

# 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).

## **Payable Tax Credits**

**(Comments by Graham Jenkinson and Bob Kilpatrick)**

Two arguments have been developed for the treatment of payable tax credits. These are shown below:

- The case for the gross treatment from Graham Jenkinson of the UK
- The case for the split treatment from Bob Kilpatrick of the US

### **The gross treatment argument by Graham Jenkinson**

First a few comments and background. When governments want to support people or activities they can do so in a variety of ways five of which are listed below:

- a payment can be made to every eligible entity (or on behalf of the entity) without any financial assessment as to whether they need it.
- a payment can be made to eligible entities on the basis of a financial needs assessment (commonly called a means test)
- entities may be given a tax allowance which reduces their income which is subject to tax. (Tax allowances are always non payable - that is they reduce tax but do not trigger payments to the entity)
- entities may be given a non-payable tax credit which reduces their tax payable
- entities may be given a payable tax credit which is deducted from their tax payable and will result in a payment to the tax payer when the tax credit exceeds the tax payable.

Currently the first two are generally described as social security benefits, while the last three are considered part of the tax system and are administered by the tax authority. In the future this distinction may be lost. The UK and several other countries may combine their social security and tax systems so that people have a single point of contact with government. Then all of these may be bundled together and there would be a single net payment each month between the individual and government.

With this in mind we should be looking at the reality of the arrangement and not take account of the language being used. Some things called “tax credits” may be equivalent to social benefits administered by the tax authority. They should be accounted for in the same way irrespective of what they are called or how they are administered.

Your note gives examples based on the consistency argument to justify the split treatment for payable tax credits. In the wider context described above the consistency argument can lead in a different direction. The case for tax credits to be scored as social benefits rests on the economic reality of how they are delivered and to whom. A simple case is “the working mother’s tax credit”. Suppose there are two mothers, one working and one not. If government policy is to help mothers, then this can be realised through a straight payment of social benefit, subject to proof that the recipient is a mother. The government may choose to administer these payments through the tax system and calls them tax credits. This tax credit is netted off the tax bill of the working

mother if she pays enough tax, and is paid direct to the non-working mother (and the working mother if she has an insufficient tax bill).

So the effect of the tax credit is identical to the social benefit in terms of the net income of the mothers.

The other consistency which we should be aiming for is consistency with GAAP accounting and it appears that the accountants are heading towards a gross accounting treatment.

As you remarked Chris Heady said that it is impossible at a theoretical level to distinguish between taxes and social benefits except for the sign. The issue then becomes whether the national accountants want guidance which attempts to do this or whether all of the categories above should be grouped together and treated the same way. This latter idea is pretty radical and is not on the table even though it has some intellectual attraction.

So if we don't treat them the same way how do we draw a clear distinction. There has been little dispute in TFHPSA that items 1 and 2 should be seen as social benefits and items 3 and 4 as negative tax. The issue then focuses on item 5 - payable tax credits. I would argue that the in reality payable tax credits may have an almost identical result to means tested social benefits - item 2. The only difference is their name and who administers them. So they should be accounted for the same way reflecting this economic reality. Logically this would have to be treatment as a social benefit.

I should qualify the views expressed above as being those of a national accounts expert and not an agreed UK view but hope this helps to present the other side of the argument.

### **The split treatment argument by Bob Kilpatrick**

We would like to reiterate our support for the split method for recording payable tax credits, which we supported in the questionnaire and at the meeting. We do not agree with recording the gross tax credit as an expense (or as a reduction in revenue). To ensure that the tax credits are embedded in the tax system, we also support a set of indicators (Recommendation 10, although we asked one question about it above) and the classification of three major social benefit programs as expenses (Recommendation 12).

The fundamental reason to support the split method is that it follows from the definition of tax revenue in Recommendation 1: “. . . compulsory, unrequited payments . . . made by institutional units to government units exercising their sovereign powers.” A payable tax credit 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 be recorded as reducing tax revenue. The reduction in compulsory, unrequited payments to the government is recorded as reducing tax revenue under the split method, but it is recorded instead as an expense under the gross method.

The flaw in the above reasoning is demonstrated by considering the case where an unambiguous social benefit is administered through the tax system, only making an actual payment to the recipient when the tax liability is insufficient to cover the social benefit amount due. The social benefit might be to compensate for a handicap, and the purpose solely to compensate for degraded life style and to meet associated extra expenses resulting from the handicap. The purpose is expressly not to encourage a return to work. So if a recipient was not a tax payer, the

benefit would be paid direct. If the recipient was paying tax, the benefit would be netted off the tax liability and either a net amount would be paid direct to the recipient, or if the tax liability was larger than the benefit, a smaller amount paid to the tax authority by the amount of the benefit.

Such a scheme may be efficient and would certainly reduce the amount of “compulsory unrequited payments made by institutional units to government units.” According to Mr Kilpatrick’s reasoning, it should therefore be recorded as negative tax revenue, reducing the tax bill where the liability is sufficient to cover the cost of the benefit. So the split treatment logically leads us to only measure the net effect on the tax system, and benefits would not be shown separately. This would misrepresent the gross flows reflecting different policy effects, and significantly reduce the ability of policy analysts and economic analysts to understand economic and social developments.

Chris Heady said that it is impossible at a theoretical level to distinguish between taxes and social benefits except for the sign, and therefore a person cannot say that one is the right way and the other is not. We agree with his theoretical analysis. The basic implication, we believe, is that at a theoretical level there is no one right way to define tax revenue. The task force is nevertheless recommending a definition of tax revenue for practical reasons, because a common definition is essential for compiling statistics in a comparable and consistent manner even though it has theoretical weaknesses. Given a definition of tax revenue, payable tax credits ought to be recorded in a way that is consistent with the definition. Therefore, given the definition of tax revenue in Recommendation 1, we conclude that the split method is the right way to record payable tax credits.

Furthermore, because the split method of recording payable tax credits is consistent with the definition of tax revenue, it is consistent with the method of recording non-payable tax credits and other tax expenditures.

- The split method of recording payable tax credits is consistent with the method of recording non-payable tax credits. For individuals or corporations who pay tax, both payable and non-payable tax credits reduce the compulsory, unrequited payments they make to government. Under the split method, the reduction in compulsory, unrequited payments to government is recorded as a reduction in tax revenue for both types of tax credit. In contrast, under the gross method, the reduction in compulsory, unrequited payments to government is recorded as a reduction in tax revenue only for non-payable tax credits; for payable tax credits, it is recorded as an expense. Only the split method would record the same effect in the same way.

This difference in treatment would be especially striking if a non-payable tax credit was made payable. The change in law would not affect someone whose tax liability otherwise due was greater than the credit both before and after the change in law. The change in law therefore should not affect the amount of tax revenue recorded for that taxpayer. Under the split method, the same reduction in tax revenue for that taxpayer would be recorded both before and after the change in law. Under the gross method, however, a reduction in tax revenue would be recorded before the change in law whereas



an expense would be recorded after the change in law. Only the split method would record the same effect in the same way.

An example is the child tax credit in the U.S. It was a payable tax credit only for households with three or more children when it went into effect in 1998; it was a nonpayable tax credit for households with one or two children (over 95 percent of the effect was on tax revenue under the split method). The child tax credit was made payable for all households in 2001. Under the gross method, the credit for taxpayers with one or two children would presumably be considered a non-payable tax credit during 1998-2000 and thus recorded as a reduction to tax revenue, but it would change to an expense in 2001. Under the split method, the credit would be recorded as a reduction to tax revenue in all years (for households who paid tax).

These two paragraphs emphasise the author's view from the world of tax revenue. When the child tax credit was made payable for all households in 2001, this represented a change in policy. Previously, the non-payable tax credit was an incentive to work for households with one or two children – if there was no work and associated tax liability, then there was no incentive payment. In 2001, changing the credit to a payable one changed the nature of the incentive. Now there was no incentive to work, but there was recognition that any household with children deserved a social benefit paid irrespective of work status. Mr Kilpatrick sees the advantage of the split treatment as preserving a consistent story over time in terms of net tax revenue. And so he finds the proposed gross treatment not reflecting a change that he sees as the important feature of the flows in the economy. But what comes over as a defence of the legitimate view of the tax revenue specialist, becomes an accusation from the national accounts perspective of the economy as a whole, revealing flows in the economy which can be used to monitor economic and social policy.

This feature becomes particularly important to the national accountant when tax credits paid to corporations are considered. Payable tax credits will be seen as subsidies, not social benefits. Recording them as negative tax will result in a different measure of GDP from that obtained from recording the flows on a gross basis.

- The split method of recording payable tax credits is consistent with the method of recording other tax expenditures and other tax provisions. For example, the U.S. has both (a) a payable child tax credit and (b) a personal exemption for each dependent. Both reduce the compulsory, unrequited payments made by households with children who pay taxes to the government. Therefore, according to the definition of tax revenue in Recommendation 1, tax revenue should be reduced by both (a) the part of the child tax credit that reduces the tax liability otherwise due and (b) the personal exemption. Tax revenue is reduced by both provisions under the split method, but under the gross method the provisions are recorded differently. Tax revenue would be decreased by the personal exemption, whereas expense would be increased by the child tax credit.