

The Treatment of Tax Credits in the National Accounts

Summary

The recording of tax credits in the system of national accounts is an issue of increasing importance. There is no guidance in the existing international manuals, neither the SNA 1993 or the European equivalent, ESA95. It is common for most tax systems to include elements of social redistribution, through the tax schedule (increasing tax rate), the choice of tax unit (individual or family taxation) and tax relief. Tax relief aimed at redistribution may be designed to reduce the amount of tax that households pay according to certain characteristics, such as the number of children. Moreover, tax relief may also be designed to encourage certain activities, such as participation in the labour force or investment in research and development. Increasingly, the term tax credits is being used to describe payments to citizens administered by the tax authorities which might otherwise be called social benefits if administered by a social security department. The name and the entity administering the money flows do not determine the nature of the payments and so how they should be recorded in the national accounts. We should look at the purpose and effect of the payments to determine how to score them in the accounts. Tax credits, granted by the government to households and to corporations, raise borderline issues between scoring them as negative tax and recording them as either social benefits or subsidies when applied to corporations.

Issue

The term *tax credits* is being used to describe payments to citizens administered by the tax authorities which might otherwise be called social benefits if administered by a social security department. The name and the entity administering it do not determine the nature of payments and so the treatment in national accounts. The treatment is more appropriately determined by the purpose and effect of the payments, according to principles laid out in the international manuals. The same principles apply to subsidies administered through the tax system.

Background

1. The conceptual framework for recording tax (SNA93, chapters 3, 7 and 8 especially) is broadly relevant. However, the current guidelines are not sufficient to ensure valid international comparisons of commonly quoted measures such as *taxes*, and so the *tax burden*. The SNA update is an opportunity to improve the guidance.
2. An issue of increasing importance is the introduction of more tax credits, granted by the government to households and to corporations. This raises borderline issues with the distinction

between tax relief (negative tax), and social benefits and subsidies. In the national accounts manuals, no guidelines currently exist for the recording of tax credits.

3. This issue is of policy interest to the UK HM Treasury. There have been high-level discussions on how tax credits should be scored in the UK accounts, and the current methodology is known as the split treatment - payments actually made are shown as benefits, payments netted off the tax bill are shown as negative tax. The gross treatment, which would show payable tax credits as social benefits irrespective of whether they are paid directly or reduce the payments due under the tax system, would increase the current measure of taxes and the associated tax burden measure. This will have implications for how government presents its record on tax.

Tax Relief and Tax Credits

4. The recording of tax credits, not treated in the present SNA93, is a new issue of increasing importance. It is common for most tax systems to include elements of social redistribution, through the tax schedule (increasing tax rate), the choice of tax unit (individual or family taxation) and tax relief. Tax relief aimed at redistribution may be designed to reduce the amount of tax that households pay according to certain characteristics, such as the number of children. Moreover, tax relief may also be designed to encourage certain activities, such as participation in the labour force or investment in research and development.

5. Tax relief can generally take the form of a tax allowance, exemption or deduction - which is subtracted from the tax base - or of a tax credit - which is subtracted directly from the tax liability (otherwise due). Tax credits can sometimes be payable, in the sense that any amount of the credit that exceeds the tax liability (otherwise due) will be paid to the taxpayer (or non-taxpayer). In contrast, some tax credits are non-payable, and so are limited to the size of the tax liability (otherwise due).

6. Increasingly, the term tax credits is being used to describe payments to citizens administered by the tax authorities which might otherwise be called social benefits if administered by a social security department. The name and the entity administering it do not determine how to classify the transaction in the national accounts, the purpose and effect do that.

The Problem: Payable tax relief and tax credit

7. Generally, a tax relief that is embedded in the tax system is recorded as reducing tax revenues. This is the case of tax allowances, exemptions and deductions, as they enter directly into the calculation of the tax liability. This is also the case for non-payable tax credits, as their value to the taxpayer is limited to the size of their tax liability (otherwise due). However, there is the special case of *payable tax credits*. These are paid by the government to the recipient when the total amount of the credit exceeds the amount of any tax liability the target may have. Current opinion on the issue of how to record these transactions in the national accounts is divided: in the UK Inland Revenue and HM Treasury favour scoring the amount actually paid by the government to be recorded as government expenditure (i.e. social benefits paid), while the rest is scored as reducing the tax liability (i.e. negative tax). This is what is known as the **split treatment** of recording tax credits, and is the current agreed treatment for national accounts.

8. The Office for National Statistics favours changing this to what is known as the **gross treatment**. This would score all of the payable tax credits, whether paid directly or netted off the tax liability, as social benefits. The tax liability would not be reduced because of this payment of benefits, and both would be scored on a gross basis. Some countries, the United Kingdom included, increasingly combine their social benefits and tax systems so that people have a single point of contact with the government. All these may, then, be bundled together and there would be a single net payment each month. This net payment can go in both directions. The result is that the distinction between tax and benefits gets increasingly blurred. Hence, recording these benefits as tax reducing distorts the assessment of relevant aggregates and limits their usefulness in international comparisons.

9 In the production account of the national accounts, when payable tax credits are not recorded as subsidies according to the gross method, but instead netted off the tax liability, as in the split method, the measure of GDP would be affected. The split method would result in a lower level of GDP in nominal terms. So if a subsidy to industry is administered through the tax system as a payable tax credit, then the level of GDP would be reduced by those subsidies which are netted off the tax liability. This seems a wholly unacceptable result of using the split treatment for recording payable tax credits. With this in mind, what we should be looking at, therefore, is the reality of the arrangement and not take account of the language being used or indeed the institution that is responsible for administering tax reliefs or credits. Some things called 'tax credits' may be equivalent to social assistance benefits or subsidies administered by the tax authority. They should, therefore, be accounted for in the same manner irrespective of what they are called or how they are administered.

9. The supporters of the split treatment argue that it follows from the definition of tax revenue i.e. compulsory, unrequited payments made by institutional units to government units exercising their sovereign powers (see Annex for SNA definition). A payable tax credit, therefore, reduces the tax liability otherwise due to the government from some individuals or corporations. Because this reduces the amount of compulsory, unrequited payments made by institutional units to government units, it should, therefore, be recorded as reducing tax revenue. They do not accept that the fact that tax credits can lead to payments to taxpayers reveals the intent behind the measures, or even that the classification should depend on the intent, mainly because, they argue, of the difficulty of actually establishing what the intent was as such schemes can have many different intentions. For example, in their view, one of the intentions behind the UK Working and Child tax credits is to make a step towards integrating the UK tax and benefits systems.

10. A simple example is when the government wishes to pay all mothers £500 per annum. It can do this either through a social benefit payment of £500 direct to all mothers through the benefit system. Or it can achieve the same effect by awarding a payable tax credit to all mothers. This is administered through the tax system. Where a mother is working, the payment is netted off the tax due, and any excess is paid direct to the mother.

11. Consider three mothers - one who doesn't work, one who works and has an annual tax bill of £250, and one who pays £750 tax. Then the first mother will receive £500 direct, the second will have her tax bill of £250 wiped out and a direct payment of £250, and the third will have her tax bill reduced to £250. Under the split treatment, the social benefits paid will be £750, and the tax revenue

of the government will be reduced by £750. Under the gross treatment, social benefits will be shown as £1500 and the tax revenue of the government will be unchanged. Notice that the gross treatment of payable tax credits gives exactly the same measures in the national accounts as if it had been administered as a normal social benefit. In the split treatment, less is recorded as a social benefit and the tax revenue is reduced.

12. It can be observed that the **split treatment** results in a path for social benefits which is difficult to explain when tax rates and allowances change or people get increased salaries. For example if there were an increase in tax allowances, so that the second mother was no longer liable to pay tax, and the third mother only paid £250, then the tax credits payable to mothers direct, and scored as social benefits, would increase to £1250. The tax revenue would decrease by this amount. So change to social benefits payable to mothers would appear in the accounts, driven by a change to the tax system, and with no effect on the net income of each mother. With the gross treatment there would be no change to social benefits which is intuitively more appealing and better reflects the policy change.

13. Any attempt to subdivide payable tax credits into a negative tax part and a social benefit part exemplified by the **split treatment** needs the specification of precise rules. The rules will have to specify which tax credits were embedded in the tax system and which were not. This is in addition to saying that the tax credits which result in payments from the government are to be treated as social benefits for the former category. No rules written have yet been wholly satisfactory. Therefore the clearest and least ambiguous rule is one which specifies the gross treatment. It also appears that accountants under the Generally Accepted Accounting Principles (GAAP) are too edging towards the gross accounting treatment rather than the split treatment.

ANNEX

SNA93 Definitions

Taxes in the SNA93

The SNA93 defines taxes as compulsory, unrequited payments, in cash or in kind, made by institutional units to governments. They are described as unrequited because the government provides nothing in return to the individual unit making payments, although governments may use the funds raised in taxes to provide goods or services to other units, either individually or collectively, or to the community as a whole (SNA93 paras. 7.48, 8.43).

Social Benefits

Social assistance benefits are current transfers payable to households by government units or NPISHs to meet the same needs as social insurance benefits but which are not made under a social insurance scheme incorporating social contributions and social insurance benefits. They exclude all benefits paid by social security funds. They may be payable in cash and in kind (SNA93 para 8.81). The SNA identifies two types: **social insurance benefits** and **social assistance benefits**. The latter consists of transfers made by government units or Non Profit Institutions to households to meet the same kinds of needs as social insurance benefits but outside of any social insurance schemes. The coverage of social insurance benefits may vary from country to country but an illustrative list may include: sickness and invalidity benefits; maternity allowances; Children's' or family allowances; other dependants' allowances; unemployment benefits; retirement and survivors' pensions; death benefits; other allowances or benefits (SNA93 paras. 8.75, 8.78).