New Zealand Treasury

Spending through the Tax System: Tax Expenditures

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Summary

The Treasury has begun investigatory work on tax expenditure (TE) reporting. If released, the TE data would provide information on the accumulated stock of policy motivated spending made through the tax system.

New Zealand's approach to fiscal reporting is well regarded internationally. However, provision of information on the stock of TEs has been cited as a potential improvement.

This paper proposes a New Zealand approach for TE reporting.

Two separate datasets or reports could be prepared:

- A **fiscal dataset** will report on the small number of tax provisions deemed to be the conceptual equivalent of government spending. This data will be published on an annual basis to support the regular suite of fiscal information.

- Depending on interest, a second **structural tax policy report** could be released at less frequent intervals. The structural tax policy report would report on TEs that are significant, cross cutting, and are of a more structural nature.

The Treasury would welcome discussion or suggestions on our approach, criteria, and the preliminary list of tax expenditures.

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Spending through the Tax System: Tax Expenditures

Transparency and accountability

The Treasury provides advice to the government on public sector management. As part of its public sector management function, the Treasury is responsible for the production of the government financial accountability documentation. The Treasury is investigating increasing the range of publicly available information by releasing tax expenditure data.

Public sector management aims to improve how resources are collected and spent. Governments around the world are involved in a wide range of activities. However, it is ultimately up to the voting population to determine the legitimacy, extent, and nature of government interaction with the economy. Fiscal information provides the information necessary to support public choice.

The transparency of New Zealand's fiscal reporting is well regarded internationally, although there is room for further improvement. A survey of 59 countries carried out in 2006 by the Open Budget Initiative (OBI, 2008) concluded that New Zealand was one of only six nations that provided documentation sufficient to hold the government accountable. However, the OBI survey cited the lack of information on spending through the tax system as a potential improvement in New Zealand's otherwise strong budgetary information.[1]

At a conceptual level the government can spend in a variety of ways. Direct expenditures such as welfare payments are well understood. However, governments also "spend" though indirect channels that are not subject to the same comprehensive reporting requirements.

Conceptually, reducing tax can be equivalent to direct spending. The tax expenditure (TE) concept — spending through the tax system — is now commonly accepted and over 40 years old. Most major OECD economies now provide TE estimates and the IMF (2001) and OECD (2002) have both chosen to include TE reporting as part of their best practice budgeting standards.

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[1] "By international standards, there are few tax expenditures in New Zealand, with the tax system in general not used to provide industry assistance... However, there are still some unreported tax expenditures (eg, a charitable donations rebate, and special provisions for the production of movies). As a result of a 2004 policy change requiring disclosure, information on all new material tax policy changes introduced in the annual Budget, that result either in increased or reduced revenues, is presented in each BEFU... Therefore, there is full transparency of tax expenditures in the first year of their introduction; but no requirement for further reporting of them in subsequent years. There is no information published anywhere on the pre-existing overall stock of tax expenditures." (OBI, 2008)

New Zealand's accountability documents

The New Zealand government produces a wide range of accountability documents that have been considered world class. However, in recent years improvements in government accounts abroad have highlighted ways that the New Zealand accounts could be further improved.

Despite New Zealand's strong standing, the Treasury is continually looking for marginal improvements that could contribute to transparency and improve confidence in reported numbers. The production of tax expenditure data is one way that the Treasury could potentially improve the completeness of accountability and financial information.[2]

This paper discusses the contribution that TE data could make towards improving the transparency of government spending through direct and indirect channels.

What are tax expenditures?

TEs are included in tax legislation, but are significantly motivated by policy goals other than to raise revenue in the most efficient manner possible. Most tax law is focussed on either raising revenue or tax administration.[3] However, tax law in most countries incorporates tax provisions that are significantly motivated by non-revenue considerations such as social policy or industry policy. For instance, in New Zealand's case, there are tax provisions that specifically reduce the tax payable by film, forestry, or mining companies.

The tax expenditure concept was originally devised by Stanley Surrey an Assistant Secretary to the US Treasury in 1967. The first published list of tax expenditures was motivated by Surrey's observation that a review of US government spending examined direct expenditures, but totally disregarded policy-motivated tax deductions, despite both items having a similar effect on the size of the government deficit.

Recognising the conceptual equivalence of direct and indirect spending allows tax legislation to be divided into two parts (Brooks, 2009):

- technical tax provisions aimed at raising revenue; and
- spending programs delivered through the tax system.

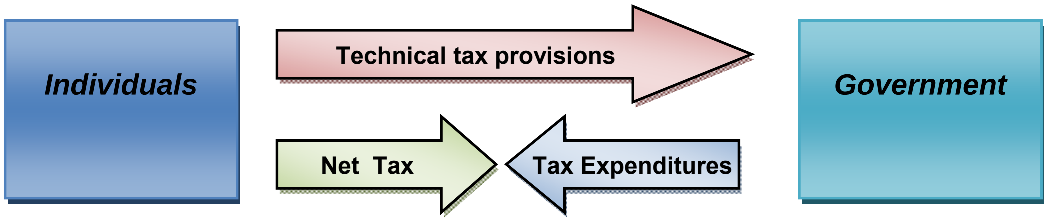
Technical tax provisions (red arrow) specify the quantity and method by which revenue is collected. These provisions form the benchmark against

2 The Treasury is responsible for the production of the government's two main accountability documents: the consolidated financial statements; and budget documentation.

3 The stated purpose of the *Income Tax Act 2007* is: "to define, and impose tax on, net income; to impose obligations concerning tax; and to set out rules for calculating tax and for satisfying the obligations imposed".

which tax expenditures are often measured. According to the World Bank, a comprehensive technical tax benchmark includes structural tax features such as rates, the tax base, and the timing of taxes, as well as any provisions aimed at facilitating tax administration (Swift *et al,* 2004).

Figure 1 **– Tax expenditures**



TEs (the blue arrow) reduce revenue and like spending are equivalent to a flow from the government back to individuals. TEs reduce an individual's tax burden and usually take the form of an exemption, allowance, credit, preferential tax rate, deferral, or tax offset.[4]

Categorisation of TEs has proven difficult in practice.[5] Tax provisions are often motivated by a range of factors and may be able to be defined as either technical tax provisions or as TEs. For example, progressive tax rates could be deemed to be motivated by social objectives such as redistribution of wealth. Alternatively progressive rates could be associated with increasing tax as the ability to pay increases. One motivation seems to suggest that progressive rates are motivated by revenue raising, the other suggests they are motivated by social policy.

Tax expenditure analysis

The TE concept allows analysts to apply different analytical lenses to different parts of the tax system. Analysts looking at government spending have historically used different tools from those used by tax analysts (Brooks, 2009). For instance, tax analysts often support a broad based tax system that is broad based, while recommendations for government spending often support spending that is carefully targeted at a limited group.

4 Some reductions in tax payable would not be classified as tax expenditures. Policies, such a Working for Families, that reduce the tax payable for taxpayers, but pay the credit as a cash payment to non-taxpayers are already appropriated and recorded as direct expenditure.

5 The categorisation is in some ways arbitrary as a government could opt to lower all rates or reduce the average rate through targeted provisions. The categorisation is, however, still useful as it highlights parts of the tax system with a focus on spending.

Table 1 – Comparative analytical techniques

Tax analysis	Spending analysis
• Taxes should be horizontally equitable. • Equivalent taxpayers should pay equivalent taxes.	• Spending should be well targeted to reach a limited or tightly specified group of people.
• Taxes affect behaviour which can create a cost. • Revenue should be raised in such a way that the costs – excess burden – of taxation are minimised. • Taxes should be neutral between taxpayers and types of economic activities.	• Spending should be configured to solve a well defined problem or achieve a specific policy goal ie, to change or improve incentives or behaviour.
• Tax should be simple and transparent to reduce compliance costs, tax structuring, and avoidance.	• Policy should be made through the most appropriate mechanism to reduce implementation costs for the government and society.

The inclusion of government spending in tax legislation and lack of information on the related fiscal cost has meant that equivalent government spending is assessed using different criteria.

The OECD notes that tax expenditures have a role to play (OECD, 2008) and that there may be legitimate reasons why the tax system may, or may not, be a suitable channel for government spending. However, a full discussion of the pros and cons of using TEs as a spending mechanism lies beyond the scope of this report. A decision to report on TEs merely informs the public of the cost of policy without judging the merits of the policies reported.

Implementation challenges

Implementing the tax expenditure concept can be difficult. There are three significant challenges when:

- categorising tax expenditures;
- collecting and gathering data; and
- calculating the value of tax expenditures (Boadway, 2007).

Data collection and quantification present a unique set of challenges. However, the first issue —categorising tax expenditures — has raised the most debate and arguably presents the most significant challenge. This paper focuses on identification and puts forward a possible approach for developing a New Zealand approach to TE reporting.

An evolution of objectives

Different objectives have led to differences in how TEs are defined internationally. Objectives have evolved from an explicit spending focus towards a combined focus on spending and structural tax reform. However, recent indications suggest that best practice may involve a clear separation of these two objectives.

The original US statement released in 1967 focused on spending. The statement did not attempt to list all tax provisions that varied from a strict definition of net income. Items were excluded where quantification was impossible or where the motivation for inclusion rested solely on "theoretical tax arguments" (Surrey and Helmuth, 1969). [6] Surrey felt highly complicated or controversial items that rested on theoretical tax arguments would becloud the utility of the analysis (*ibid*: 530).

Other countries or organisations have been more ambitious in their approach by seeking to integrate analysis of more structural tax features. This analysis intends to answer broader questions about the structure of the tax system. These TE statements usually estimate the cost of structural tax features against a normative tax benchmark usually based on a Haig-Simons (HS) definition of income. The HS definition of income includes both consumption and any increase in accumulated wealth over the period.

The efficacy of each objective (structural tax reform or spending analysis) has been mixed. The experience of the US, which has had TEs for longer than most countries, has been instructive. Both the US Congress and Treasury publish TE estimates although each institution pursues different objectives. The U.S. Treasury's main benchmark is focussed on spending, while the Congress has historically focussed on micro tax reform.

The US Treasury temporarily moved away from an explicit spending focus, but re-established the primacy of fiscal reporting with a spending focus as the key objective under the Reagan administration. Despite this, the US Treasury has recognised that there are a number of ways to look at TEs and now report a range of figures against a series of benchmarks (JCT, 2008; GAO, 2005).

The US Congress's Joint Commission on Taxation (JCT) also publishes a TE statement. However, the JCT, as a tax body, historically saw TE statements as being more useful as a tool of tax policy (JCT, 2008: 6). The JCT has until recently continued to favour a normative benchmark built upon a broad Haig-Simon definition of income.

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[6] Surrey changed positions during his working life. The quoted comments reflect his thinking while active as an Assistant Secretary to the US Treasury. His later work, however, advocated the use of Haig-Simons income and was more focused on tax reform. Surrey published *Pathways to Tax Reform: the Concept of Tax Expenditures* in 1973.

However, ongoing debate has led to a re-examination of JCT's approach. The JCT (2008) commented that their TE estimates had been driven off track by seemingly endless debate about what should be included in the "normal" tax base and that the statement was no longer able to advance its goals. In an attempt to improve the perceived neutrality of their analysis, the JCT has now moved to separate their TE statement's twin objectives into two groups: tax subsidies; and tax-induced structural distortions.

The OECD no longer supports the idea of a normative benchmark as definition of a normative tax base is a very political problem that may not be able to be resolved (Kraan, 2004). For this reason, the OECD suggests that a benchmark should be based on current tax practice rather than ideal tax practice. Broad-based support for tax expenditure analysis requires that estimates be viewed as both neutral and principled (JCT, 2008).

The US experience highlights the importance of clear objectives and the need to separate policy advice from fiscal reporting. TE statements can make a positive contribution, but the effectiveness of statements critically requires that descriptive reporting be clearly separated from views or advice on how the tax system should be constructed. Few countries have the resources to produce the wealth of information included in the multiple benchmarks produced by the US. However, countries with relatively limited resources can still produce effective tax expenditure estimates providing they are clear about their domestic objectives.

Table 2 – Comparative international tax expenditure reporting practice

Country	Primary Purposes	Definition and classification	Relationship to the budget	Estimation method
Australia	- Fiscal reporting - Contributing to the design of the tax system - Informing public debate	Uses a formal TE definition and a normative tax benchmark based on HS income and current tax practice.	- Separate Treasury document - Legal obligation to publish	Revenue forgone on an accrual basis
Austria	- Tax reform - Fiscal reporting as part of a wider subsidy report.	Uses a normative tax benchmark and three way classification system	- Part of a subsidy report that sit in an annex to the annual budget documents - Legal obligation to publish	Revenue forgone on an accrual basis
Belgium	- Fiscal reporting	Uses a TE definition that includes deviation from a benchmark and a loss of revenue. Does not formally publish any benchmark tax system.	- Annex to the Budget - Legal obligation to publish	Revenue forgone on a cash basis
Canada	- Transparency and provision of fiscal and tax information - Tax reform (memorandum items)	Uses a narrow normative benchmark that picks up only the most fundamental structural elements of the tax system. Focus on provision of as much information as possible. Reported costs of structural features included as memorandum items.	- Published alongside budget documents, although is not formally linked. - Legal obligation to publish	Revenue forgone on a cash basis
France	- Fiscal reporting	Formally defines tax expenditures as a loss of revenue through an easing of the tax burden relative to current tax norms.	- Annex to the annual Budget Bill. - Legal obligation to publish	Revenue forgone on a cash basis
Germany	- Fiscal reporting as part of a wider subsidy report	Publishes tax concession deemed to be equivalent to direct subsidies as part of a '*subsidy report'* that also reports direct subsidies made via direct cash payments.	- Part of the budget Subsidy Report - Legal obligation to publish	Revenue forgone on a cash basis
Netherlands	- Transparency - Fiscal reporting	Publishes a definition that includes deviation from a benchmark and a reduction of revenue. Publishes a benchmark that is based on current tax practice.	- Part of a budget memorandum, although not formally linked to the budget. - No legal obligation to publish	Revenue forgone on an accrual basis
United Kingdom	- Fiscal reporting and tax policy	Publishes tax expenditures in three categories: structural; non structural; and borderline provisions that sit between the two.	- Part of a statistical supplement to the Autumn statement Recommendation to publish a report by the Expenditure Review Committee.	Revenue forgone on an accrual basis

Country	Primary Purposes	Definition and classification	Relationship to the budget	Estimation method
US Treasury	- Fiscal reporting and tax policy	Publishes a both a normative (tax policy) based on tax theory and reference (fiscal policy) benchmark based on current tax policy	- Part of annual budget documents - Legal obligation to publish	Revenue forgone, outlay equivalent, and net present value on a cash basis
US Joint Commission on Tax (JCT)	- Tax reform	Publishes a report that divides tax expenditures into "tax subsidies" and "structural tax distortions"	- Report to the Congress Joint Committee on Taxation (JCT)	Revenue forgone, outlay equivalent, and net present value on a cash basis

Source: OECD (1996); Polackova et al. (2004)

Categorising tax expenditures

Identifying tax expenditures is a categorisation exercise that can be approached in different ways. As a result, different countries have adopted different approaches. There are perhaps two broad methods that could be used. TEs could potentially be categorised by:

- first defining the benchmark (ie, what a TE isn't); or
- defining what constitutes a TE (ie, what a TE is).

Most countries have chosen to define TEs through a benchmark.

Approach one: defining a benchmark

There is no international consensus as to how a benchmark should be defined. Attempts to categorise tax expenditures through a benchmark tax have been the subject of long-standing debate.

There are three broad approaches that New Zealand could use to build or create a benchmark. The approaches draw on:

- international best practice;
- a theoretically ideal or perfect tax structure; or
- the current (status quo) tax system.

International practice and tax policy

International reporting practice offers few workable insights that New Zealand could apply as tax design and the objectives motivating TE reporting varies from country to country. As a result, there has been limited progress on a standardised approach (OECD 2008: 7). A summary of different approaches is included in Table 2.

An optimal theoretical tax benchmark

Applying tax theory can be challenging as there is a lack of consensus in optimal or applied taxation theory as to how a normative tax benchmark should be constructed. The concept of a normative tax base has been heavily attacked in academic literature. Boris Bittker (1969) provided an early criticism that there was no commonly accepted definition of the normal tax system as any system of taxation is an aggregation of decisions about a range of structural issues that theoretical tools such as the Haig-Simons (HS) definition[7] of income do not purport to settle.

Theoretical tax benchmarks allow the difference between a specific tax and an "ideal" tax structure to be measured. This difference, relative to a theoretical tax structure, may differ markedly from the tax that is actually

[7] Haig-Simons income includes all changes in wealth including income and any capital appreciation over the period.

forgone relative to the actual tax structure.[8] Thus, the further the theoretical tax structure moves from the current tax structure, the less useful numbers are from a fiscal perspective.

Most attempts to use a theoretical tax base have in practice been tempered by a range of practical considerations. The US Treasury takes into account a range of factors including the "generally accepted structure of income tax" (Surrey and Helmuth, 1969: 531). The Australian Treasury, which publicly provides a large amount of data on their benchmark, starts with a HS definition of income, but then tailors the benchmark to sit more closely with current tax practice (the Australian Treasury, 2008).

The current tax system as a benchmark

Thus, most countries, in forming a benchmark, rely to differing degrees on their current tax structure. This improves the quality of fiscal estimates. However, using the entire current tax system as a benchmark is not possible as doing so presents the obvious difficulty that if the entire tax system is considered part of the benchmark there would be no tax expenditures to measure.

The difficulty in communicating the wide number of choices involved in specifying a benchmark may create uncertainty about which parts of the benchmark are deemed to have theoretical support and which parts are motivated by other considerations. Australia provides comprehensive information about the structure of their tax benchmark. However, interpretation of TE benchmarks in other countries is made difficult as a result of limited or insufficient information.

One solution is to work in the other direction by first creating a tax expenditure definition.

Approach two: defining tax expenditures directly

A few countries are starting to define TEs directly rather than indirectly through a benchmark[9]. Japan and Korea do not specify a benchmark and instead define TEs as a deviation from certain principles (OECD, 1996). In the US the JCT and the Treasury have also chosen to define some TEs directly.

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8 An example could be a tax deduction that reduces personal income tax from 38% to 33% for a small number of people. The tax expenditure relative to the tax that would otherwise be collected equals 5%. Measuring the size relative to any other figure other than 38%, for instance a flat tax rate of 25%, would produce different cost estimates. A flat tax rate may be attractive as an ideal tax structure, but it would be useless as a basis for measurement of the actual cost of a tax expenditure.

9 Defining TEs directly may still implicitly use a benchmark. However, using the US conservative requirement that TEs have a clear alternative tax treatment removes the need for a benchmark. The alternative tax treatment is localised removing the need to focus on the wider structure of the tax system.

TEs under the US approach are defined as an exception from a current tax law. The advantage of this approach is that the remaining body of tax law becomes a residual factor, rather than the focus of analysis. This reduces the normative implications associated with specification of an alternative tax treatment where no clear exception exists.

The US still reports a range of other TEs, but these estimates are clearly separated within their TE statement. The US Treasury and the JCT's definition now specifies that a TE must:

i. be special in that it applies to a narrow class of transactions or taxpayers; and

ii. have a general tax provision to which the special provision is a clear exception.

The JCT adds an extra stipulation that the feature must also decrease revenue. The US Treasury has also accepted a spending leg to its definition that specifies that TEs should be able to be replaced by a direct spending programme (GAO, 2008).

Regardless of the definition, an element of judgement will still be required, although the basis for decisions may be much clearer. The JCT noted that their direct definition does not require the kinds of normative judgements that go into the construction of a "normal" tax benchmark, but that it is nonetheless not automatic in application (JCT 2008: 40).

The key advantages of a direct definition over a benchmark-based approach are transparency and relative objectivity. It is much easier to communicate a concise tax expenditure definition than it is to communicate an entire benchmark tax system.

However, depending on the structure of the tax system, direct definition comes with some disadvantages. Direct definition may miss large cross-cutting TEs that apply to all members of the population, but are still heavily policy motivated. For instance the universal subsidies provided under the Australian Superannuation Guarantee (ASG) that are motivated by superannuation and savings policy would not be picked up under the US definition as all taxpayers pay the same rate of tax on ASG accounts. A benchmark that specifies a desirable level of tax is needed to report and estimate the cost of these cross-cutting TEs.

Debate and criticism

Aspects of the tax expenditure concept have been contentious. The ideal tax system has been the focus of this debate. However, if TEs are measured relative to a clear alternative tax treatment, normative statements are reduced. The residual debate usually relates to judgement calls around the TE definition's boundary (Kahn and Lehman, 1992).

Table 3 – Common objections [10]

Objection	Response
Tax expenditures are hard to estimate.	There are issues with valuations in all fields. For instance, many assets on the Crown balance sheet (ie, the Treaty of Waitangi or national parks) are unique, have no active market, and could never be sold.
TE estimates based on revenue forgone ignore behavioural effects.	Fiscal reporting accounts for the cost of a policy in isolation from other policies. Behavioural responses to discontinued social spending programmes, such as a transfer to another benefit, are not included in reported figures for direct spending.
The TE concept implies the government owns all taxpayers' income.	The current rate structure, which claims a limited proportion of income, defines the government's current claim on income. Tax expenditures act to reduce not enhance that claim.
The TE concept is pejorative. It implies that the identified provision should be removed.	Reporting the cost of direct expenditures in financial statements does not suggest they should be removed. TEs have budgetary implications, but there is no reason why bringing reporting for tax expenditures on par with direct spending should suggest that that the policy is ineffective or should be removed.
TEs are a back door to tax reform.	TEs are more closely associated with a spending review. A descriptive evaluation of the cost of direct or indirect expenditures makes no statement about whether the spending represents value for money.
TEs reporting aims to lower the tax rate and reduce the size of the state.	TE reporting provides the public with financial information without judgement.

[10] This table is derived from Brooks (2009) which discusses the main objections to TE reporting.

New Zealand objectives

The primary motivation for providing TE data would be to provide information on the full cost of New Zealand public sector expenditure as a supplement to our current financial reporting. [11] This motivation can be broken down into three sub-parts:

1) Fiscal strategy: transparency and accountability

   The TE statement will improve the transparency and accountability around fiscal strategy by providing more complete information about the full scope of government expenditures.

2) To estimate or list the stock of tax expenditures

   New Zealand publishes the estimated cost of new tax expenditures when they are introduced, but does not provide public information on the current stock of tax expenditures. [12]

3) To make direct and indirect expenditures comparable

   TE reporting will allow comparison between TEs and equivalent direct spending programmes.

Structural tax questions, while relevant, are not the primary motivation for TE reporting in New Zealand.

A New Zealand approach

Improving public information on TEs has been cited as a potentially useful addition to the New Zealand accountability documents. While, New Zealand has comparably few TEs and many are relatively small in size, additional transparency would provide the information necessary to assess the ongoing effectiveness of TEs that accumulate over time.

Our instinct is that transparency is desirable and so any debate is likely to be beneficial. TEs have generated academic debate abroad and this debate has ultimately placed TEs transparently in the spotlight. TE reporting has not always led to widespread tax reform or spending cuts in overseas jurisdictions (Shaviro, 2004), but the reporting has contributed to

[11] No decision has been made as to how TEs would sit relative to the Budget documents. TEs could be released as supplementary information either in formal documentation or as a separate release covering the same period.

[12] The 2004 amendment of the Public Finance Act 1989 added a requirement to report significant tax policy changes (Sections 26O & 26R). This reports the estimated cost in the year of introduction. There is no requirement to report the accumulated stock of tax expenditures beyond the year of introduction.

a continued re-examination and debate about the efficacy of tax-based spending.

Descriptive financial reporting should support debate, but needs to be, as far is possible, impartial. The challenge for New Zealand will be to create a statement that clearly reports the cost of spending, while avoids any policy judgements. Debate about effectiveness should be separated from reporting.

Descriptive reporting will require a definition that is:

- easy to use;
- able to be understood; and
- avoids pejorative or normative statements.

A direct definition, rather than a benchmark, is considered more likely to achieve these three requirements. A normative benchmark would require a range of judgements that, given complexity, are difficult to communicate.

A wide range of options exist, but, based on international practice, the New Zealand statement should, where possible, separate fiscal reporting from advice on structural tax change. This suggests two separate reports.

1) *Fiscal reporting — annual tax based spending data*

   Annual tax expenditure data would support existing financial information. Tax-based spending data would be based upon a TE definition and would, where possible, seek to measure TEs against the tax that would otherwise be collected.

   This information could be provided on the web, as a standalone report, or as a very basic note to the financial statements.

2) Policy perspectives — a tax policy report

   Information on TEs that are significant, cross-cutting, and are not picked up in other fiscal reporting could be released in a structural tax policy report built on a tax benchmark. However, the benefits of the report would need to be assessed in light of demand and existing reporting.

   This work would involve a range of policy judgements and would be released as the Treasury's view ie, either as a Treasury policy perspectives paper or as a working paper.

Releasing data in the first report would be a basic minimum first step. Further information could be released if interest exists.

The production of any TE data is expected to require a reasonable amount of initial set up work. For this reason, reporting may be rolled out over a number of years. Initial reports would release a qualitative list of TEs, but may only quantify a few significant TEs. Due to data limitations many TEs may never be able to be quantified.

TE reporting is not covered by generally accepted accounting practice (GAAP). However, every attempt would be made to render TEs directly comparable to other fiscal data.

Definition and criteria

This section lays out a potential tax expenditure definition. Normative benchmarks required for the second tax policy report will not be covered in this paper.

This paper proposes that New Zealand define a tax expenditure as:

> "... a tax provision significantly motivated by a policy objective other than to raise revenue that: reduces revenue by lowering tax for a limited or select group of taxable entities; is able to be replaced by a direct expenditure programme; and is neither administrative in nature or motivated by a domestic double taxation objective"

The five key criteria included in this definition are discussed below. Table three provides an illustration of how the criteria could be applied.

1. Non-revenue policy objectives

TEs are significantly motivated by policy objectives that are tangential to the Tax Act's stated revenue raising focus.

"Significantly motivated" does not require that a non-revenue policy objective is the only motivation. An element of judgement will be required where tax provisions have multiple objectives.

2. A reduction in revenue

Spending reduces the funds available for other projects. Tax expenditures decrease revenue, while direct spending affects the operating balance (deficit/surplus) through an increase in government expenditure. Thus, both have the same net effect.

3. A limited or targeted group of taxable entities

Tax expenditures should be limited to, or targeted at, either:

- a small group of economic entities; or
- some specific form of economic activity.

Policy-motivated tax provisions that are generally applicable to all taxpayers would not be classified as a TE as, under the proposed approach, an alternative tax treatment is needed.

4. Able to be replaced by direct spending

Tax expenditures, as the conceptual equivalent of spending, should be able to be replaced with a direct expenditure programme.

Some countries that use a normative tax benchmark also report "over taxation" as a negative tax expenditure. High excise taxes that exceed common tariff rates could be an example. High taxation would not be included in this definition as high tax has no conceptual equivalent in spending terms. These taxes are published elsewhere.

5. Administrative and domestic double tax measures

The final two criteria are aimed at removing provisions that are motivated by either administrative simplicity or double taxation.

Administrative provisions would not be reported as they are technical tax provisions that specify how tax is collected. Individuals are often excluded from tax where collecting the tax may be uneconomic or practically impossible.[13] Reporting administrative provisions is unlikely to add value to domestic policy debate.

Double taxation provisions would not be reported as they seek to align effective tax rates between different tax structures. For instance imputation credits align tax on investment income with personal tax rates. This is not motivated by any alternative policy goal.

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[13] For example Section LC3 of the Income Tax Act 2007 provides children with a tax credit that is capped at $292.50. Collecting such small amounts of tax is not economic.

Table 3 – An illustrative use of tax expenditure criteria

Tax features	Non-revenue raising objective	Reduces potential revenue	Targeted at a limited group or activity	Able to be replaced by a direct expenditure programme	Not an administrative or a double taxation measure	Status
R&D tax credits	✓	✓	✓	✓	✓	**Tax expenditure**
Expensing of forestry capital improvements (Planting Costs)	✓	✓	✓	✓	✓	**Tax expenditure**
House holding tax credit	✓	✓	✓	✓	✓	**Tax expenditure**
Trusts	✓	✓	✗	✗	✓	**Structural**
Imputation credits	✓	✓	✓	✓	✗	**Structural**
Portfolio Investment Entities (PIEs)	✗ ✓	✓	✗	✗	✓	**Structural**
Progressive tax rates	✗ ✓	✓	✗	✗	✓	**Structural**
Lack of capital gains tax	✗	✓	✗	✗	✓	**Structural**

A tick and a cross indicates that the primary purpose of the tax feature is debatable

Invitation for comment

There is no wrong or right way to configure a tax expenditure statement and there are likely to be different views about aspects of this report.

From a public sector management perspective, a TE statement is likely to make a positive contribution. However, it is important that TE data meet domestic needs and requirements. The data should also be easy to understand and should be able to support robust policy debate.

This paper provides some initial discussion about TE reporting and lays out options for a New Zealand approach. However, we would welcome feedback about the value of a New Zealand TE statement.

Some specific feedback could include answers to the following questions:

- Would basic TE information be useful?
- Do the proposed criteria and definition capture the items of interest?
- Should the criteria be broader or narrower?
- What items should be added to or subtracted from the preliminary list of tax expenditures in Annex one?

Annex One: possible tax expenditures

The following table provides a selection of tax expenditures captured under the proposed approach. Sections refer to the relevant sections in the *Income Tax Act 2007*. The list should be treated as a preliminary cut for the purpose of illustration and is not deemed comprehensive at the point of publication.

Possible Tax Expenditure	Section
Payments of interest post-war credits: exempt income Interest derived by a person under section two of the *Income Tax (Repayment of Post-War Credits) Act 1959* of the United Kingdom Parliament is exempt income.	CW 5
Payments of interest on farm mortgages: exempt income Fifty percent of the interest that a person derives from a mortgage securing a loan made by a seller of a farm is exempt income if the Rural Banking and Finance Corporation of New Zealand approves the mortgage.	CW 6
Income of the Governor-General: exempt income The salary of a person acting as the Administrator of the Government and the salary and allowance of the Governor-General are exempt income under the *Civil List Act 1979*.	CW 16
Income for military or police service in operational area: exempt income When a member of the New Zealand Defence Force (or the police) derives income for serving in an operational area, an operational allowance and any amount that the ministerial committee decides upon is exempt income of the member.	CW 23
Deferred military pay for active service: exempt income Deferred military pay that is granted or paid under the *Defence Act 1990* to a person for service in the New Zealand armed forces in an active service area is exempt income.	CW 24
Jurors' and witnesses' fees: exempt income Fees paid by the Crown to jurors and its witnesses, other than expert witnesses, are exempt income.	CW 26
Certain income derived by transitional residents: exempt income New tax residents in New Zealand gain a temporary tax exemption for four calendar years on most foreign-sourced income.	CW 27, HR 8
Scholarships and bursaries: exempt income Any scholarship or bursary payment for attendance at an educational institution is exempt income, except for a basic grant or an independent circumstances grant under the *Education Act 1989*.	CW 36
Film production grants: exempt income A grant provided to a company as a large budget screen production is exempt income.	CW 37
Local and regional promotional bodies: exempt income The income derived by a charitable association or society is exempt income if it is primarily established for beautification purposes.	CW 40
Charities: exempt income Business, non-business and charitable bequests are all exempt income for registered charitable entities, provided the charity is not used for personal benefit.	CW 41-43
Friendly societies: exempt income Income derived by a friendly society is exempt income except where the amount is derived from business is beyond the membership or from a company registered as an insurer under the *Accident Insurance Act 1998*.	CW 44
Funeral Trusts: exempt income Interest or a dividend derived by a trustee in trust for a fund is exempt income.	CW 45

Possible Tax Expenditure	Section
Bodies promoting amateur games and sports: exempt income Income derived by a club, society or association is exempt income if it is established to promote an amateur game or sport and no funds are used for private pecuniary profit.	CW 46
TAB and racing clubs: exempt income Income derived by the New Zealand Racing Board, New Zealand Thoroughbred Racing, Harness Racing New Zealand and the New Zealand Greyhound Racing Association is exempt income.	CW 47
Income from conducting gaming-machine gambling: exempt income Income derived by a person that is gross gambling proceeds from gaming-machine gambling is exempt income if the person complies with the *Gambling Act 2003*.	CW 48
Bodies promoting scientific or industrial research: exempt income Income derived by a society or association established mainly to promote or encourage scientific or industrial research is exempt income if the society or association is approved by the Royal Society of New Zealand and no funds are used for private pecuniary profit.	CW 49
Veterinary services bodies: exempt income Income derived by a veterinary association, club or society established mainly to promote efficient veterinary services in New Zealand is exempt income, provided that no funds are used for private pecuniary profit.	CW 50
Herd improvement bodies: exempt income Income derived by a herd improvement association or society established mainly to promote the improvement of the standard of dairy cattle in New Zealand is exempt income, provided that no funds are used for private pecuniary profit.	CW 51
Community trusts: exempt income Income derived by the trustee of a community trust is exempt income.	CW 52
New Zealand companies operating in Niue Dividends derived from or by a company incorporated in New Zealand that derives its income wholly or mainly from Niue is exempt income.	CW 59
Charitable or other public benefit gifts by company: deduction A company is allowed a deduction for a charitable or other gift that produces a public benefit when made to a society, institution, association, organisation, trust, or fund set out in schedule 32 of the *Income Tax Act 2007*.	DB 41
Farming and aquaculture business expenditure Deductions granted for improvements and enhancements to land for farming and aquaculture can be expensed rather than treated as capital.	DO
Forestry expenditure: deduction Deductions granted for expenditures associated with forestry (ie, improvements or planting costs) can be expensed rather than treated as capital improvements.	DP
Film industry expenditure: deduction Expenditure incurred acquiring film rights can be deducted over one year for New Zealand films and over two years for non New Zealand films.	DS
Petroleum mining expenditure: deduction Petroleum exploration expenditure can be deducted where it generates an asset. Development expenditure is written off over an accelerated seven year period.	DT EJ12
Mineral mining expenditure: deduction A mining company can deduct all exploration and development expenditure in the year it is incurred. Other concessionary deductions, the immediate deduction on the purchase of long-lived capital items.	DU
Non-profit organisations: deduction Non-profit organisations are allowed deductions for the lesser of $1,000 and the amount that would be the organisation's net income in the absence of any deductions.	DV 8

Possible Tax Expenditure	Section
Māori authorities – donations: deductions A Māori authority is allowed a deduction for a donation that it makes to a Māori association as defined in the *Māori Community Development Act 1962*. A charitable or other public benefit gift that a Māori authority makes to a society, institution, association, organisation, trust, or fund is deductible.	DV 12
Housekeeping: tax credit A tax credit of up to $310 is granted each year for a person who makes housekeeping or childcare payments in a tax year for the services of a housekeeper.	LC 6
Charitable or other public benefits: tax credit Where donations are made to approved organisations you can claim a tax credit to the value of the lesser of: 33.33% of the total donation you have made; or 33.33% of your taxable income.	LD
Interest on home vendor mortgages: tax credit When a person derives interest in relation to a home vendor mortgage a tax credit is available in a tax year on 2% of the interest amount up to a limit of $500.	LZ
Redundancy payments tax credit: Redundancy payments can receive a $3600 payment or six cents for every complete dollar of payment.	ML 2
KiwiSaver superannuation contribution tax exemption: Employers are exempt from paying employer superannuation contribution tax (ESCT) up to the value of the lesser of: the employee's contribution or 4% of employee's gross pay.	RD
Accelerated depreciation The ability to depreciate capital items faster than their economic life reduces income by a greater amount in earlier years (deferring tax payments).	Schedule 20 DO 4-5,12 DP 3 DZ 17-18 EE31
Child tax credit A tax credit of up to $292.50 is granted to children as defined in the Act for each tax year.	LC3

The four working for families' tax credits are not pure tax expenditures. The hybrid tax credits, which are appropriated in the current financial statements, are often paid as a cash welfare payment by Work and Income New Zealand. As these credits are already appropriated, they would not be included in the tax expenditure statement.

KiwiSaver tax credits will be excluded as they a direct payment from the Crown to participants. These credits are appropriated and, despite their name, are more similar to a direct payment than tax expenditure.

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