



**Australian Government**

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**The Treasury**

Standing Committee on Tax and Revenue

**Inquiry into the Tax Expenditures Statement  
Submission**

August 2015

## Introduction

Treasury welcomes the opportunity to lodge a submission to the Inquiry. To assist the Committee's consideration of the Tax Expenditures Statement (TES), this submission outlines the broad framework underpinning the annual TES, as well as a number of caveats relating to the document.

In addition, Attachment A to this submission outlines Treasury's current view of the recommendations of the following reports:

- the 2008 Australian National Audit Office (ANAO) Audit Report No.32 2007-08 Performance Audit "Preparation of the Tax Expenditures Statement"; and
- the 2009 Joint Committee of Public Accounts and Audit (JCPAA) inquiry Report 414 "Review of Auditor-General's Reports tabled between August 2007 and August 2008", as it relates to the 2008 ANAO report.

With the benefit of further consideration, Treasury now considers that the recommendations contained in these reports are no longer relevant or appropriate.

Currently, Treasury's primary concern is that TES estimates are often misunderstood in public debate, with little acknowledgement made of their limitations and associated caveats (which are set out in this submission and in the TES itself).

Treasury has implemented the sole recommendation of the 2013 ANAO Audit Report No.34 (see 2013 Tax Expenditures Statement at p10).

The Australia's Future Tax System (AFTS) review in December 2009 contained three recommendations relating to tax expenditures (see Attachment B). The former Government's response to the AFTS review – *Stronger, Fairer, Simpler: A Tax Plan for Our Future* – released on 2 May 2010, did not adopt these recommendations.

## Identifying tax expenditures

A tax expenditure arises where the actual tax treatment of an activity or class of taxpayer differs from the benchmark tax treatment.

- Tax expenditures typically involve tax exemptions, deductions or offsets, concessional tax rates and deferrals of tax liability.
- A positive tax expenditure reduces tax payable relative to the benchmark. A negative tax expenditure increases tax payable relative to the benchmark.

Benchmarks represent a notional "standard" taxation treatment that applies to similar taxpayers or types of activity. Benchmarks may also incorporate structural elements of the tax system; for example, the progressive income tax rate scale for individual taxpayers. Tax expenditures are defined and measured as deviations from this benchmark.

Determining benchmarks involves judgment. Consequently, the choice of benchmark may be contentious and benchmarks may vary over time.

Importantly, the choice of benchmark should not be interpreted as indicating a view on how an activity or taxpayer ought to be taxed, which is fundamentally a policy matter.

## The Tax Expenditures Statement

The TES provides a description of Australian Government tax expenditures and, where possible, the estimated value or order of magnitude of the tax expenditure. The TES is intended to facilitate scrutiny of tax expenditures by Parliament, the media and the general public. Transparent reporting of tax expenditures also helps inform debate on the efficiency and equity of the tax system.

The latest TES (2014 TES) was published in January 2015 and reflects Australian Government policy up to and including the 2014-15 *Mid-Year Economic and Fiscal Outlook* (MYEFO).

### Estimating tax expenditures – revenue forgone approach

Consistent with most OECD countries, estimates of the size of tax expenditures in the TES reflect the existing utilisation of a tax expenditure, similar to Budget estimates of outlays on demand-driven expenditure programmes. This is known as the ‘revenue forgone’ approach.

- For example, Budget Paper No.1, Budget Statement 5 – Expenses and Net Capital Investment, reports expenditure on the age pension. Broadly, the amount reported reflects the number of age pension recipients and the amount of pension each receives. Budget Paper No.1 does not provide any estimate of the hypothetical saving to the Budget should the expenditure cease.
- Similarly, the estimated size of a tax expenditure reflects the number of taxpayers utilising the tax expenditure and the notional amount of tax expenditure each receives. Revenue forgone estimates do not indicate the hypothetical saving to the Budget should the tax expenditure cease.

In practice, the revenue forgone approach involves estimating the difference in revenue between the existing and benchmark tax treatments, but importantly assuming taxpayer behaviour is the same in each circumstance.

This approach can be illustrated using the GST exemption for water, sewerage and drainage services (H6 in the 2014 TES).

- By definition, no GST revenue is raised under the existing tax treatment. The benchmark treatment is the imposition of GST on water, sewerage and drainage services. The estimated value of the tax expenditure is therefore the amount of GST revenue that would be raised on water, sewerage and drainage services assuming that consumption of these services remained unchanged under a GST.

### Estimating tax expenditures – revenue gain approach

An alternative approach – known as the ‘revenue gain’ approach – involves estimating the impact of abolishing a tax expenditure taking account of the potential changes in taxpayer behaviour, unlike revenue forgone estimates. Because of this, revenue gain estimates are often lower than revenue forgone estimates. Revenue gain estimates for individual tax expenditure items are more akin (but not identical) to estimates of the revenue impact of budget measures.

- Introducing a tax expenditure may create incentives for taxpayers to change their behaviour to utilise (or avoid) the new tax provision. Removing the tax expenditure (so that the benchmark tax treatment prevailed) would remove this incentive and may cause a corresponding change in taxpayer behaviour.

In particular, taxpayers may make greater use of other tax expenditures if a particular tax expenditure were to be (hypothetically) abolished.

- For example, a revenue gain estimate for the concessional treatment of employer superannuation contributions would take account of the potential for voluntary employer contributions to be redirected to other tax-preferred investments.

Revenue gain estimates are particularly problematic.

- They assume that a tax expenditure is abolished, which may be implausible in many cases.
- In practice, the revenue gain can be difficult to estimate as there is usually little, if any, information on how taxpayers might react to the removal of a tax expenditure. Assumptions about taxpayer behavioural responses therefore need to be made, and these assumptions can be difficult to meaningfully substantiate.
- Judgments also need to be made about likely policy settings – for example, whether it is realistic to assess the abolition of a single tax expenditure (for example, a particular GST exemption) while keeping other tax expenditures unchanged (for example, other GST exemptions).

Consistent with a recommendation of the Australian National Audit Office (ANAO) in its 2007-08 performance audit of the TES, the TES reports revenue gain estimates for 10 large tax expenditures.<sup>1</sup> Experience suggests that these are particularly problematic as the necessary behavioural assumptions in practice cannot be meaningfully substantiated.

### **Interpreting tax expenditure estimates**

Tax expenditure estimates in different editions of the TES are generally not comparable. Estimates may change between editions as benchmarks are modified, tax expenditures are revised or new data become available, or changes in modelling methodology are made.

Care should be exercised when comparing tax expenditure estimates with direct expenditure estimates.

- Tax and direct expenditure estimates may measure different things. For example, the tax expenditure estimate for the Private Health Insurance Rebate (A17) relates to the tax exemption for the rebate, not the rebate itself.
- Direct expenditure estimates of non-taxable transfer payments effectively include the value of the tax exemption for the payments. Summing the direct and tax expenditure estimates would therefore overstate the cost of the government support to the budget.

Tax expenditure estimates are generally not additive, particularly because the removal of one tax provision will often affect the utilisation of others.

Consistent with Australian Government budget procedures, tax expenditure estimates are in nominal dollars. For example, 2014-15 estimates are in 2014-15 dollars and 2015-16 estimates are in 2015-16 dollars. Tax expenditure estimates are prepared on an accruals basis.

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<sup>1</sup> ANAO Audit Report No. 32, 2007-08, Preparation of the Tax Expenditures Statement, Recommendation 5.

## Quantifying tax expenditures

In the 2014 TES, estimates are available for 2014-15 for around 51 per cent of tax expenditures – that is, 152 out of 297 expenditures. These items are quantifiable because sufficient data exist to produce estimates of at least very low reliability. Where data do not exist, the estimate will be shown as being unquantifiable or ‘not available’. Unquantified tax expenditures have been assigned an order of magnitude classification rather than an estimate of their value. Category classifications are provided as a broad guide only.

Where it has been possible to produce tax expenditure estimates, these estimates vary in reliability depending on:

- the quality, detail and frequency of the underlying data;
- the extent to which calculations are based on assumptions; and
- the sensitivity of the results to those assumptions and whether future taxpayer behaviour is reasonably predictable. Unexpected changes in economic conditions or volatility in markets may also influence the future value of tax expenditures, thus affecting the reliability of tax expenditures projections.

The TES reports the reliability of each tax expenditure estimate. Consistent with a recommendation of the ANAO in its May 2013 performance audit,<sup>2</sup> a standardised system is used to score the reliability of tax expenditures estimates. Broadly, the reliability of each estimate is assessed against the three factors listed above.

## Conclusion

Treasury would be pleased to further assist the Committee over the course of its inquiry into the Tax Expenditures Statement.

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<sup>2</sup> ANAO Audit Report No. 34, 2012-13, Preparation of the Tax Expenditures Statement, Recommendation 1.

ATTACHMENT A

ASSESSMENT OF RECOMMENDATIONS OF THE 2008 ANAO AUDIT AND 2009 JCPAA REPORT

2008 ANAO AUDIT

Recommendation	2013 ANAO report comment	Treasury view
<p><b>Rec. 1</b></p> <p>That Treasury:</p> <p>(a) develop an approach for the conduct of an ongoing prioritised review of the existing program of tax expenditures; and</p> <p>(b) publish, for each tax expenditure, information on the timing and outcome of the review.</p>	<p>Between 2007 and 2011, Treasury conducted 123 tax expenditure reviews. The timing and outcome of the reviews were not made public. The ANAO noted that the reviews were ceased 'due to the utility of the reviews relative to other priorities'. The ANAO stated that 'there is still a strong case for conducting a priority-based program of reviews'.</p>	<p>Treasury considers that there would be little value in undertaking stand-alone reviews of tax expenditures in addition to the consideration of tax expenditures undertaken in the annual Budget process.</p> <p>Past reviews provided little value, as they tended to not be aligned with the policy agenda of the government of the day.</p>
<p><b>Rec. 2</b></p> <p>That Treasury examine and advise Ministers on options to better integrate the consideration of outlays and tax expenditures in the annual Budget process.</p>	<p>While the ANAO recognised that the rule that only ERC can recommend new spending or revenue proposals to Cabinet was relevant to this recommendation, it found that 21 of 45 tax expenditures in the 2011 TES associated with new policy proposals were not considered by ERC. It further found that 'there is the potential to increase the quantification of tax expenditures resulting from new policy proposals' in the Budget papers. It found that only 23 of 45 tax expenditures in the 2011 TES resulting from new policy proposals had been explicitly quantified in the Budget.</p>	<p>Tax expenditures are actively considered in the annual Budget process. The specific tax expenditures considered depend on the Government's policy agenda.</p> <p>The Budget process is conducted in accordance with the Budget Process Operational Rules, which are agreed by the Government and which ensure appropriate consideration of expenditure and revenue proposals, including proposals involving tax expenditures.</p>

Recommendation	2013 ANAO report comment	Treasury view
<p><b>Rec. 3</b></p> <p>That Treasury develop standards to govern the integrated reporting of outlays and tax expenditures under the Charter of Budget Honesty, drawing on international developments in this area.</p>	<p>The ANAO found that ‘unlike other areas of financial reporting, there are no external reporting standards to guide the reporting of tax expenditures’, and that the development of such standards would provide a ‘stronger conceptual underpinning to the TES, enhance transparency and reliability of statements and promote comparability between years’.</p> <p>The ANAO also noted that the AFTS review (and Murray review) had made a similar recommendation (see Rec. 137 below).</p>	<p>It is not Treasury’s role to develop reporting standards of this nature.</p> <p>Further, developing reporting standards is unlikely to resolve the key issues concerning tax expenditures. In particular, the choice of benchmark is critical to the existence and size of tax expenditures. The choice of benchmark inherently involves judgement. For example, plausible arguments may be made in support of using an income tax benchmark and an expenditure tax benchmark for savings tax expenditures (see 2013 TES at pp4-5 and Appendix A). Reporting standards would not resolve debates of this nature.</p>
<p><b>Rec. 4</b></p> <p>That Treasury promote more comprehensive reporting on taxation expenditures by:</p> <p>(a) liaising with Commonwealth entities that collect revenue to identify all entities that also administer forms of relief from Commonwealth taxes, including tax expenditures; and</p> <p>(b) developing arrangements, as part of the preparation of the annual TES, to obtain relevant data from entities outside the Treasury portfolio.</p>	<p>The ANAO noted that only four tax expenditures had been identified using this process (since 2008), and that there would be ‘potential benefits’ in ‘the Treasury adopting a more active approach towards identifying new tax expenditures in other portfolios’.</p>	<p>While Treasury implemented this recommendation, the benefits were marginal.</p> <p>As Treasury has responsibility for all major taxes, it is highly likely that most significant tax expenditures are within the Treasury portfolio. Further, it is reasonable to expect that, consistent with prior experience, allocating further resources to identifying tax expenditures in other portfolios would not yield significant gains.</p>

<b>Recommendation</b>	<b>2013 ANAO report comment</b>	<b>Treasury view</b>
<p><b>Rec. 5</b></p> <p>That Treasury and the ATO identify opportunities to develop estimates of large or otherwise significant tax expenditures using the revenue gain method.</p>	<p>The ANAO stated that 20 revenue gain estimates could be included in the TES or Treasury should explain why this hadn't happened.</p>	<p>The TES continues to report ten significant tax expenditures using the revenue gain method. Treasury considers that this is sufficient, and that the revenue forgone approach is the most appropriate methodology for estimating tax expenditures. In particular, this approach is the most appropriate means of ensuring a level of comparability with estimates for demand-driven outlays in the Budget. Chapter 1 of the 2014 TES outlines the limitations of revenue gain estimates.</p>
<p><b>Rec. 6</b></p> <p>That Treasury:</p> <p>(a) develop an approach to prioritise improvements to the reliability of published tax expenditure estimates;</p> <p>(b) examine options for disclosing in the TES information on the reliability of individual tax expenditure estimates;</p> <p>(c) work with the Australian Taxation Office to develop reliable models to estimate the revenue forgone for existing tax expenditures that are large or otherwise significant; and</p> <p>(d) when developing advice for Ministers on policies that are</p>	<p>While acknowledging that information about the reliability of estimates has been included in the TES, the ANAO found that successive TESs 'have demonstrated that arrangements introduced to improve the reliability of published tax expenditure estimates have not resulted in any significant improvements to the reported reliability ratings over time. More importantly, the Treasury has not developed a formal approach to improve the overall reliability of tax expenditure estimates, as recommended by the 2008 audit'.</p>	<p>This recommendation fails to recognise that the reliability of tax expenditure estimates is critically linked to the availability of data.</p> <p>Tax expenditures can be highly specific. Consequently, highly specific data may be required to produce an accurate estimate of the value of a tax expenditure. A key source of information is tax returns. While in some cases it might be possible to gather relevant data by including additional questions in tax returns, this generates additional compliance costs for taxpayers.</p>



<b>Recommendation</b>	<b>2013 ANAO report comment</b>	<b>Treasury view</b>
expected to result in a tax expenditure, assess options for the reliable measurement of the effect of the proposed measure.		

## 2009 JCPAA REPORT

<b>Recommendation</b>	<b>2013 ANAO report comment</b>	<b>Treasury view</b>
<p><b>Rec. 1</b></p> <p>That Treasury publish a paper for inclusion in the Tax Expenditures Statement calculating the twenty largest tax expenditures using both the revenue foregone and revenue gained methods to allow comparison with the Budget Papers.</p>	<p>The ANAO stated that 20 revenue gain estimates could be included in the TES or Treasury should explain why this hadn't happened.</p>	<p>Treasury considers that reporting ten significant tax expenditures using the revenue gain method is sufficient (see ANAO Rec. 5 above).</p>
<p><b>Rec. 2</b></p> <p>That Treasury further investigate the merits of the Canadian model of taxation expenditure reporting, publishing its findings in the paper proposed in Recommendation 1.</p>	<p>The ANAO noted that Treasury had advised the JCPAA in December 2009 that the Department had investigated the Canadian model but did not intend to move further in that direction.</p>	<p>Treasury continues to monitor international developments in the reporting of tax expenditures. However, Treasury is concerned that introducing new information into the TES – for example, 'memorandum items' as reported in Canada – would exacerbate existing levels of misunderstanding of the TES.</p>
<p><b>Rec. 3</b></p> <p>That Treasury include information in the Budget Papers on the extent to which tax expenditure reporting has improved through the receipt of reliable data from other agencies.</p>	<p>See ANAO Rec. 6 above.</p>	<p>See ANAO Rec. 6 above.</p>

ATTACHMENT B

AUSTRALIA'S FUTURE TAX SYSTEM REPORT 2009 – RECOMMENDATIONS RELATING TO TAX  
EXPENDITURES

Recommendation	Current situation
<p><b>Rec. 136</b></p> <p>The government should introduce legislation to amend the <i>Charter of Budget Honesty Act 1998</i> to recognise the publication of detailed information about tax expenditures in a TES separate from the Mid-Year Economic and Fiscal Outlook. However, the TES should continue to be released by the end of January in each year, or within six months of the last Budget, whichever is later.</p>	<p>The former Government's response to the AFTS review, the <i>Stronger, Fairer, Simpler</i> package, released on 2 May 2010, did not adopt recommendations 136-138.</p>
<p><b>Rec. 137</b></p> <p>The government should ensure that reporting standards are independently developed for the identification and measurement of tax expenditures in the TES. In addition, the standards should establish a basis for reporting the broader economic and distributional effects of tax expenditures in the periodic Tax and Transfer Analysis Statement.</p>	
<p><b>Rec. 138</b></p> <p>The Council of Australian Governments should examine the ways in which the States could uniformly report tax expenditures annually according to the independent standards developed under Rec 137.</p>	