Annex - 2

Tax Expenditure

A Note on Tax Expenditure

Tax expenditures are provisions in the tax code, such are exclusions, deductions, credits, and deferrals that are designed to encourage certain kinds of activities or to aid taxpayers in special circumstances. When such provisions are enacted into the tax code, they reduce the amount of tax revenues that may be collected. In this sense, the fiscal effects of tax expenditure are just like those of direct government expenditure. Some tax expenditures involve a permanent loss of revenue, and thus are comparable to a payment by the government; others cause a deferral of revenue to the future, and thus are comparable to an interest-free loan to the taxpayer. Tax expenditures include exemptions from the tax base, allowances deducted from gross income, tax credits deducted from tax liability, tax rate reductions, and tax deferrals (such as accelerated depreciation). Any tax revenue lost because of these exemptions, allowances, and deductions is considered to be a tax expenditure. Since tax expenditures are designed to accomplish certain public goals that otherwise might be met through direct expenditures, it seems reasonable to apply to tax expenditures the same kind of analysis and review that the budget appropriation receives.

It is essential to distinguish between those provisions of the tax code that represent tax expenditures and those that are part of the "basic structure" of a given tax. The basic structure is the set of rules that defines the tax; tax expenditure is an exception to those rules. In general, most taxes have a series of features that define their basic structure. These features are a base on which the tax is levied, such as net income or a particular class of transactions; a taxable unit, such as a person or a corporation; a rate, to be applied to the base; a definition of the geographic limits of the state's exercise of its tax jurisdiction; and provisions for the administration of the tax.

The total expenditures for FY 2008-09 has been estimated to be around Rs.119.65 billion, which is about 38.1 percent higher than the amount incurred in FY 2007-08. The estimated revenue loss stemming from tax expenditure was substantially higher in the previous year mainly due to withdrawal of capital gains to promote stock markets. The details for the FY 2008-09 are discussed below:

Income Tax

The tax expenditure concept posits that an income tax is composed of two distinct elements. The first element consists of structural provisions necessary to implement a normal income tax, such as the definition of net income, the specification of accounting rules, the determination of the entities subject to tax, the determination of the rate schedule and exemption levels, and the application of the tax to international transactions. The second element consists of the special preferences found in every income tax. These provisions, often called tax incentives or tax subsidies, are departures from the normal tax structure and are designed to favor a particular industry, activity, or class or persons. They take many forms, such as permanent exclusions from income, deductions, deferrals of tax liabilities, credits against tax, or special rates. Whatever their form, these departures from the normative tax structure represent government spending for favored activities or groups, effected through the tax system rather than through direct grants, loans, or other forms of government assistance.

Section 53 of the Income Tax Ordinance, 2001 empowers the Federal Government to exempt from tax any income or classes of income, or persons. However, these powers are not being exercised by the Government as it is following a conscious policy of phasing out the existing exemptions gradually and not to allow fresh ones. Categories of exemption listed in Part-I of Second Schedule to the Income Tax Ordinance, 2001 are broadly as under:-

- Exemption related to pensions, provident funds and superannuation fund;
- Exemption of interest on borrowings from external sources;
- Exemption to non-profit charitable, religious and welfare activities;
- Exemption to non-profit educational institutions;
- Exemption relating to electric power generation; and
- Un-expired period to tax holidays for industrial undertaking.

The total number of exemptions under the aforesaid categories contained in Part-I of Second Schedule to the Ordinance 2001 is around 100. The cost of these exemptions amounts to Rs.40.86 billion for the outgoing fiscal year. It may be noted that exemption expenditure mainly relates to allowances, capital gains, pensions, provident fund and superannuation fund. Furthermore, exemptions related to charitable activities and non-profit educational institutes are common in both developed and developing countries. The position with regard to the basic threshold of income for charging taxes is similar. The following is the estimated cost of exemptions in fiscal year, 2008-09 as compared to fiscal year 2007-08:-

Table 1: Income Tax Expenditure *(Rs. in billion)*

No.	Major Income Tax Expenditure Items	Estimated Revenue Loss	
		2007-08	**2008-09**
1.	Pensions	0.39	0.054
2.	Allowances	-	0.359
3.	Income from Funds (e.g. NIT units)	0.22	0.828
4.	Donations and Contributions to Charitable Organizations	1.74	0.517
5.	Independent Power Producers	4.70	0.772
6.	Income from Certain Trusts, Welfare and charitable institutions/ non-profitable organization	0.92	1.050
7.	Profits on Debt/interest from government securities and certain foreign currency accounts/ books/ profit on debt earned by certain non-residents individuals and institutions	0.21	0.025
8.	Income of Boards of Education, Universities & computer training institutes	-	-
9.	NSS interest income	-	-
10.	Export of Information Technology	0.03	0.602
11.	Other interest income	-	-
12.	Capital gains	18.48	18.760
13.	Other Sector and enterprise specific exemptions	0.97	17.897
	TOTAL:	**27.66**	**40.864**

Sales Tax

Key exemptions of Sales Tax are pharmaceutical products, tractors and other agricultural machinery and fertilizers. The cost of Sales Tax exemptions is estimated to be Rs.17.5 billion for the fiscal year 2008-09 as against Rs.17.6 billion last year. The modest increase is mainly attributable to a rise in tax expenditure related to pharmaceutical. The Following are the main exemptions in Sales Tax allowable in fiscal year 2008-09 [Table 2].

Table 2: Sales Tax Expenditure		*(Rs. in billion)*	
No.	**Major Sales Tax Expenditure Items**	**Estimated Revenue Loss**	
		2007-08	**2008-09**
1.	Pharmaceutical (excluding life saving drugs)	2.30	3.1
2.	Tractors and other agriculture machinery.	5.60	5.7
3.	Fertilizers	9.20	8.20
4.	Others (e.g. agri seeds, cattle feed)	0.50	0.50
	TOTAL:	***17.60***	***17.5***

Customs

Customs exemptions are mainly given on raw materials and components; plant, machinery and equipment imported by high-tech, priority and value added industries; imports for energy sector projects; and exemptions to exploration and production companies. Some of these exemptions are due to international contractual obligations. The following is the break-up of main exemptions in customs duties allowable in fiscal year 2008-09 compared to fiscal year 2007-08 [Table 3].

Table 3: Exemptions in Customs Duties			**(Rs. in Million)**	
S. #	**SRO No. & Date**	**Description**	**Estimated Revenue Loss**	
			2007-08	**2008-09**
1.	410(I)/2001, dated 18.6.2001	Conditional Exemption of customs duty and sales tax on temporarily imported goods for subsequent exportation.	1.838	2.335
2.	456(I)/2004, dated 12.6.2004 Superseded by 565(I)/2005, Dated 05-06-2006	Conditional exemption of customs duty on import of raw materials and components etc. for manufacture of certain goods (Survey Based)	2.949	2.839
3.	567(I)/2005, dated 06.6.2005 Superseded by 567(I)/2006, Dated 05-06-2006	General and conditional exemption of customs duty (non Survey)	5.869	18.121
4.	678(I)/2004, dated 12.6.2004	Exemption of customs duty and sales tax to Exploration and Production (E&P) companies on import of machinery.	2.239	4.401
5.	570(I)/2005, dated 06.6.2005	Concession of customs duty on goods imported from Sri Lanka.	0.022	0.036
6.	575(I)/2005, dated 06.6.2005 Superseded by 575(I)/2006, Dated 05-06-2006	Exemption from customs duty and sales tax on import of specified machinery, equipment, apparatus and items	9.139	11.189
7.	Other SROs		19.341	22.361
	Total :		***41.397***	***61.282***

Following is the consolidated summary of tax expenditures showing percentage increase/ decrease for the fiscal year 2008-09 compared to FY 2007-08 [Table-4]

Table 4: Summary of Tax Expenditures (Rs. in billion)			
Type of Tax	**Cost of Exemptions**		**% Change**
	2007-08	**2008-09**	
1. Income Tax	27.66	40.864	47.74
2. Sales Tax	17.60	17.5	-0.57
3. Customs Duties	41.397	61.282	48.03
Total	***86.657***	***119.646***	***38.1***