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Note on Tax Expenditures and Fiscal Transparency: 'Best Practices' and Current New Zealand Reporting

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NOTE ON TAX EXPENDITURES AND FISCAL TRANSPARENCY: 'BEST PRACTICES' AND CURRENT NEW ZEALAND REPORTING[1]

Reporting on tax expenditures used to finance public policy objectives is widely recognized as an essential element in fiscal transparency, with guidance on 'best practices' from the IMF, World Bank, OECD and the International Budget Partnership (IBP) all highlighting the importance of a detailed statement of tax expenditures as part of budget and/or other routine fiscal documentation.

Tax expenditures can take a variety of forms (e.g. exemptions, deductions, offsets/credits, concessionary rates or deferrals) and can together constitute a significant volume of public resources. In some countries (e.g. Canada and UK), tax expenditures are estimated to sum to more than 10% of GDP. Despite potentially significant fiscal and economic implications, tax expenditures typically lack the degree of scrutiny or oversight given to 'direct expenditures.' Reasons for this include: (i) their being defined in tax law and thereby not subject to annual appropriation; and (ii) once approved, they are normally administered by a revenue agency rather than a ministry or department with direct responsibility for fiscal policies in a specific functional area.

An increasing number of countries, including New Zealand, have taken the initiative to include reporting on tax expenditures as part of annual fiscal documentation, though the scope, format and content of country-specific reporting vary quite widely. The 2003 NZ NIS noted the lack of tax expenditure reporting in NZ, and recommended the government introduce regular reporting, as did the 2006 and subsequent Open Budget Surveys of NZ. Following a 2009 Treasury policy paper discussing options for reporting, NZ started publishing a statement of tax expenditures as part of the annual budget documentation with the 2010 Budget (with the last published information on tax expenditures having been in 1984). The decision to include an annual Tax Expenditure Statement (TES) was an important step toward enhancing budget/fiscal transparency. Yet, comparison against both guidance on 'best practices' and practices in other countries (especially Australia) indicate opportunities for improving on the scope and quality of New Zealand's current reporting on tax expenditures.

'Best Practice' Guidance for Reporting on Tax Expenditures

Alternative sources provide relatively consistent guidance on 'best practices' for reporting information about specific tax expenditure items. While there are alternative methodologies for defining and quantifying tax expenditures (e.g. measuring against a 'benchmark' tax system, measuring revenue foregone or measuring potential revenue gains), there is consensus around characteristics to be reported, including the following:

i) The type of tax expenditure – exemption, credit, preferential rate, etc.;

[1] This note was drafted by Jonathan Dunn (smitana@ihug.co.nz) as an input to the Transparency International New Zealand 2013 National Integrity System assessment of New Zealand. It provides analysis in support of the recommendation in the NIS report that reporting of tax expenditures should be deepened. It should be read in conjunction with NIS Supplementary Paper 2 on Fiscal Transparency in New Zealand, at www.transparency.org.nz/docs/2013/Supplementary-Paper-3-Fiscal-Transparency.pdf

ii) The basis or source, e.g. tax laws, administrative practice or tax treaty;

iii) An explanation of policy objective(s) underlying the tax expenditure, including some identification of beneficiaries;

iv) Information about the expected duration (e.g. on-going or with 'sunset clause');

v) Estimates of fiscal impact (e.g. revenue foregone) with time-series data inclusive of both preceding and future years, together with an indication of the reliability of the estimates;

vi) An explanation of significant distributional impacts associated with particularly large tax expenditures; and

vii) Information about the timing and conclusions of the government's most recent review/assessment.

In addition to standards for reporting characteristics of individual items, guidance for 'best practices' indicates that a tax expenditure statement should also:

i) provide a clear definition of what constitutes a tax expenditure;

ii) explain the method used to quantify the cost of individual tax expenditures;

iii) report on tax expenditures aggregated by standard functional classification (e.g. health, education, etc.) comparable to that used for classifying direct spending;

iv) report on tax expenditures aggregated by tax type (e.g. income, GST, etc.); and

v) use 'materiality' to prioritise and focus analytical attention and reporting on the fiscally most significant individual tax expenditures.

The timing of reporting on tax expenditures is also important. Including a comprehensive statement of tax expenditures as a component of annual budget documentation does contribute to fiscal transparency. However, making documentation available to the public well in advance of legislative consideration and voting on the annual budget can support a more thorough opportunity for discussion/debate of the merits of specific tax expenditures before the public resources are allocated to finance those policies. On this basis, some version of a tax expenditure statement would be issued as part of a mid-year fiscal/budget policy statement or at least well in advance of the annual budget itself e.g. at the time of the Budget Policy Statement (BPS).

Elements of these 'best practices' are, to a greater or lesser degree, reflected by tax expenditure reporting in a number of countries (e.g. Australia, US, UK, South Africa and others). Of the countries recently reviewed, current tax expenditure reporting in Australia appears to go furthest in meeting 'best practice' standards. As such, and taking into consideration institutional "common ground" between Australia and New Zealand in other aspects of public financial management and fiscal reporting, a closer look at Australia's reporting on tax expenditures provides valuable practical guidance for specific steps to improve the quality of current reporting in New Zealand.

Australian Tax Expenditure Statement

The Australian Tax Expenditure Statement is comprised of four chapters preceded by a brief summary of 'Highlights'. The content of these is summarised in Box 1.

Box 1: The Australian Tax Expenditure Statement

The Australian statement contains the following sections:

Highlights
Identifying aggregate trends, along with largest, new, modified and eliminated items.

Chapter 1: Overview
Overview of trends over time, examination of largest individual tax expenditures, and aggregation both by tax type and by functional classification, including a comparison by functional classification of tax expenditures against direct expenditures.

Chapter 2: Framework
Definition of tax expenditures, rationale for reporting, explanation of methodology for "revenue foregone" approach and discussion of related methodological issues.

Chapter 3: Tax Expenditures
Listings of 363 individual tax expenditures, as well as an introductory "guide to tax expenditure descriptions" with explanation of categories for "order of magnitude" quantification and categorising the reliability of estimates.

Chapter 4: Revenue Gain Estimates of Tax Expenditures
Comparison of "revenue gain" estimates versus the "revenue foregone" estimates for a selection of the largest individual tax expenditures items, with revenue gain estimates (unlike revenue foregone estimates) allowing for some degree of "behavioural response" over time to changes in tax provisions.

For each tax expenditure listed in Chapter 3, the following standard format is used to report on specific characteristics and provide a concise description:

TES Code Number: Title of Tax Expenditure
Functional Classification

Tax expenditure type:	**2011 TES code:**
Estimate Reliability:	***Category:**
Commencement date:	**Expiry date:**
Legislative reference:	

<u>Brief description of the tax expenditure</u>

To summarise, the Australian TES meets many criteria set out in 'best practice' guidance. It offers a concise summary of 'highlights' and overview; an extensive listing with multi-year quantification and relatively thorough description of each individual tax expenditure using a consistent accessible format (shown in Box 1). Accepting that precise quantification of certain individual tax expenditures is difficult, the Australian report provides an 'order of magnitude' estimate, together with another code qualifying the reliability or precision of quantitative estimates for individual tax expenditures. Documentation also includes an informative background explanation of the framework and methodology, including a comparison with alternative methodologies and use of materiality criteria to focus this methodological analysis on a sample of the most significant individual tax expenditures. Aggregate time-series data (covering 8 years) both by tax type and by functional classification, as well as a comparison against direct expenditures are presented and analysed. Finally, in addition to comprehensive coverage/content, the mid-year timing for publication well in advance of the annual budget allows ample time for review and debate. Relative to 'best practice' guidance about reporting on characteristics for individual tax expenditures items, the only items apparently absent from the Australian TES are analysis/discussion of distributional impacts associated with the largest tax expenditures, and information about the timing/conclusions of the government's most recent policy review.

Reporting in Selected Other Countries

A review of tax expenditure reporting in selected other countries (US, UK, Canada, South Africa) indicate substantial coverage and/or data also being reported as part of annual budget documentation. Of these, the US appears to provide relatively comprehensive reporting, with the annual budget including a thorough inventory and descriptions of individual tax expenditures, as well as a 7-year time series quantifying individual tax expenditures grouped by functional classification and by tax type. Other data tables show projected revenue effects of individual tax expenditures ordered by magnitude, and present value calculations of selected tax expenditures coming in the form of tax deferrals.

Current New Zealand Tax Expenditure Statement - Opportunities for Improvement

As previously noted, New Zealand's resumption of reporting on tax expenditures in 2010 followed a 2009 Treasury policy paper discussing the relevant issues and options. That paper stated three specific "New Zealand objectives" for reporting on tax expenditures:

i) improve transparency and accountability around fiscal strategy by providing more complete information about the full scope of government expenditures;

ii) estimate or list the current stock of tax expenditures; and

iii) allow for comparison between tax expenditures and direct spending.

The same background policy paper clearly set out an approach for defining what constitutes a tax expenditure, and the annual Tax Expenditure Statement issued since 2010 reflects that approach. A recent independent cross-country study refers to New Zealand taking a relatively 'cautious approach', in terms of both the scope of what constitutes a tax expenditure, for example, by excluding concessionary tax treatment broadly available to all taxpayers, e.g. Portfolio Investment Entities and trusts.

The most recent Tax Expenditure Statement (2012) includes a concise explanation of the framework used to define what constitutes a tax expenditure and a listing of individual tax expenditures, along with references to their respective basis in the tax code. The listing includes 43 individual tax expenditure items, 37 of which have their basis in the 2007 Income Tax Act and six in the 1985 Goods and Services Tax Act.

Quantitative estimates are provided for only six individual tax expenditures, all relating to income tax concessions. The total estimated value of these six quantified tax expenditures is roughly $435 million for the 2011/12 financial year, with the majority of that total (i.e. $394 million) attributable in roughly equal shares to just two items – (i) the tax credit for charitable donations or other public benefits and (ii) the independent earner tax credit.

A comparison of the latest 2012 Tax Expenditure Statement, against 'best practice' guidance and Australian reporting, points to areas requiring further attention and effort to improve the scope and transparency of New Zealand's fiscal reporting.

- Lack of quantification for most items and no information to assess the relative fiscal significance/materiality;
- No identification of the functional classification for individual items;
- Individual items currently grouped by tax type (income and GST), using an alphabetical listing within these two broad categories. A more useful presentation could employ a listing by functional classification, or by some other policy-relevant classification, and by materiality;
- Description of individual items in some cases is minimal and would benefit from further explanation, including some information about beneficiaries to the extent possible;
- No information is given about recent or current government reviews of individual provisions; and
- Timing of the statement's release coinciding with the budget precludes substantive review/public debate prior to decision-making on budget policies.

Relatively 'Low-Cost' Options for Improving Current Reporting in New Zealand

i) Apply functional classification labels, as appropriate;

ii) Produce some information about the materiality of individual items, even if precise estimates of fiscal impacts are not feasible or 'cost effective';

iii) Investigate options for quantifying individual items, including possibility of using 'order of magnitude' and/or 'reliability of estimate' categories such as those used in Australia to accommodate instances where precise estimate may not be feasible due to data or other constraints;

iv) Indicate the timing of the most recent or next expected policy review of individual tax expenditures;

v) Review descriptions to ensure sufficient explanation of policy objectives, including possibly more about observed/observable benefits or beneficiaries; and

vi) Consider releasing the report in advance of the annual budget, e.g. together with the Budget Policy Statement, to allow for more open discussion as part of fiscal policy decision-making.