23.3 per cent of GDP.⁴⁷

The considerable magnitude of tax expenditures highlights how misleading international comparisons of public spending may be if account is not taken of the different policy 'tools' used in various countries.⁴⁸ Government spending could, in principle, be reduced simply by redesigning programmes as tax reliefs or tax incentives.⁴⁹

The Commonwealth's tax expenditures are unevenly distributed across functions. Table 1 shows that a large proportion of tax expenditures are categorised under the 'social security, health and welfare' function, although this may be overstated due to the possible underestimation of tax expenditures falling under other functions, as noted earlier.

Table 1. Tax Expenditures Share by Function, 2000–01

Function	Aggregate tax expenditures by function % of total tax expenditures
Social security and welfare	60
Other economic affairs	11
Non fuels mining and mineral resources, manufacturing and construction	8
Fuel and energy	6
Health	5
Agriculture, fisheries and forestry	1
Transport and communications	0

Source: Treasury, *2001 Tax Expenditures Statement*, Australian Government Publishing Service, Canberra, 2001.

It is also apparent that tax expenditures are extensively used as a delivery mechanism for some government functions and much less so for other functions. Table 2 shows that, for example, much of the Commonwealth's budgetary assistance to the mining and manufacturing sector is through tax expenditures, whereas most social security, health and welfare spending is through direct spending programs.

Table 2. Tax Expenditures as Share of Budgetary Assistance by Function, 2000–01

Function	Tax expenditures % of budgetary assistance
Non fuels mining and mineral resources, manufacturing and construction	74
Other economic affairs	53
Fuel and energy	41
Social security and welfare	21
Agriculture, fisheries and forestry	11
Health	5
Transport and communications	3
Other purposes	0

Source: Treasury, *2001 Tax Expenditures Statement*, Australian Government Publishing Service, Canberra, 2001.

However, the functional classification of tax expenditures is based on the legal, not economic incidence of the tax concession. So, for example, tax expenditures for private health insurance or superannuation may provide industry assistance through permitting higher premiums or asset management fees, notwithstanding the fact that individuals access the concessions. While recognising that the question of who finally bears the tax burden (or tax relief) may be unresolved, this problem arises similarly in allocating direct subsidies. According to the OECD, even when there is a clear duality of beneficiaries most countries allocate tax expenditures 'to the taxpayer who immediately and directly benefits from them'.⁵⁰

It is also apparent that the same major tax expenditure items have remained important over the last two decades. For example, as can be seen from Table 3, concessional treatment of superannuation, rebates for recipients of taxable pensions and so on, as well as exemptions from interest withholding tax, which were identified as major items in the early 1990s, remained prominent even a decade later.

Table 3. Major Tax Expenditure Items, Actual and Projected, Selected years: 1991–92 to 2004–05

	1991–92 estimated revenue costs, \$m	1996–97 estimated revenue costs, \$m	2001–02 projected revenue costs, \$m	2004–05 projected revenue costs, \$m
Accelerated depreciation allowance for plant and equipment		1730		
Accelerated depreciation allowances	1360			
Application of statutory formula to value car benefits		740	910	980
Capital expenditure deduction for mining, quarrying, and petroleum operations	340			
Capital gains tax discount for individuals			1180	1480
Concessional excise on aviation gasoline and aviation turbine fuel		727	860	910

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	1991–92 estimated revenue costs, \$m	1996–97 estimated revenue costs, \$m	2001–02 projected revenue costs, \$m	2004–05 projected revenue costs, \$m
Concessional tax on unused long service leave for service up to 15/8/78	280			
Concessional treatment of superannuation	4765	8650	9485	11 875
Concessional treatment of non-superannuation termination benefits		1290	1580	1890
Depreciation pooling for low value assets				750
Exemption from excise for 'alternative fuels'		540	900	1200
Exemption from interest withholding tax on certain public overseas share issues or interest on loans	655			
Exemption from interest withholding tax on widely held debentures		740	590	
Exemption of certain social security and repatriation payments	1090	1250		
Exemption of certain war-related payments and pensions	246			
Exemption of family tax benefit, parts A and B including expense equivalent			2210	2390
Exemption of private health insurance rebate/benefit, including expense equivalent			720	820
Rebate for housekeeper	974			
Rebate for low-income earners		530		
Rebate for recipients of taxable pensions; or benefits			630	700
Rebate for recipients of taxable repatriation or social security pensions; or unemployment, sickness or special benefits	1196	1930		
Research and development tax concession	305	800		
Senior Australians' tax offset			1390	1600

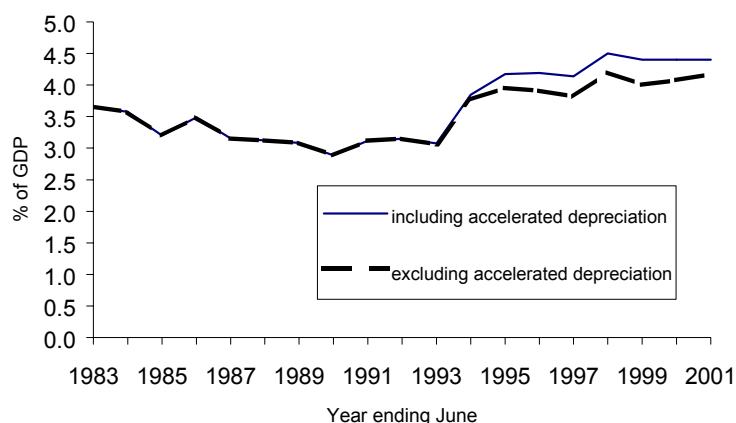
Note: Grey shading indicates not applicable

Sources: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years.

Although the tax reform process resulted in a winding back of tax expenditures during the late 1980s and early 1990s, there has been an increasing use of tax expenditures as a tool of government fiscal policy since then.⁵¹ A listing of significant tax expenditure measures introduced since 1996 is provided at Appendix 1.

Figure 1 shows trends in measured Commonwealth tax expenditures, including the trend when the effect of accelerated depreciation is removed.⁵² This shows that aggregate per cent of GDP in 1997–98. Excluding accelerated depreciation, tax expenditures peaked at 4.2 per cent of GDP and have remained around that level since 1997–98.

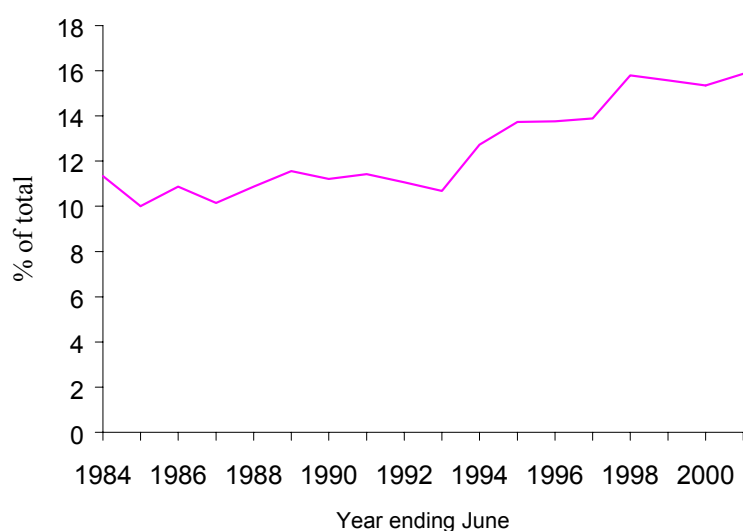
Figure 1. Tax Expenditures as a Per Cent of GDP, 1983–2001



Sources: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years (1986–2001)

Tax expenditures have also risen faster than outlays (Figure 2). These trends are due partly to the rising costs of existing tax expenditures, partly to the introduction of new tax expenditures, and partly to changes to the tax structure.⁵³ The recent stabilisation of the aggregate cost of tax expenditures mainly reflects the abolition of accelerated depreciation provisions from September 1999; cost savings have partly been offset by introduction of some new tax expenditures as well as by the rising cost of existing tax expenditure items.

Figure 2. Tax Expenditures Compared with Total (Direct and Tax) Expenditures, 1983–2001



Source: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years (1986–2001) Canberra.

The expansion of the GDP share of tax expenditures in the late 1990s is associated with a rise of over 20 per cent in the number of tax expenditures since 1997–98. Adjusting for changes in classification, Table 4 shows that 218 tax expenditures were identified in 2001–02 compared to fewer than 180 in 1997–98.

Table 4. Number of Tax Expenditures, 1996–97 to 2004–05

	1996–97	2001–02	2004–05
Number of tax expenditures identified by Commonwealth Treasury in TES	178	218	216

Sources: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years (1986–2001)

Treasury has attributed an expected underlying growth in tax expenditures to the introduction of the capital gains tax discount for individuals and the rapid growth in the cost of the excise exemption for alternative fuels.⁵⁴ Increased take-up of private health insurance arising from the Life Time cover policy⁵⁵ has also contributed importantly to underlying growth in the cost of tax expenditures.⁵⁶

The increase in total measured tax expenditures, as a share of GDP in 2000–01, largely reflects the first full year operation of the Family Tax Benefit (a tax exempt payment) and the introduction of the capital gains tax discount for individuals. The subsequent projected decline reflects the impact of the policy decision to remove accelerated depreciation for plant and equipment.⁵⁷

The accelerated depreciation for plant and equipment is estimated to decline from a large positive tax expenditure in 1998–99 to a large negative tax expenditure in 2005–06. It becomes a negative tax expenditure because accelerated depreciation merely brings forward tax deductions; hence deductions in coming years for investments made before accelerated depreciation was removed will be lower than they would have been under the benchmark.⁵⁸

The recent trend of stability or modest growth in aggregate tax expenditures belies the pattern for some significant individual tax expenditures. For example, tax expenditures mainly directed at the elderly rise from 1.2 per cent in 1991–92 to a projected 1.8 per cent of GDP in 2004–05, notwithstanding the impact of the superannuation surcharge in containing growth in superannuation tax expenditures.⁵⁹

As noted earlier, the TES estimates for 2001 exclude new tax concessions associated with superannuation, 'baby bonus' and low alcohol beer excise measures included in the 2002–03 Budget. Including the projected budgetary cost of those items, the total cost of Commonwealth tax expenditures is projected to stabilise at around 4 per cent of GDP from 2001–02. However, after excluding the effects of accelerated depreciation, tax expenditures will rise as a percentage of GDP after 2001–02.

Reduced personal income tax rates and the Howard Government's tax reform package known as *A New Tax System* (ANTS) have also influenced these trends. That is:

- lower tax rates brought in by the ANTS package reduced the measured cost of personal income tax expenditures, and
- substituting the Family Tax Benefit for the existing family tax rebates gave rise to a new tax expenditure because the TES counts the income tax exemption of the former as a tax expenditure, but not the income tax exemption of the latter. This also affects costings for the 30 per cent private health insurance incentive scheme, which replaced the previous tax rebate with a refundable tax credit (that is, it included a cash payment option).⁶⁰

Table 5. Major Social Tax Expenditure Items, Actual and Projected, 1992–2005, \$m

	1991–92	1996–97	2001–02	2004–05
Superannuation and termination payment concessions	4 765	9 940	11 065	13 765
Social security exemption/exemption of Family Allowance/ exemption and payments of Family Tax Assistance/Family Tax Benefit/Sole Parent Rebate	*1 254	1 267	3 060	3 380
Senior Australians' tax offset	0	0	1 390	1 600
Capital gains tax discount for individuals	0	0	1 180	1 480
Private health insurance	0	0	990	1 130
Pensioner and beneficiary rebate	1 196	1 930	630	700
Childcare benefit exemption	0	0	410	490
Low-income earner rebate	0	530	390	340
Medicare levy exemption	234	350	350	370
War payment exemption	246	295	330	380
Housekeeper/dependent spouse rebate	974	400	310	330
Charitable deduction	160	195	300	370
Total or partial exemption income earned by Australians working overseas	62	180	290	370
Capped taxation rate for unused leave	240	230	195	170
Zone rebate	131	175	175	190
Medical expenses rebate	110	105	170	220
Pre-1978 long service leave concession	280	185	155	150
Sole parent rebate	164	220	0	0
<i>Total</i>	9 816	16 002	21 390	25 435
<i>GDP*</i>	406 103	529 887	708 961	842 176
Major social expenditures as % of GDP	2.4	3.0	3.0	3.0

Sources: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years 1986 to 2001; Treasury, *Budget Paper No. 1*, 2002–03 Statement 5, pp. 5–32.

*GDP estimates for 2004–05 from *Budget Paper No. 1*, Statement 5, pp. 5–32.

The largest tax concessions measured and costed by Treasury are those that might be classified as social; these are projected to grow substantially in the future. Tables 5 and 6

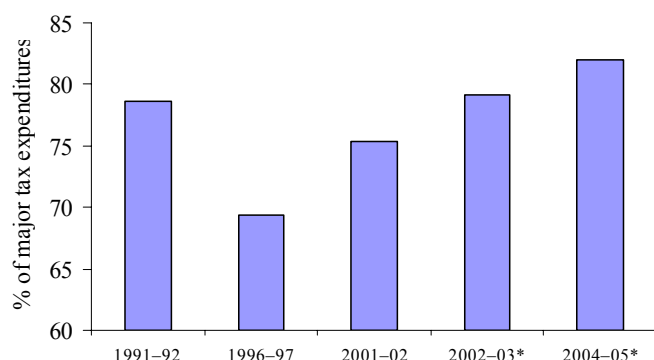
set out major social and business tax expenditures and their GDP share at intervals over the past ten years, while Figure 3 shows the social share of these major tax expenditures between 1991–92 and 2004–05.⁶¹ Table 6 summarises the new tax expenditure items introduced since 1996.

Table 6. Major Business Tax Expenditure Items, Actual and Projected, 1992–2005, \$m

	1991–92	1996–97	2001–02	2004–05
Application of statutory formula to value car fringe benefits		740	910	980
Exemption from excise for 'alternative fuels'	<i>na</i>	540	900	1200
Concessional rate of excise levied on aviation gasoline and aviation turbine fuel	<i>na</i>	727	860	910
Exemption from interest withholding tax on widely held debentures	655	740	590	590
Depreciation pooling for low value assets	0	0	550	750
Transitional exemption of small business from abolition of accelerated depreciation, balancing charge offset and low value pooling	0	0	470	–60
Research and development tax concession/premium tax concession	305	800	460	505
Accelerated depreciation for mining buildings	340	260	290	260
The Simplified Tax system	0	0	280	340
Accelerated depreciation allowance	1360	1730	280	–1040
Accelerated depreciation for software	0	0	250	175
Benefits provided by public benevolent institutions (excluding public hospitals) to their employees	<i>na</i>	150	240	270
Development allowance	0	330	200	0
Fringe benefits provided by religious institutions	<i>na</i>	160	180	185
Concessional rate of excise levied on beer sold in containers greater than 48 litres	<i>na</i>	360	150	160
Transitional taxation of life insurance management fees	0	0	150	135
Concessional rate of excise levied on fuel oil, heating oil and kerosene	<i>na</i>	360	130	115
Benefits provided by public hospitals to their employees	<i>na</i>	175	120	130
<i>Total</i>	2660	7072	7010	5605
<i>GDP</i>	406103	529887	708961	842176
TOTAL: Major business tax expenditures as % of GDP	0.7	1.3	1.0	0.7

Sources: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years (1986–2001); Treasury, *Budget Paper No. 1, 2002–03 Statement 5*, pp. 5–32.

Figure 3. 'Social' Share of Major Tax Expenditures, 1991–92 to 2004–05



*Projections for 2002–03 and 2004–05

Sources: Treasury, *Tax Expenditures Statements*, Australian Government Publishing Service, Canberra, various years (1986–2001); Treasury, *Budget Paper No. 1*, 2002–03 Statement 5, pp. 5–32.

Major 'social' tax expenditures accounted for around 2.4 per cent of GDP in the late 1980s while 'business' tax expenditures were around 0.7 per cent of GDP. As can be seen in Table 5, major social tax expenditures rose faster than GDP between 1992–93 and 1996–97, but have since stabilised at around three per cent of GDP⁶².

Major business tax expenditures rose faster than GDP in the last ten years, although the abolition of accelerated depreciation provisions has slowed this growth since 1999 as shown in Table 6. 'Business' tax expenditures other than accelerated depreciation have tripled as a share of GDP since 1991–92, reaching 0.9 per cent of GDP in 2001–02.⁶³

State Government Tax Expenditures

A lack of comprehensive, consistent or long-term aggregate data for the states means that trends in state government tax expenditures cannot be examined. In the mid 1980s, the New South Wales Tax Task Force estimated the value of the state's land tax expenditures at \$1.8 billion per annum—several times the value of land tax collections.⁶⁴ In 1998, states' gambling tax expenditures were estimated to be around \$400 million annually.⁶⁵ In the context of identifying budgetary assistance to industry, the Productivity Commission estimated that state tax expenditures through payroll tax concessions were around \$3.2 billion a year.⁶⁶

However, information published in the Budgets of the largest two states, New South Wales and Victoria, and by some other states permits some discussion of recent patterns and trends for state tax expenditures.⁶⁷

Compared to Commonwealth tax expenditures, which relate to Australia's collections of income tax, GST, and customs and excise duties, states have much more limited taxing powers. Nevertheless, tax expenditures are substantial. The most significant state tax expenditures relate to payroll taxes, stamp duties, land taxes and gambling taxes. In New South Wales, tax expenditures (excluding thresholds) totalled around \$2.7 billion in 2002–03, while in Victoria the aggregate was \$1.7 billion. The aggregate of tax expenditures for the Australian states is at least \$9.5 billion annually.⁶⁸

The largest tax expenditures vary from state to state. In New South Wales, tax expenditures are largest for stamp duties (on contracts and conveyances, general and life insurance and marketable securities), payroll tax, land tax and gambling and betting. In Victoria, South Australia and Western Australia land and payroll tax expenditures are the main tax expenditures.

State tax expenditures are typically focused on industry and social policy as well as revenue objectives. In New South Wales:

The largest categories of tax expenditures are Other Economic Activities (which constitutes assistance to industry generally rather than to a particular type of economic activity), Recreation and Culture (reflecting the gambling and betting tax expenditure) and Health (mainly reflecting payroll tax exemptions for hospitals and nursing homes).⁶⁹

The largest tax expenditure items in New South Wales relate to stamp duty exemptions for 'corporate reconstructions', payroll tax exemptions for public hospitals, land tax exemptions for primary producers and concessional tax rates on club gaming machines.

It should be noted that the previous comment on New South Wales tax expenditures by functional categories excludes consideration of the value of payroll tax thresholds. Victoria presents separate estimates of the tax expenditures associated with thresholds. These estimates show that the tax expenditure value of payroll tax tax-free threshold far exceeds the main tax expenditure items costed for payroll taxation.⁷⁰ For example, while Victorian payroll tax expenditures (excluding thresholds) had a value of \$430 million in 2002–03, this compared with \$1.4 billion of tax expenditures for its payroll tax exemption of \$550,000.⁷¹ In New South Wales, payroll tax expenditures excluding thresholds are around \$645 million, and the value of the taxfree threshold would be commensurably higher.

Payroll tax expenditures (excluding thresholds) in New South Wales in 2001–02 are around 16 per cent of tax collections, the same as in Victoria. Land tax expenditures are around 40 per cent of New South Wales land tax collections and around 150 per cent in Victoria.⁷²

While the aggregate level of tax expenditures by state governments is considerably less than for the Commonwealth, the use of tax expenditures is comparable relative to their tax revenues. For example, in Victoria, tax expenditures are around 17 per cent of collections

and have been for several years. In New South Wales, there is a declining trend from 2000–01, with tax expenditures falling from 26.2 per cent to 21.3 per cent as a ratio of state tax collections.

'Tax Expenditure' or 'Direct Spending': Why Does it Matter?

Tax expenditures are not intrinsically undesirable. They may provide an efficient delivery mechanism for public programs. However, important public policy issues arise from the potential for tax expenditures to have a number of adverse effects when compared to equivalent funding delivered through a direct spending program. For example, tax expenditures may adversely affect:

- the integrity of the tax system
- the efficiency of delivery of government programs (resource use)
- budget control and fiscal management, and
- transparency, political accountability and democratic decision-making.

However, as the orientation of this paper is primarily a financial management one, the emphasis of the following discussion is on efficiency and fiscal issues. It is recognised that there are many public administration and political issues that are associated with the use of tax expenditures as a public policy instrument; these are intentionally not dealt with in detail in the discussion.

The Integrity of the Tax System

It is increasingly recognised that the willing compliance of taxpayers with the tax system is a valuable aspect of a country's social capital.⁷³ The *Charter of Budget Honesty*, discussed below, cites the Commonwealth Government's responsibility to maintain tax system integrity, manage the risks of tax base erosion and promote reasonable predictability in taxation levels.

Tax expenditures reduce the tax burden on those groups or activities that benefit from favourable tax treatment. However, narrowing the tax base increases the overall rate of taxation that is necessary for revenue. A growing list of new Commonwealth tax concessions and incentives has been blamed for keeping taxation levels up since the mid-1990s despite tax reforms aimed at lowering taxes.⁷⁴ Because tax expenditures narrow the tax base, their growth in recent years seems at variance with the general thrust of recent tax reform strategies, which have emphasised broadening the tax base to facilitate lower tax rates and fairer, less complex taxes.⁷⁵

Tax expenditures may also give rise to difficulties in tax system management. Using the tax system to promote non-revenue objectives can hamper effective tax administration and

enforcement, and make it more difficult for tax authorities to administer and enforce such taxes equitably. In the United States, special tax benefits and greater tax complexity is argued to have reduced taxpayer confidence that burdens are spread fairly, and to have fuelled taxpayer discontent about tax administration and progressive income taxation.⁷⁶

In Australia it has likewise been argued that tax concessions for superannuation, capital gains and fringe benefits facilitate tax avoidance and promote unethical behaviour.⁷⁷ In addition, while it may appear that providing a benefit through the tax system reduces program administration costs, in practice it may be that these costs are transferred to all other taxpayers because tax returns are made more complex than they would be otherwise.

Tax concessions may have the advantage of increasing middle-class support for taxation, encouraging an attitude of, 'I am getting something back from the government, not just giving'. In this way it may facilitate redistribution and a positive taxpayer ethic. However, overseas studies suggest that a proliferation of tax concessions may threaten, rather than bolster, the integrity of the progressive income tax. Non-revenue measures in the personal income tax system—for example, the Medicare Levy surcharge—may reduce the perceived fairness of taxation if such provisions are perceived primarily as industry subsidies. Tax concessions for certain types of fuel may generate public cynicism about taxation if such concessions encourage fuel use and work against widely publicised environmental programs to reduce greenhouse effects.

Taxpayer hostility, if widespread, can be detrimental to the collection of taxes such as income tax, which rests substantially on voluntary compliance and trust in the tax authorities, and a sense of 'tax morality' and altruism by citizens.

Such adverse potential effects of tax expenditures on tax system integrity should be factored into any appraisal of tax expenditures and their appropriate use.

A possible approach to monitoring and assessing this problem would be for the Treasury and the Department of Finance and Administration to periodically publish estimates of the tax gap from tax avoidance and evasion, including that associated with concessional provisions of tax legislation. In the United States, tax gap estimates refer to illegal evasion of tax responsibilities, either through overstating deductions and credits or under-reporting income. The Internal Revenue Service takes the view that the need to maintain public confidence in the integrity, efficiency and fairness of the Internal Revenue Service warrants the publication of tax gap details. In Australia, the tax gap would be the difference between the tax due under the collection laws of the Commonwealth administered by the Australian Taxation Office (ATO) and the tax actually collected by the ATO.⁷⁸ Consistent with other *Charter of Budget Honesty* commitments on taxation, the Auditor-General might be required to report on and certify the robustness of these estimated revenue losses. However, estimating the tax gap requires random audits of a broad sample of taxpayers because actual audits are biased towards non-compliant returns.

In a similar manner to which the Office of Regulation Review examines the 'red tape' implications of new proposals, the Auditor-General might also be asked to examine and report publicly on the repercussions of tax expenditures for tax system integrity, as well as on their implications for the efficiency of public resource use (see below).

Tax Expenditures and the Efficiency of Program Delivery

Like direct spending programs, tax expenditures have an 'opportunity cost'—other taxpayers face higher taxation than would otherwise be the case or other government programs cannot be funded. While new tax concessions represent 'tax cuts' for specific taxpayer groups, tax expenditures may more appropriately be viewed as new spending programs.

The key concern from this viewpoint is how well tax concessions compare with direct programs in achieving the public policy goal of value for money—that is, the effectiveness of the expenditure when evaluated against criteria usually applied to direct spending programs.

Each 'tool' of government action has its own characteristics and its own consequences for program operations:

Many of the problems attributed to the poor management of public programs may consequently really be a product of the choice of tool that is made. Under these circumstances, it becomes critically important to examine the characteristic properties and operating features of these different tools.⁷⁹

In many countries, including Australia, however, tax expenditures reporting 'appears to be least accepted for the purpose for which it is most commonly advocated—consideration of the resource allocation effects of Budget policy'.⁸⁰

An assessment of the costs and benefits of using tax expenditures instead of direct programs as public policy instruments could include the following considerations:

- targeting and equity
- bureaucratic mindsets and skills
- compliance and enforcement, and
- administrative costs.

Efficiency of Targeting

There are some areas where the use of tax expenditures as a policy tool may be advantageous:

- the use of taxation data can provide a streamlined way of assessing eligibility, where eligibility depends on annual income
- benefits provided through the tax system may be more accessible than through a direct spending program because the public mind may place less stigma on benefits received via the tax system, and
- businesses or individuals may respond more favourably to incentives provided through the tax system than through a direct spending program.

It has also been suggested that the lack of administrative discretion which often characterises tax expenditure programs may have the benefit of providing reduced opportunities for political favours or patronage because direct expenditure programs are said to be more vulnerable than tax expenditures to 'manipulation by individuals with effective personalities or the right political connections'.⁸¹ By preventing arbitrary discrimination or favouritism, the legal framework and the reduced administrative discretion common to tax expenditures are designed to reduce vulnerability to political or patronage considerations.

On the other hand, the greater administrative discretion in direct grants programs generally helps implement the legislative intent, and targets intended beneficiaries more accurately than using the tax system to deliver benefits. Sometimes this reflects poor design of tax expenditures or misunderstanding of their policy intent. Using the tax system to income test benefits may aid efficient targeting in some cases.

Nevertheless, as targeting through the tax system is limited to using eligibility indicators based on information in tax returns, it may not accurately target need based on criteria other than income. For example, annual income may not accurately assess need in low-income families or families with irregular or uncertain weekly incomes. In some cases, a shorter period for income assessment may be more appropriate for assessing eligibility. Likewise, the tax system may not be an efficient delivery vehicle for other kinds of assistance that are contingent on characteristics not commonly reported in tax returns, such as Aboriginality, disability or rurality.

A common criticism of many tax expenditures is their regressive effects. Tax expenditures often take the form of deductions, exemptions or deferral of tax liability. Superannuation tax concessions are mainly in this form. The benefit of such concessions to the taxpayer is greater for higher income taxpayers facing higher marginal rates. Some individuals or entities have greater flexibility than others about the timing or character of their receipts and can use trusts, income splitting or other devices to unfairly increase their benefit from such concessions.

Although tax rebates are more equitable than deductions, non-taxable or low-income individual taxpayers or businesses may still not fully benefit. The equity of tax concessions can sometimes be increased by designing a tax concession as a 'refundable tax

credit'. Refundable tax credits, such as the 30 per cent private health insurance rebate or Family Tax Payment, are available as a payment either as a tax rebate or a cash payment regardless of the size of the applicant's tax liability. While a refundable tax credit can reduce the inequity of tax benefits, it may be more vulnerable politically because its costs are conventionally reported in the budget as outlays and it may be characterised as 'welfare spending'.⁸²

Some tax concessions are inherently regressive because they match or offset private spending on items that are typically bought by higher income earners. This may still be effective if the purpose and design of the program aims to provide higher income groups with a financial incentive for particular activities or purchases.

For example, the tax concession for charitable donations has been defended on such grounds, although a more effective design that has a less distorting effect on the types of charities supported might be to replace the deduction with a tax rebate.⁸³ By contrast, tax concessions for contributions to superannuation are likely to be both inequitable and wastefully designed. As the concession provides a greater benefit to higher income earners, it is more inequitable than a rebate providing a similar level of incentive. Those without an income have little access to the tax benefits of this tax incentive program unless their parent or spouse is in a position to make substantial contributions for them. The tax benefit applies to all contributions, including a substantial proportion that would probably have been made in the absence of the tax concession. Thus, for many taxpayers, the tax expenditure program results in a windfall rather than an incentive to save. The particular form and complexity of this indirect subsidy to superannuation savings also makes it relatively invisible and so it is unlikely to be an effective incentive; much of the program expenditure is likely to be wasted. For such reasons, it has been suggested that this tax expenditure would be more effective and more equitable if designed as a tax credit.⁸⁴

In this context, it might be argued that the tax system is an unlikely candidate for delivering assistance to new mothers as occurs through the 'baby-bonus' program whose eligibility criteria and design add complexity to the tax system. Further, as the bonus amount is calculated in relation to the size of previous tax liabilities it disproportionately benefits relatively well-off taxpayers. As a result, its distribution contradicts the progressive intent of other family assistance programs.

Similarly, a Canadian study has concluded that tax-system based social programs for retirement incomes, childcare or family support particularly disadvantage women and minority groups. This is partly attributed to the particular organisational culture, social attitudes and lack of relevant program expertise in tax agencies and treasuries and partly to the ways the different social and economic participation patterns of such groups interact with conventional tax design.⁸⁵ For example, superannuation tax expenditures mainly comprise deductions and exemptions for fund contributions and earnings. Because women often have an intermittent connection with the labour market and lower average incomes, men receive a disproportionate share of the \$10 billion superannuation tax benefit.⁸⁶ That is, the economic disadvantage of women reduces their access to the major tax benefits.

Administration Costs

There may be administrative savings associated with using the tax system rather than a new agency or an additional bureaucracy to implement spending programs. However, it may also be that the administrative costs are not transparent.

While establishing a new agency has obvious budgetary and administrative costs, these may be little different from those borne within the tax administration in one form or another.

Program Management Capabilities

The greater involvement of the Taxation Office in the delivery of tax expenditure programs can have important implications for program management. These include:

- greater use of non-program experts to administer programs. In some cases, it can be viewed as an advantage for program administration to reflect 'Treasury' or 'finance ministry' skills and culture. However, in some cases, this may not be appropriate or may not reflect project objectives, and the lack of specialist program skills may reduce the efficiency of the agency in program delivery. One example here is the innovative and generally effective use of the tax system to enforce a child support program. However, effective management of welfare cases that are complex or sensitive means that Child Support Agency staff require specialist training, skills and organisational culture that will differ quite considerably from those needed for efficient tax administration.
- benefits delivered through the tax system may result in greater private sector control of decision-making than programs delivered through program agencies, implying less control and discretion by government over how public resources are allocated. Again, the charitable deduction is an example of this; so too are various other tax concessions aimed at environmental, business or health goals, such as landcare tax concessions for primary producers, the tax concession for private infrastructure financing or tax incentives for private health insurance.

Compliance and Enforcement

The use of the tax system can reduce the extent of administrative discretion but gives rise to other complicating issues:

- using the tax system can be an advantage to some programs where the take-up rate is sensitive to such issues and accessibility is a high priority objective. For example, businesses may find accessing benefits to be more convenient when processed semi-automatically through the tax return process rather than through identifying and applying for relevant business subsidy schemes. The take-up rate for family assistance or private health insurance may be greater where eligibility is assessed as part of the

income tax assessment process rather than through direct application to Centrelink, which may be viewed as more stigmatising.

- but there may be less thorough scrutiny of eligibility for tax expenditures, with eligibility being largely determined through self-assessment, and compliance with eligibility requirements sought through later audit rather than on all initial applications.
- where government portfolios pursue a particular outcome through both a direct expenditure program and a tax concession, administration is more complex and difficult and can therefore be vulnerable to fraudulent claims. An example is the 30 per cent private health insurance rebate: a recent report by the Auditor-General found the Australian Taxation Office and the Health Insurance Commission had neglected to jointly establish procedures preventing duplicate claims.⁸⁷

Whether a tax expenditure is a good thing or a bad thing from a financial management or resource efficiency viewpoint depends as much on specific design aspects of the tax expenditure program as on whether the cheque comes from the ATO or from a program agency. The important issue is to match the characteristics of different policy tools with the required task to improve program performance.

For some program objectives, where maximising access and minimising 'bureaucracy' are implicitly more important than minimising excess or fraudulent claims, a tax incentive may allow better design and reduced administration and compliance costs. Tax expenditures may also be a way of increasing private decision-making on the expenditure of public funds.⁸⁸ The desirability of such an outcome depends on case-by-case assessment. However, on balance, there remains the risk that tax expenditures may be less effectively targeted, more regressive and subject to less rigorous assessment and audit of eligibility and compliance than equivalent social programs funded through direct spending.

Enhancing the Transparency of Tax Expenditures

The allocation of public resources might be considerably improved by enhancing the rigour and transparency of the assessment processes used to determine whether a tax expenditure is the best delivery tool to achieve a particular objective.

One possible measure is tax expenditure reporting, which would facilitate the combined consideration of tax expenditures and direct expenditures.

This measure would respond to concerns that treating tax expenditures differently from direct spending programs may result in the efficacy of public spending in meeting public policy goals being reduced and the potential for better use of public money forfeited. However, there has been doubt expressed over whether tax expenditure reporting alone would necessarily produce these benefits:

Although proponents of reporting advocate reporting as a vehicle for focussing on the resource allocation effect of budget policy, it is unlikely that tax expenditure accounting as currently implemented motivates the combined budgetary assessment of tax expenditures and direct expenditures.⁸⁹

This suggests the accompanying need for greater attention to program effectiveness issues. One option is to add to the *Charter of Budget Honesty* a new requirement for a justification statement for each tax expenditure listed in the Commonwealth Treasury's annual TES. This might be reviewed regularly and certified by an independent body such as the Australian National Audit Office (ANAO), with an appropriate mandate to undertake such work. The justification statement should include a detailed evaluation of why a tax expenditure, rather than a direct spending program, has been used as a delivery vehicle. In view of the significant magnitude of tax expenditures in the Commonwealth Budget, and consistent with the ANAO's role in ensuring the Commonwealth gets 'value for money' from direct spending programs, the ANAO might also be asked to make evaluation of existing and new tax expenditures a specific component of its performance and assurance audit program.

Budget Processes, Budget Management and Budgetary Control

Budget decision-making processes, accounting treatment, display and visibility to the public are different for tax expenditures and direct spending. In 1996, the National Commission of Audit (NCOA) highlighted the significant levels of budgetary assistance provided by tax expenditures and the problems that they created:

First, spending on tax concessions is not monitored to the same extent as spending on programs. Treasury noted in its submission to the Commission that it can be three years before a tax expenditure is fully costed.

Second, consideration of tax concession proposals is hampered by the general difficulty of accurately costing them. This difficulty stems in part from the lack of resources devoted to monitoring tax concessions compared with those devoted to monitoring programs, and the consequent insufficient level of information about tax expenditures.

Third, unlike tax concessions, control of program expenditure is enhanced by individual Ministers being held responsible for spending by their portfolio.

Finally, established procedures exist for the Department of Finance and the responsible portfolio to examine ways of containing blowouts in program expenditure but not blowouts in tax concessions.⁹⁰

Quoting the example of the research and development tax concession, the NCOA noted that:

because tax concessions, like entitlement based programs, are almost open ended (that is they are available to all those who meet certain criteria) they can blow out in spectacular fashion.⁹¹

In a recent report examining overall government budgetary assistance to industry, the Productivity Commission noted that the main determinant of year-to-year changes in budgetary assistance was the volatility of major tax expenditures:

A feature of tax concessions is that they can be open-ended, involving no cap on revenue forgone, and thereby lead to a rise in revenue forgone in response to growth in applications for assistance. The relatively high levels of budgetary assistance between 1994–95 and 1996–97 reflect the changes in revenue forgone from the R&D tax concession, and the investment and development allowances.⁹²

While many tax expenditures are open ended, concessions can often be designed to contain costs. The parameters are the choice of the legislature rather than an intrinsic feature of tax expenditures. An example is the successor to the tax concession for private infrastructure financing, introduced in 1992. This scheme was closed to new projects and redesigned as a direct spending program with a specific Budget allocation after the open-ended tax expenditure threatened a large cost overrun in 1997. The cost of the scheme is now capped at \$75 million per annum.

The NCOA noted that Australia fell short of overseas best practice regarding tax expenditures. It recommended that 'all tax expenditures should be treated as much as possible like program expenditures in all published fiscal reports and statements and in all budgetary processes'.⁹³

The NCOA had thus concluded that tax expenditures should be treated as much as possible like program expenditure in an Australian fiscal reporting Act:

This would entail the inclusion, where possible, of estimates of the revenue cost of tax concessions in budget documents and the scrutiny of tax concessions along with program expenditure in the lead up to the budget.

As recommended in chapter 3, this reform needs to be preceded by a comprehensive review of all existing tax concessions. Such a review would facilitate regular and ongoing monitoring of the cost and effectiveness of tax concessions and would be consistent with the objectives of the Charter of Budget Honesty. While outside the Commission's terms of reference, the review could also assess the extent to which tax concessions are meeting policy objectives.⁹⁴

In the 1996–97 Budget, responding to the NCOA recommendations, the Commonwealth Government announced a review of tax expenditures. It stated that:

The Government intends to review all existing tax expenditures to ascertain the extent to which they are contributing towards the achievement of its policy goals, and whether some tax expenditures might be converted to outlays programmes to achieve a better outcome. In relation to new tax expenditure proposals, the Government will consider whether assistance can be more effectively provided through outlays programs.⁹⁵

In 1998–99, the Government announced the completion of the aforementioned review, stating that:

A feature of the Government's Charter of Budget Honesty is the requirement to publish an overview of tax expenditures as part of the Budget. Following a review of existing tax expenditures, first announced in the 1996–97 Budget, the Government has decided to undertake periodic monitoring and evaluation of all tax expenditures through normal budget processes to ensure they deliver Government assistance in an effective manner.⁹⁶

'Normal budget processes' have for some time involved the Government considering whether proposed *new* tax expenditures can be provided more effectively through an outlays program. The intention of the NCOA tax expenditure review proposal, as Treasury noted, was to: 'complement this approach and help ensure that *existing* [emphasis added] tax expenditures are subjected to the same degree of scrutiny as new proposals for tax expenditures'.⁹⁷

It is not clear to what extent the Commonwealth Government has met its undertakings regarding integrating tax expenditure analysis into its fiscal management practices. Since 1998, information on Commonwealth tax expenditures has been published as a requirement of the Commonwealth's *Charter of Budget Honesty*. With its focus on sound fiscal management and accountability, the *Charter of Budget Honesty Act* also contains a number of commitments relevant to policies on tax expenditures. For example, according to the Act, the Government is to:

- manage financial risks including risks from erosion of the tax base
- pursue spending and taxing policies that are consistent with a reasonable degree of stability and predictability in the level of the tax burden
- maintain the integrity of the tax system, and
- ensure that policy decisions have regard to their effects on future generations.⁹⁸

A key feature of tax expenditures is that many effectively are equivalent to entitlement programs such as social security spending. Around 25 per cent of Commonwealth Budget outlays are appropriated as a fixed dollar amount, while the other 75 per cent are approved by Parliament in the form of 'special' appropriations that authorise the payment of benefits to all those meeting specified entitlement criteria, without any cap on the aggregate level of funds.

Also, while discretionary direct spending is reviewed annually, tax expenditures maybe examined only once—when they are introduced.

Tax expenditures are not included in the Budget estimates process, which requires justification of the spending against policy priorities and new spending proposals. Tax expenditures are considered by the Expenditure Review Committee (ERC) of Cabinet and

are, in effect, given priority over expenditure programs as they are decided after available revenues have been determined. This means there are no formal ERC processes to ensure tax expenditures are prioritised against other spending of portfolios or to assess the efficiency of a tax expenditure against portfolio outcomes as occurs for direct spending programs. It also means that tax expenditures may be uncoordinated (or even conflict) with spending programs in the same policy area.

The results of the Government's foreshadowed review of tax expenditures have not been published and Portfolio Budget Statements, including for the health and ageing portfolios, do not include major tax expenditures in their outcomes–outputs frameworks. Individual ministers are not held responsible for tax expenditures related to their portfolios. It is difficult to discern whether the NCOA's recommended reforms regarding the comparable fiscal treatment of tax expenditures and direct spending or the review of tax expenditures conducted by the Government have resulted in any changes to budgetary or financial management processes.

Furthermore, the Commonwealth's largest and fastest growing area of tax expenditure is superannuation concessions. With the *Charter of Budget Honesty* emphasising the need to assess risks to fiscal sustainability, the 2002 Budget documents included a report on the long-term effects of population ageing on Commonwealth financial sustainability.⁹⁹ Despite their size (at \$10 billion nearly half the cost of the public age pension of \$23 billion in 2001–02) and relevance to long-term budget stability, risk and sustainability, these tax expenditures on the aged were not included in the report.

Similar issues arise regarding the budget sustainability of existing tax expenditures for health, including—notably—the 30 per cent private health insurance rebate.

As tax expenditures are not reviewed, costed or monitored as well as direct spending, their increased use implies a greater willingness by governments or parliaments to expose future governments to greater budget volatility and reduced flexibility.

It is notable that when Canadian tax expenditures were fully integrated into budgetary processes and portfolio decision-making, tax expenditures declined.¹⁰⁰ However, the variability of political commitment to such integrated processes resulted in their later demise and a return to lesser budgetary control over tax expenditures.

According to the OECD's *Best Practices for Budget Transparency*:

To the extent possible, a discussion of tax expenditures for specific functional areas should be incorporated into the discussion of general expenditures for those areas in order to inform budget choices.¹⁰¹

The above analysis suggests the need to integrate tax expenditure decisions and impacts into Budget management, decision-making processes and documentation, and to gain ongoing political commitment to make costing, monitoring and reviewing tax expenditures

a part of the budgetary processes. For example, it would assist transparency and public confidence in budgetary processes if the Commonwealth Government published detailed evidence and results from its 1996 review of tax expenditures. The efficiency and effectiveness of tax expenditures as a program delivery tool may also be increased by:

- introducing Expenditure Review Committee processes that require spending and coordinating agencies to examine and report annually on:
 - the policy rationale for retaining each particular tax expenditure when considered against the policy objectives and outcomes for the relevant spending portfolio, and,
 - the relevance and justification for pursuing the relevant policy outcomes through tax expenditure rather than expense programs
- assigning tax expenditures to the relevant spending portfolios as part of budgetary decision-making processes
- requiring the inclusion of tax expenditures in portfolio budget statements and annual reports of the relevant spending agency, and
- including relevant tax expenditures such as those for health and the aged in future reports on intergenerational issues.

Transparency, Political Accountability and Democratic Decision-Making

Because tax concessions have not traditionally been viewed as government spending, public or parliamentary scrutiny and evaluation of tax expenditures is less than that for direct outlays. It is generally acknowledged in Australian tax literature that tax expenditures raise particular issues of parliamentary process and political accountability.

Overseas research has found that the political forces driving the growth of tax expenditures are different from those influencing direct spending programs.¹⁰² One American study concluded that the lesser visibility of tax concessions served to reduce political controversy over interventions in non-traditional areas or where political consensus was lacking.¹⁰³

An analysis of the use of tax expenditures for social policy in the United States supports this conclusion, arguing 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.¹⁰⁴

In another article, the same author concluded that tax concessions were misleadingly presented to the public as tax cuts rather than as fiscal benefits for selected taxpayer groups:

Tax incentives appear to service the needs of political leaders by enabling them to reduce spending and taxes while at the same time pursuing an activist policy that promotes popular programs.¹⁰⁵

Experience in Canada suggests that tax expenditures are used differently—and with different motivations—for social and business programs. A study found that there were fewer 'social' tax expenditures than 'business' tax expenditures, but the social expenditures were larger. The social tax expenditures were shaped by the priorities of Treasury/Finance ministers because their revenue costs were highly significant to the sustainability of fiscal policy. On the other hand, 'business' tax expenditures tended to reflect the influence of economic ministers and business interests.¹⁰⁶ As noted earlier, it has been suggested that providing general business subsidies through the tax system may limit political influence in dispensation of grants or tenders.

In Australia, the NCOA concluded that tax expenditures were a largely non-transparent form of assistance that was inconsistent with the *Charter of Budget Honesty* and proper fiscal decision-making. It noted:

This lack of transparency makes less visible the effect of tax concessions on the budget and reduces accountability. It also increases the likelihood that poorly targeted concessions will remain on offer. This lack of transparency is also inconsistent with the Charter of Budget Honesty's objectives to ensure greater transparency for the decisions and operations of government. Treasury's submission to the Commission also noted that 'lack of transparency and minimal accountability for tax concessions have made them a popular vehicle for those seeking government assistance'.¹⁰⁷

While parliamentary estimates committees are charged with reviewing direct expenditures, this process does not include the systematic review of tax expenditures, nor does it integrate such review with the scrutiny of budgetary appropriations. Typically, only the largest and most controversial tax expenditures which fall on both expenses and revenues tend to be examined by these committees.

Thus, tax expenditures can be uncoordinated and contradictory in effect to direct spending approved by parliament. For the same reason, the tax expenditures program or individual items may be a risk to fiscal stability or sustainability without this necessarily becoming evident through the estimates committee process.

Overseas experience suggests a variety of motivations for using tax expenditures in preference to direct spending programs. Some tax expenditures may reflect valid tax policy considerations, some will be the most efficient way of delivering budget assistance in accordance with government policies, and some may enhance the integrity of public assistance programs or the tax system.

However, this will not always be the case. Tax expenditures may be used instead of direct spending in order to understate the size of government or misrepresent the overall impact of taxation policies by presenting specific tax reliefs or incentives as 'tax cuts'. Tax expenditures may reflect behind-the-scenes lobbying by special interests rather than fully scrutinised and carefully considered budget assistance programs.

It is important that when the tax expenditure tool is chosen as the instrument for allocating public resources, the public policy basis for this choice and the underlying motivations are transparent, fully articulated and understood by parliamentarians and the public.

The last parliamentary committee report on tax expenditures appeared about 20 years ago.¹⁰⁸ This paper suggests that the time is ripe for another parliamentary committee to examine tax expenditures.

Conclusions

This paper shows that tax incentives are emerging as a more important tool of social policy, despite modest projected growth in tax expenditures in the near future. While some view the difference between direct and tax expenditures as simply one of government administration,¹⁰⁹ there are important differences in the political and practical implications of using the tax expenditures route.

As outlined above, tax expenditures might be a useful tool of government policy in some circumstances. For example, such expenditures may be preferred where the tax system provides a natural means test and a ready-made administrative system that avoids creating a new agency. Tax expenditures may be most effective where the program objective is to provide assistance to a clearly defined but broad category of activities or taxpayers. Tax expenditures suggest themselves as a policy tool when wide access, a lack of stigma and high take-up rates are design priorities, and where limiting fraudulent or ineligible claims is a lesser priority.

However, choosing tax expenditures as a policy tool also involves a willingness to trade off increased tax complexity, wider opportunities for tax avoidance and a reduction in the perceived fairness of the tax system for potential political and possibly spurious program design benefits. Furthermore, the effective use of tax expenditures is contingent on rigorous scrutiny of project goals and design aspects of tax expenditure programs that is currently lacking. As tax expenditures are not presently scrutinised as thoroughly as direct spending programs, their greater use may reflect a lower priority to program effectiveness or to traditional equity concerns. Because of this, and because the tax system appears more difficult for the public to understand, it may be easier to enact wasteful, inequitable or ineffective programs through the tax system than via direct spending.

There is a general consensus in the academic literature that direct expenditures are likely to be preferable to tax expenditures in most instances.¹¹⁰ A review of tax expenditures

concluded that 'For most if not all of these tax measures there are actual or conceivable alternative direct spending programs that would accomplish the same objectives'.¹¹¹

Leading commentators on the subject such as McDaniel have concluded that the argument is a pragmatic one:

On balance, the problem of administering the tax system and the perception of taxpayers that tax expenditures involve tax inequities and tax loopholes creates a presumption against the use of tax expenditures as tool for government action. ... Although it is arguable that the use of the tax expenditure tool might be preferable to alternative forms of government action tools in selected areas, past experience does not indicate any optimism that the use of the tool can be kept within bounds that will permit efficient administration of the revenue collecting responsibilities of tax administration and that will alleviate concerns of taxpayers over issues of tax fairness.¹¹²

It is also apparent that as the tax code becomes more crowded with various special incentives, the marginal effect of each is minimised.¹¹³

The Australian experience with tax expenditures reporting appears consistent with that overseas, in that Commonwealth tax expenditures reporting has proved useful but has remained focused on revenue policy (resource acquisition), rather than on resource allocation or Budget policy. Hence, reporting has not secured budgetary control over tax expenditures. Portfolio budget statements contain little information on tax expenditures, existing tax expenditures appear not to be part of budgetary consideration of individual portfolio spending decisions, and tax expenditures are not assessed against outcomes and performance criteria for portfolio spending. This treatment of tax expenditures appears to be inconsistent with the requirements of the *Charter of Budget Honesty*. Previous commitments in this area regarding the review of existing tax expenditures and their integration into the Budget process have apparently not been implemented.

Likewise, at the state government level, tax expenditures reporting is in its infancy, uses incompatible definitions of tax expenditures that make comparisons between States difficult, and is also not integrated into Budget processes and reporting.

As a consequence, tax expenditures continue largely to escape Budget, parliamentary and public scrutiny. Why does the potential for tax expenditure reporting to be used as a tool for analysing resource allocation remain unfulfilled? Does a 'cultural' barrier between the producers of tax expenditures statements and legislature mean tax expenditures information is provided in a form or context that is not useful to Budget decision-makers and legislators? Or alternatively, as United States experience suggests, are there institutional or other (political) barriers in legislatures that discourage control over tax expenditures as resource allocations?

Excessive use of tax expenditures may mislead the public about the real size of government and the nature of government tax or fiscal policies. This has wide implications for political accountability and democratic processes, including for the public's trust in

government.¹¹⁴ The greater use of tax expenditures may also reflect a transition to new 'tools' of public action that transfer 'discretion' over use of public funds to the private sector.

This paper has observed a growth in the number of Commonwealth tax expenditures and an underlying upward trend in their budgetary cost. On the limited evidence available, state tax expenditures appear to be stable or declining compared to tax collections.

The implications of the trend to expanding Commonwealth tax expenditures could include:

- reduced stability and equity in the tax burden and risk to tax system integrity
- compromised program efficiency and equity and higher administrative costs
- weaker budgetary control and management, and
- diminished transparency, democratic decision-making and political accountability in the use of public funds.

On the other hand, it is possible that a systematic and careful review of tax expenditures would reveal a number that were an efficient way of meeting public policy goals. The information to draw a conclusion currently is limited, despite the tax expenditures program being twice the size of the defence budget.

These issues of tax system integrity, spending coordination and appraisal, budget control and legislative and administrative responsibility might be addressed by:

- the Commonwealth Government publishing detailed evidence and results from its tax expenditures review
- requesting the Auditor-General to regularly examine and report on the repercussions for tax system integrity of new and existing tax expenditures
- introducing *Charter of Budget Honesty Act* amendments requiring that:
 - the Treasury and the Department of Finance and Administration periodically publish estimates of the 'tax gap' including that arising from avoidance and evasion associated with tax expenditures, with the Auditor-General scrutinising and reporting on the robustness of these estimates
 - the implications of age-related tax expenditures be reported and assessed in future Intergenerational Reports, and

- the Treasury include a tax expenditure justification statement for each major tax expenditure, which has been independently reviewed, in the annual *Tax Expenditures Statement*
- requesting the ANAO to include tax expenditures in its performance and assurance audits
- encouraging the inclusion of tax expenditures in the portfolio budget statements and annual reports of the relevant spending agency, with the object of integrating tax expenditure decisions and impacts into Budget decision-making processes and Budget documents
- encouraging tax expenditures to be assigned to the relevant spending portfolios as part of budgetary decision-making processes
- encouraging the introduction of Expenditure Review Committee processes that require spending and coordinating agencies to examine and report annually on:
 - the policy rationale for retaining each particular tax expenditure when considered against the policy objectives and outcomes for the relevant spending portfolio, and
 - the relevance and justification for pursuing the relevant policy outcomes through tax expenditure rather than expense programs
- parliamentary committees requiring that information attribute all tax expenditures to the relevant spending portfolios for Estimates Committee and similar purposes.

Such changes might be implemented largely through appropriate amendment of the *Charter of Budget Honesty Act 1998* and the *Auditor-General Act 1997*, and through determinations by the relevant parliamentary committees.

Appendix 1. Significant Tax Expenditures Introduced from 1996

Tax expenditure item

Year introduced 1996

Senior Australians' tax offset
Family Tax Assistance parts A and B

Year introduced 1997

Capital gains tax exemption for payments made under the Sydney Aircraft Noise Insulation Project
Capital gains tax exemption for payments made under the M4/M5 Cashback scheme
Fringe benefits tax exemption for record keeping for small business
Fringe benefits exemption for some car parking for small business
Small business capital gains tax rollover
Small business sale 50% capital gains tax/partial exemption/exemption for goodwill sale of active business assets
Income tested offset for private health insurance
[Medicare surcharge]¹¹⁵

Year introduced 1998

Immediate depreciation relating to Y2K upgrades
Accelerated depreciation for software
Non income-tested rebate for expenditure on private health insurance
Extension of beneficiary tax rebate for Community Development Employment Project (CDEP)
Tax rebate for expenditure on landcare work to primary producers with incomes up to \$20,000
Tax rebate for savings
Deduction for investments in Film Licensed Investment Companies
New tax offset scheme for interest from infrastructure investments
Farm Management Deposits scheme

Year introduced 1999

Transitional exemption of small business from abolition of accelerated depreciation, balancing charge offset and low value pooling
Small business sale 50% capital gains tax/partial exemption/exemption for goodwill sale of active business assets
Small business 15-year retirement capital gains tax exemption
Venture capital capital gains tax concessions
Capital gains tax discount for individuals
Capital gains tax discount for superannuation funds
Capital gains tax rollover relief on involuntary disposals
Concession for eligible scientific research
Transitional arrangements for prepayments
Exemption from the tax shelter prepayments measures for passive investments
Penalty rate of excise levied on cigarettes

Year introduced 2000

Family Tax Benefit A and B, and exemption
Exemption of Child Care benefit
Fringe benefits tax exemption for housing benefits provided by charities and non-profit employers for employees in regional areas
Exemption of one-off savings bonus to senior Australians
Exemption from non-commercial losses provisions for primary producers and artists

Tax expenditure item

Non-excise free threshold for other excisable alcoholic beverages not exceeding 10 % alcohol
Depreciation pooling for low value asset
Immediate deductibility for GST-related plant and software
Transitional taxation of life insurance management fees

Year introduced 2001

Better Superannuation System changes to tax treatment of superannuation
First child tax rebate
National excise scheme for low alcohol beer
Increase in Medicare levy threshold
The simplified tax system
Concessional rate of excise levied on beer sold in containers greater than 48 litres
Premium tax concession for additional research and development
Refundable tax offset for investment in large-scale film production
Capital gains tax discount for investors in listed Licenced Investment Companies
Research and development tax offset for small businesses
Exemption of one-off payment to older Australians

Year introduced 2002

Exemption from income tax of the baby bonus payment
Concessional tax treatment for venture capital managers
Deduction for the payment of the Incurred-But-Not-Reported levy
Fringe benefits tax exemption for certain payments to prescribed employee entitlement funds
Tax relief for demergers of companies and trusts
Removal of income tax at the point of conversion or exchange of traditional securities
Statutory effective life caps on a range of assets used in the oil, gas and airline industries

Measures not previously reported but recently identified as tax expenditures

Immediate deduction for depreciating assets costing no more than \$300 that are used to produce assessable income of a non-business nature
An amendment to legislation to allow for the division of superannuation either by court order, or by agreement between the two parties on marriage breakdown
Exemption from excise of condensate produced or marketed separately from a crude oil stream
Concessional tax treatment for eligible foreign authorised deposit-taking institutions (ADIs), or the holding company of eligible foreign ADIs, or newly established local ADIs, when transferring assets and liabilities
Additional excise applied to diesel with a sulphur content higher than 50 parts per million

Sources: Treasury, *Tax Expenditures Statement*, Australian Government Publishing Service, Canberra, various years 1986 to 2002.

Endnotes

1. The first *Tax Expenditures Statement* was published in 1986.
2. Organisation for Economic Cooperation and Development, *Tax Expenditures: A Review of the Issues and Country Practices*, OECD, Paris, 1984, p. 7.
3. United States Office of Management and Budget, *Analytical perspectives, Budget of the United States Government*, United States Government Printing Office, Washington, 2002, p. 99.
4. Treasury, *Tax Expenditures Statement 2002*, Australian Government Publishing Service, Canberra, 2002, p. 1.
5. S. Fiekowsky, 'The relation of tax expenditures to the distribution of the 'fiscal burden'', in *Canadian Taxation*, Winter, 1980; pp. 211–219. V. Thuronyi, 'Direct Expenditures versus Tax Expenditures for Economic and Social Policy: Comment', in N. Bruce (ed.), *Tax expenditures and government policy: Proceedings of a conference held at Queen's University, 17–18 November, 1988*, John Deutsch Institute for the Study of Economic Policy, Queen's University, Kingston, Ontario, 1989, pp. 330–32.
6. S. S. Surrey and P. R. McDaniel, *Tax Expenditures*, Harvard University Press, Cambridge, MA, 1985, p. 81.
7. Economists also draw an analytical distinction between tax expenditures intended as financial 'incentives', which can be analysed as a price subsidy, and tax expenditures used primarily as a tool for income redistribution, akin to transfers.
8. See, for example, contributions to the conference volume edited by Bruce, op. cit. An Australian perspective on conceptual and measurement issues in estimating tax expenditures is found in J. R. G. Butler, and J. P. Smith, 'Tax expenditures on health in Australia: 1960–61 to 1988–89', *Australian Economic Review*, vol. 99, no. 3, 1992, pp. 43–58.
9. It is sometimes argued that other benchmarks, such as an 'expenditure tax', should be used: for example, to measure tax expenditures on superannuation. Against that, however, it can be argued that the tax regime applying to that of non-superannuation savings is income taxation, and that judging the concessionality of the tax treatment of superannuation by an 'expenditure tax' benchmark would introduce inconsistencies in the treatment of other forms of private saving and would be inappropriate to the chosen income tax benchmark.
10. OECD, op. cit., *Tax Expenditures: A Review of the Issues and Country Practices*, OECD, Paris, 1984, p. 16.
11. Organisation for Economic Cooperation and Development, *Tax Expenditures: Recent Experiences*, OECD, Paris, 1996, p. 9.
12. Treasury, *Tax Expenditures Statement 1997–98*, Australian Government Publishing Service, Canberra, 1999, Appendix A, p. 59.
13. J. Saxton, 'Tax expenditures: A review and analysis', *Joint Economic Committee United States Congress Study*, Joint Economic Committee, Washington DC, 1999. In response, however, it can be argued that the revenue offsets required by these budget rules need not be

tax expenditures; they could also be changes in the baseline tax structure, like changes in tax rates, personal exemptions, standard deductions and so on. US federal budget rules require mandatory (not all direct) spending to be offset by revenues. (Mandatory is another word for entitlements such as public age pensions in Australia.) There is no explicit limit on tax expenditures, although in the past the budget rules have limited the growth of tax expenditures because they had to be traded off against either other tax changes or mandatory spending.

14. M. Feldstein, 'A contribution to the theory of tax expenditures: the case of charitable giving', in H. J. Aaron and M. J. Boskin (eds), *The Economics of Taxation*, The Brookings Institution, Washington DC, 1980, p. 103.
15. J. E. Harris, and S. A. Hicks, 'Tax expenditure reporting: the utilization of an innovation', *Public Budgeting and Finance* vol. 12, no. 3, 1992, pp. 32–49.
16. Harris and Hicks, *ibid.*
17. Discussed at page 10 below.
18. P. R. McDaniel, 'Tax expenditures as tools of government action', in Lester Salamon, (ed.), *Beyond Privatization: The Tools of Government Action*, Urban Institute Press, distributed in the US and Canada by University Press of America Lanham, Lund, Washington, DC, 1989, p. 167.
19. Surrey and McDaniel, *op. cit.*, p. 81.
20. *ibid.*, p. 180.
21. C. F. L. Young, *Women, Tax and Social Programs: the Gendered Impact of Funding Social Programs Through the Tax System*, Status of Women Canada, Ottawa, 2000; C. F. L. Young, 'Taxing times for women: feminism confronts tax policy', in R. Krever (ed.), *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate*, Kluwer Law International, London, pp. 261—292.
22. B. Toohey, 'The new welfare state', *Australian Financial Review*, 16 February 2002; B. Toohey, 'The new welfare state. How the older generation is milking taxpayers', *Australian Financial Review*, 9 June 2001.
23. OECD, *op. cit.*, 1996, p. 7.
24. Treasury, *Tax Expenditures Statement 2002*, Australian Government Publishing Service, Canberra, 2002, p. 2.
25. R. Bird, 'Comment', in Bruce, *op. cit.*, pp. 123–126.
26. http://www.aph.gov.au/Senate/committee/economics_ctte/tax_effects/tor.doc
27. E. A. Zelinsky, 'James Madison and public choice at Gucci Gulch: a procedural defence of tax expenditures and tax institutions', *Yale Law Journal*, vol. 102, no. 5, 1993, pp. 1165–207.
28. Members of United States Congressional tax-writing committees (Senate Finance and House Ways and Means) are known to attract relatively large campaign contributions—precisely because of their influence on special interest legislation (E. Toder, informal communication, 7 November 2002).

29. N. Bruce, 'Pathways to Tax Expenditures: A Survey of Conceptual Issues and Controversies', in Bruce, *op. cit.*, pp. 21–61.
30. The committee's *Report on Taxation Expenditures* was tabled on 16 September 1982.
31. Time series estimates have since been produced for a number of specific tax expenditures in Australia. See, for example, Economic Planning Advisory Council, 'Tax expenditures in Australia', *Council Paper No. 13*, 1986. One-off estimates of the revenue cost of tax concessions for health related items were also published during the 1970s and a time series back to the 1960s estimated in Butler and Smith, *op. cit.*, pp. 43–58.
32. The *Charter of Budget Honesty Act 1998* can be found at <http://scaleplus.law.gov.au/html/pasteact/2/3115/top.htm>. The Bills Digest is at <http://www.aph.gov.au/library/pubs/bd/1996-97/97bd085.htm>. This Act resulted from an undertaking made by the Government during the 1996 election. See also Commonwealth of Australia (Joint Committee of Public Accounts), *An Advisory Report on the Charter of Budget Honesty Bill 1996*, Australian Government Publishing Service, Canberra, 1997; Commonwealth of Australia (Joint Committee of Public Accounts), *Financial Reporting for the Commonwealth: Towards Greater Transparency*, no. 341, Australian Government Publishing Service, Canberra, 1995.
33. Treasury, *Tax Expenditures Statement 2000*, *op. cit.*, p. 2.
34. *ibid.*, p. 2.
35. At issue is whether Australian income tax applies to non-resident income sourced in Australia. Arguably, with internationally mobile capital, a higher rate of tax would be passed on to Australian residents in the form of higher borrowing costs (relative to the rest of the world).
36. Based on 2000–01 balance of payments figures (Australian Bureau of Statistics, *Balance of Payments and International Investment Position, March Qtr 2002*, Catalogue No. 5302.0, Canberra, 2002).
37. Deductions are allowed for the entire interest costs even though only part of the proceeds from the investment (for example, capital gains) are assessable. In other countries, any shelter to other income from rental losses is denied or limited, and/or capital gains are more fully taxed.
38. R. Krever, 'Structure and policy of Australian income taxation', in R. Krever (ed.), *Australian Taxation. Principles and Practice*, Longman Cheshire, Melbourne, 1987, pp. 1–25.
39. See J. Smith, 'The Medicare levy surcharge: tax penalty or tax subsidy', *Australia Institute Discussion Paper No 38*, Australia Institute, Canberra, 2001.
40. See Treasury, *Tax Expenditures Statement 1997–98*, *op. cit.*, 1999, Appendix C.
41. This figure is calculated assuming a 10 per cent discount rate to TES estimates of deferred revenues over the period 1992–93 to 2004–05. The United States tax expenditure budget separately displays the present value of revenue loss from such 'timing' tax expenditures.
42. Treasury, *Tax Expenditures Statement 2002*, *op. cit.*, p. 31.

43. Australian Bureau of Statistics, *Information Paper: Accruals-based Government Finance Statistics*, Australian Bureau of Statistics, Canberra, Catalogue No. 5517.0, 2000; Australian Bureau of Statistics, *Taxation Revenue, Australia, 1997–98*, Australian Bureau of Statistics, Canberra, Catalogue No. 5506.0, 1998; and Auditor-General, *Audits of the Financial Statements of Commonwealth Entities for the Period Ended 30 June 2001*, Australian National Audit Office, Canberra, 2002.
44. http://parlinfoweb.parl.net/parlinfo/view_document.aspx?id=71203&table=PRESSREL
45. Treasury, *Budget Paper no. 1*, Budget Statement 5, Appendix C, pp. 5–27 and 5–28. It should be noted that Budget estimates may differ from TES estimates because they are estimated differently.
46. Treasury, *Budget Paper no. 2*, p. 163.
47. This is less than in the United States. See E. J. Toder, 'Tax incentives for social policy: The only game in town' Leadership and Public Policy Series, Paper No. 5, The Burns Academy of Leadership, University of Maryland, College Park, Maryland, 1999, p. 7 and E. J. Toder, 'The Changing Role of Tax Incentives: 1980–1999', in C Howard (ed.), *Proceedings: Ninety-first Annual Conference on Taxation, Austin, Texas, November 8–10, 1998 and minutes of the annual meeting of the National Tax Association, Sunday, November 8, 1998*, National Tax Association, Washington DC, 1999, pp. 411–18.
48. W. Adema, 'What do countries really spend on social policies. A comparative note', in *OECD Economic Studies*, vol. 28, no. 1, 1997, pp. 153–167. For example, converting the Commonwealth's tax expenditures to outlays would show a real increase in spending of around 19 per cent, without changing at all the fiscal impact of the current Budget. Alternatively, Commonwealth taxes could average around 17 per cent lower if revenue forgone under the current structure of tax concessions was redirected to lowering taxes.
49. D. F. Bradford, 'Tax Expenditures and the Problem of Accounting for Government', in N. Bruce, op. cit., pp. 427–34.
50. OECD, *Tax Expenditures: A Review*, op. cit., p. 22.
51. Tax expenditures have increased to around 16 per cent of Commonwealth Budget outlays, compared to around 10–12 per cent of outlays during the 1980s. This reflects improvements in Treasury's identification and measurement of tax expenditures as well as wider coverage of the estimates. However, the share of major tax expenditure items shows similar trends, indicating that better identification and measurement of tax expenditures does not explain this growth.
52. The size and volatility of accelerated depreciation costs mean that trends in this item mask underlying changes in the aggregate of tax expenditures.
53. To a lesser extent, it was the inclusion of previously uncosted tax expenditures. These later inclusions were generally of minor tax expenditures.
54. Treasury, *Tax Expenditures Statement 2000*, op. cit., p. 6.
55. J. R. G. Butler, 'Policy change and private health insurance: did the cheapest policy do the trick?', *Working Papers*, no. 44, 2001.

56. Treasury, *Tax Expenditures Statement 2001*, op. cit., p. 6.
57. Treasury, *Tax Expenditures Statement 2002*, op. cit., p.6.
58. Treasury, *Tax Expenditures Statement 2002*, op. cit., p.6.
59. Tax expenditures mostly directed at the elderly include superannuation, the Senior Australians' tax offset and termination payment concessions. The last of these is aggregated with superannuation in earlier TES estimates.
60. It is also worth noting that the *A New Tax System* (ANTS) package included a number of new income tax expenditures that were compensation for the distributional effects of increased consumption taxation under the GST. The exemption of basic foods and other items from the GST would also be measured as a tax expenditure if the GST were counted as a Commonwealth tax expenditure. However, putting aside debates over whether the ANTS package was distributionally neutral, it might be argued that such increased tax expenditures reflected simply a change in the tax mix and the previous omissions from the TES of tax expenditures for the sales tax, rather than an increase in redistribution through tax expenditures.
61. Using the 'taxpayer affected' classification reported in the TES, social tax expenditures are defined as tax expenditures affecting donors, government, hospitals superannuation funds and beneficiaries, non-profit organisations, personal income taxpayers, retirees/allowees and students. Business tax expenditures are defined as those affecting businesses, defence, employees employers, financial institutions, property owners, primary producers, non-residents, and miscellaneous taxpayers. Similar trends are evident distinguishing social items from business tax expenditures using the 'taxpayer affected' classification in the TES. See Treasury, *Tax Expenditures Statement 2001*, op. cit., pp. 10–11, for discussion of tax expenditures by taxpayer affected.
62. 'Major' expenditures are defined here as those exceeding 0.1 per cent of GDP in 1991–92, 1996–97, or 2001–02.
63. An alternative classification of capital gains tax preferences as 'business' instead of social, such as is used in a recent study of United States tax expenditures would further increase the growth in the business share of tax expenditures. See E. J. Toder, *The Changing Composition of Tax Incentives: 1980–1999*, http://www.urban.org/tax/austin_toder.html.
64. New South Wales Tax Task Force, *Review of the State Tax System Volume 2: Commissioned Studies: Tax Reform and NSW Economic Development*, Government Printer, Sydney, 1988.
65. J. P. Smith, 'Taxation and government', *Australian Rationalist*, vol. 47, 1998, pp. 31–35. This is prior to gambling tax adjustments associated with introduction of the GST (see J. Smith, 'Gambling taxation: public equity in the gambling business', *Australian Economic Review*, vol. 130, no. 2, 2000, pp. 120–144, for further discussion of this issue).
66. Productivity Commission, *Trade and Assistance Review 2000–01*, Annual Report Series, Productivity Commission, AusInfo, Melbourne, 2001. By comparison, state own source taxes (pre-GST) totalled around \$35 billion a year.
67. Government of New South Wales, 'Appendix B: Tax expenditure and concessions statement', in *Budget Paper 2 Budget Statement 2002–03*, Sydney, 2002; Government of New South

- Wales, 'Chapter 6: Tax expenditure and concessions', in *Budget Paper 2 Budget Statement 2002–03*, Sydney, 2002; Government of Victoria, 'Appendix F: Tax expenditures', in *Budget Statement 2002–03*, Melbourne, 2002; Government of Western Australia, 'Appendix 3: Tax and royalty expenditure statement', in *Budget Paper No. 3 Economic and Fiscal Outlook*, Perth, 2002; Government of South Australia, 'Appendix 3: Tax expenditure statement', in *Budget Paper No 3 Budget Statement 2002–03*, Sydney, 2002; Government of Queensland, 'Appendix A: Tax Expenditure Statement', *Budget Paper 3 2002–03*, Brisbane, 2002.
68. This is based on estimates of tax expenditures in South Australia totalling around \$750 million for 2001–02, in Queensland \$1.9 billion, and in Western Australia around \$1 billion. It includes the estimated cost of tax expenditures on tax-free thresholds in Victoria to the New South Wales and Victorian figures cited above.
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