

Audit Report No. 32 2007-2008

Preparation of the Tax Expenditures Statement

Background

4.1 Alongside social welfare programs, tax expenditures are two of the oldest forms of financial assistance provided by the Commonwealth government. Notwithstanding this, there is no clear definition of a tax expenditure. Instead, measures constituting a tax measure can change over time and between jurisdictions. The *Taxation Expenditures Statement 2006* defines a tax expenditure as:

A tax concession that provides a benefit to a specified activity or class of taxpayer... A tax expenditure can be provided in many forms, including a tax exemption, tax deduction, tax offset, concessional tax rate or deferral of tax liability.¹

4.2 To apply this concept, The Department of the Treasury (Treasury) selects a 'normal', non-discriminatory or benchmark tax system. The benchmark taxation system should not favour or disadvantage

¹ Commonwealth of Australia, *Tax Expenditures Statement 2006*, February 2007, pp 1-2.

similarly placed activities or classes of taxpayer,² and is the tax system that would exist if the tax expenditure to be investigated did not exist.

- 4.3 Once the benchmark is selected, Treasury compares tax expenditures to the benchmark. Tax concessions that are consistent with the benchmark are not considered tax expenditures and are not reported, while those that do not match the benchmark are treated as tax expenditures and are reported.

Reporting on tax expenditures

- 4.4 Between 1968-69 and 1982-83, some information on tax expenditures was printed in the Budget papers. From 1987, Treasury (using estimates and advice from the Australian Taxation Office (ATO)) commenced publication of a separate *Taxation Expenditures Statement* (TES). This practice has continued annually since, with the exception of 1999-2000. The aim of the TES is to:
- allow tax expenditures to receive a similar degree of scrutiny to direct expenditures;
 - allow for a more comprehensive assessment of government activity; and
 - contribute to the design of the tax system, by promoting and informing public debate on all elements of the tax system.³
- 4.5 The reporting of tax expenditures also allows private investors to make decisions with better information on taxation and government assistance in the Australian economy. This assists in the efficient action of global markets.
- 4.6 The *Charter of Budget Honesty Act 1998* introduced two requirements for annual reporting on tax expenditures:
- an annual budget economic and fiscal outlook containing estimated tax expenditures for the budget year and the three years to follow; and
 - a Mid-Year Economic and Fiscal Outlook (MYEFO) report containing a detailed statement of tax expenditures to provide information to allow mid-year comparison with the budget papers.
- 4.7 The *Tax Expenditures Statement 2006* was tabled in December 2006. It contained details of 272 Commonwealth Government tax expenditures, with an aggregate value of over \$41 billion. This

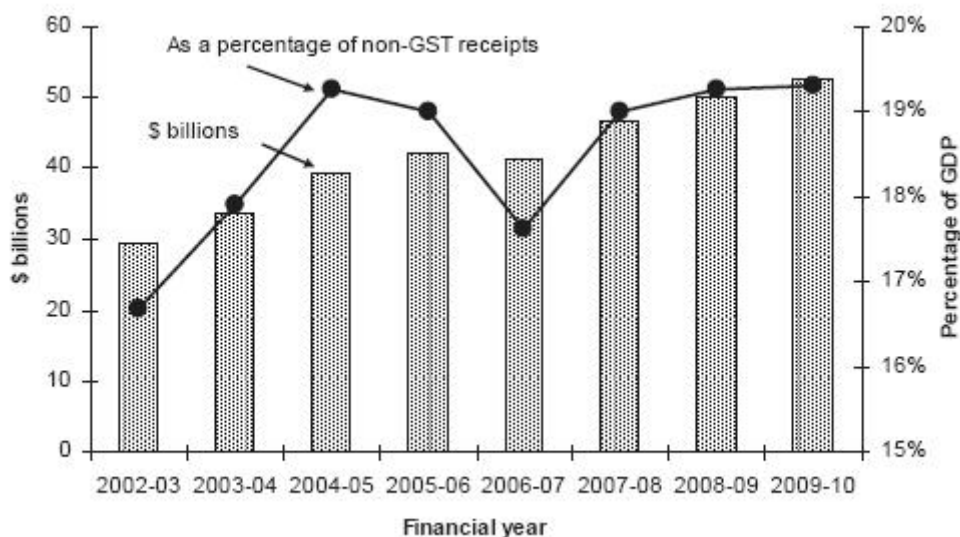
2 The Treasury, *Tax Expenditures Statement 2007*, p. 1.

3 Commonwealth of Australia, *Tax Expenditures Statement 2006*, February 2007, p. 1.

constituted 17.6 per cent of the year's estimated value of all government receipts, excluding the Goods and Services Tax.

- 4.8 The value of tax expenditures is expected to increase in later years. Figure 1 illustrates the actual and anticipated growth of tax expenditures from 2002-03 to 2009-10.

Figure 1 Estimated Tax Expenditures: 2002-03 to 2009-10



Source

- 4.9

been found each year, with an average of 8 expenditures being withdrawn. It appears that tax expenditures are withdrawn as a result of sunseting and policy changes. The growth in tax expenditures can be attributed to missed tax expenditures being identified as well as new expenditures being introduced.

The Audit

Audit objectives

- 4.10 The audit objective was to assess the completeness and reliability of the estimates reported in the *Taxation Expenditures Statement 2006*. Further, the audit examined suggestions for greater transparency in the reporting of tax expenditures.

Audit conclusion

- 4.11 The audit report made the following conclusion:

The purpose of the Charter of Budget Honesty Act was to establish an integrated fiscal framework to provide for greater discipline, transparency and accountability in fiscal policy. A key element of this integrated framework was that the

MYEFO report was to include detailed estimates of both tax expenditures and outlays, thereby promoting the scrutiny of both forms of expenditure. However, due to methodological challenges, Treasury has not yet found a way to integrate the reporting of outlays and tax expenditures, with the result that the detailed estimates of tax expenditures are reported in a separate TES document. Treasury has advised ANAO that it is not possible to include the full detailed tax expenditure estimates in the MYEFO release without significant changes to the focus of the MYEFO document and without delaying the release of MYEFO itself.

Treasury's view is that the best focus for controlling tax expenditures is at the policy development stage by ensuring that the Budget processes require that the cost of any new tax concession proposal (and any savings offsets) are examined in the same way as occurs for outlays. However, past practices in this area have been inconsistent. This has been compounded by shortcomings in the post-implementation measurement, monitoring and reporting (through the TES) of tax expenditures. In particular:

- the benchmarks used in preparing the TES are selected by Treasury based on judgements with the result that benchmarks may vary over time and can be arbitrary; whilst the Charter of Budget Honesty Act requires the TES to be based on external reporting standards,⁴ neither the Australian accounting standards or the economic reporting standard issued by the Australian Bureau of Statistics have been developed to account explicitly for tax expenditures. In particular, as few tax expenditures arise from direct transactions and other events of the kind commonly recorded in accounting systems, neither AAS31 nor Government Finance Statistics (GFS) is designed to capture all the notional transactions involved in the majority of tax expenditures. The external reporting standards also do not address the selection of tax benchmarks;
- there are unreported categories of tax expenditures. Each TES from TES 1995–96 onwards has identified, on average, ten tax expenditures arising from tax concessions or relief

4 Defined in the CBH Act as:

- the concepts and classifications set out in Australian System of Government Finance Statistics economic reporting standard developed by the Australian Bureau of Statistics; and
- public sector accounting standards developed by the Public Sector Accounting Standards Board.

already in place but previously unreported. In this respect, during the course of the audit, Treasury took or foreshadowed action to improve the coverage of the TES by reporting tax expenditures in relation to Customs Duty and Goods and Services Tax, as well as expanding the reporting of superannuation tax expenditures; and

- TES 2006 included quantified estimates for less than 60 per cent of those tax expenditures that were reported and, of these, two thirds were not based on reliable estimates. Modelling of the effect of tax expenditures and estimation of their cost has been made more difficult by the trend of reducing the compliance burden on taxpayers, which results in less information being collected from which estimates can be made. This situation also impedes analysis of whether individual tax expenditures are achieving their objectives.

Against this background ongoing review of tax expenditures would be beneficial given the lack of regular, risk-based reviews and evaluations of tax expenditures as to whether they are achieving their objectives and, if so, at what cost. Such a review, and ongoing scrutiny of tax expenditures, would benefit from:

- the development of standards to govern the integrated reporting of outlays and tax expenditures under the Charter of Budget Honesty, drawing on international developments in this area. This should contribute to the development of a more comprehensive picture of total Commonwealth expenditure, irrespective of the manner in which it is delivered and provide more rigour over the selection of tax expenditure benchmarks;
- the identification of opportunities to better integrate the consideration of outlays and tax expenditures in the annual Budget process so that the cost of any new tax concession, and any potential offsetting savings, is fully considered; and
- improvements to the reliability of those tax expenditure estimates that are published, recognising that there is a balance to be struck between more reliable estimates and increasing the demands on taxpayers to provide additional information (the compliance burden).

Over the last 35 years there have been a number of Government and Parliamentary reviews of tax expenditures. However, few of the recommendations of these reviews have been adopted. As a result, each successive review reported similar shortcomings and made similar recommendations.

ANAO notes that the Government has recently announced⁵ that, before the 2008-09 MYEFO is released, it will undertake a program-by-program review of government spending and tax concessions with the objective of increasing efficiency, transparency and accountability.

- 4.12 To conclude, the ANAO found significant shortcomings in the completeness and reliability of the estimates reported in the Tax Expenditures Statement 2006. These shortcomings arose from the variation and arbitrary nature of benchmarks, the discovery of existing but previously unreported tax concessions, and insufficient data resulting in unreliable estimates.

5 The Hon. Lindsay Tanner MP, Minister for Finance and Deregulation, *Address to National Press Club Canberra Wednesday 5 February 2008*, p. 4

ANAO recommendations

4.13 The ANAO made the following recommendations:

Table 1.1 ANAO recommendations, Audit Report no. 32, 2007-2008

1.	<p>ANAO recommends that the Department of the Treasury:</p> <ul style="list-style-type: none"> (a) Develop an approach for the conduct of an ongoing prioritised review of the existing program of tax expenditures; and (b) Publish for each tax expenditure information on the timing and outcome of the review. <p><i>Agency response: Treasury agreed to part (a) and agreed with qualification to part (b).</i></p>
2.	<p>ANAO recommends that the Department of Treasury examine and advise Ministers on options to better integrate the consideration of outlays and tax expenditures in the annual Budget process.</p> <p><i>Agency response: Treasury agreed.</i></p>
3.	<p>ANAO recommends that the Department of the 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><i>Agency response: Treasury agreed with qualification.</i></p>
4.	<p>ANAO recommends that the Department of the Treasury promote more comprehensive reporting on taxation expenditures by:</p> <ul style="list-style-type: none"> (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 (b) developing arrangements, as part of the preparation of the annual Taxation Expenditure Statement, to obtain relevant data from entities outside the Treasury portfolio. <p><i>Agency Response: Treasury agreed. The ATO agreed with part (b).</i></p>
5.	<p>ANAO recommends that the Department of the Treasury and the Australian National Audit Office identify opportunities to develop estimates of large or otherwise significant tax expenditures using the revenue gain method.</p> <p><i>Agency response: Treasury agreed.</i></p>
6.	<p>ANAO recommends that the Department of the Treasury:</p> <ul style="list-style-type: none"> (a) develop an approach to prioritise improvements to the reliability of published tax expenditure estimates; (b) examine options for disclosing in the Taxation Expenditures Statement information on the reliability of individual tax expenditure statements; (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 (d) when developing advice for Ministers on policies that are expected to result in a tax expenditure, assess options for the reliable measurement of the effect of the proposed measure. <p><i>Agency response: Treasury and the ATO both agreed with parts (a), (b) and (c) and agreed with qualification to part (d).</i></p>

The Committee's review

- 4.14 The Committee held a public hearing on Wednesday 17 September 2008, with the following witnesses:
- Australian National Audit Office (ANAO); and
 - the Department of the Treasury (Treasury).
- 4.15 The Committee took evidence on the following issues:
- modelling;
 - ⇒ revenue gained and revenue foregone methods;
 - ⇒ behavioural responses; and
 - ⇒ benchmarking;
 - reporting;
 - ⇒ compliance with the *Charter of Budget Honesty Act 1998*;
 - ⇒ the Canadian model of reporting; and
 - data.

Modelling

Revenue gained and revenue forgone methods

- 4.16 The Committee noted one of the key findings of the audit was the differing methods of economic modelling used in preparing the Budget Papers and the TES. The Budget Papers are prepared using the revenue gain method, while the TES is prepared using the revenue foregone method.⁶
- 4.17 The revenue gain method endeavours to account for potential changes in taxpayer behaviour including 'second order' effects such as interactions with other tax policies. This produces a more accurate estimate of tax expenditures allowing for more reliable comparison with outlay measure estimates. It must be noted, however, that the revenue gain method requires more data of higher quality to produce more thorough modelling.
- 4.18 The revenue foregone method compares the revenue raised under current law with the revenue that would have been raised if the tax expenditure provision did not exist. This method relies on the assumption that the tax law remains consistent and that behaviour of taxpayers is unchanged. These assumptions are a weakness of the

⁶ Mr Bond, Australian National Audit Office (ANAO). Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 3.

method. Its major advantage is that it requires the least amount of data to produce an estimate of a tax expenditure.

- 4.19 The ANAO noted the impact of the Budget Papers being prepared using the revenue gain method and the TES using the revenue foregone method:

There is a discrepancy between these two models and it can be quite substantial or it can be minor. The issue at hand for the audit was that we suggested firstly that there be some attention paid to applying the model that is used in the budget process to large tax expenditures so that Parliament could get a gauge on some of those and their ongoing revenue effects. The revenue foregone method that is adopted in the TES will not show you those effects over time.⁷

- 4.20 Treasury advised that the revenue foregone method was the method used for the TES as it was the method that best suited the purposes of the TES, and that it was also the method used by most OECD countries.⁸ Treasury further illustrated the point:

On the outlay side of the budget you do not have forward estimates which incorporate behavioural response. If you are looking at spending on aged pension you never ask yourself the question, 'What would behaviour look like if we abolished the aged pension?' You have an accounting treatment which just says, 'This is how much we're spending.' The revenue foregone approach parallels that in saying, 'On the basis of existing behaviour, this is how much tax we're not collecting.'⁹

- 4.21 The Committee is not convinced with Treasury's reasons for using the revenue foregone method, as it does not indicate ongoing revenue effects over time. The discrepancies between the Budget Papers and the TES greatly weaken the credibility of the revenue foregone method.

- 4.22 While the Committee understands the difficulty in applying the revenue gained method in all cases, it is important for the Parliament and the Australian people to be able to see the ongoing revenue

7 Mr Bond, ANAO. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 3.

8 Ms Mrakovcic, Department of the Treasury (Treasury). Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), pp. 3-4.

9 Mr Gallagher, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 4.

effects of large tax expenditures over time. Accordingly, the Committee recommends:

Recommendation 7

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.

Behavioural responses

- 4.23 The Committee asked Treasury to explain the audit finding of the audit that the Budget Papers and TES sometimes contained drastically varying figures for the same tax expenditure.
- 4.24 Treasury replied that when tax expenditures are considered in the budget process, attempts are made to consider the behavioural response of taxpayers and industry. Further, when the TES is prepared, the method undertaken is the revenue foregone method, which does not incorporate behavioural responses.¹⁰
- 4.25 The Committee notes that incorporating the first round (that is, the immediate) behavioural effects of a tax concession would provide a more accurate indication of costs to the government.
- 4.26 The Committee asked how Treasury measured behavioural responses. Treasury replied that they used a variety of sources including academic studies indicating how a similar measure had been introduced overseas, and models internal and external to Treasury. Treasury advised they endeavoured to be as rigorous as possible as behavioural change had the potential to have large ramifications.¹¹
- 4.27 The Committee asked whether second and third round (that is, more indirect macroeconomic ramifications of policy change) effects were taken into account. Using the example of First Home Saver Accounts, Treasury replied:
- ...we do stay clear of thinking that the effect would lead to a change in interest rates or any other general macroeconomic effects. There have been occasions when the second round

10 Ms Mrakovcic, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports, Nos 27 (2007-08) to 2 (2008-09), p. 6.

11 Ms Mrakovcic, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports, Nos 27 (2007-08) to 2 (2008-09), pp. 8-9.

has been formally included in Treasury costings of significant government packages.

...In these cases, the normal guidelines of not including second round behaviour were waived. Because of the scale of those packages, it was thought necessary to take a broader economic view.¹²

- 4.28 Treasury's acknowledgement of the impact of first round behavioural responses indicates the weakness of the revenue foregone method. Further, it illustrates the importance of obtaining better quality data to enable more use of the revenue gain method to improve the quality of the reporting of tax expenditures.

Benchmarking

- 4.29 The Committee noted Treasury and Customs had agreed to adopt a zero rate for the customs duty tax benchmark, and asked whether this benchmark concealed tax concessions.
- 4.30 Treasury replied that the benchmark was set to zero to allow for comparison with domestically produced goods, arguing that any duty imposed on imported goods was equivalent to taxes imposed on domestic goods such as excise. Further, Treasury argued that the zero benchmark allowed measurement of the benefit tariffs provide to the taxpayer, and that the tariff was shown as a negative tax expenditure.¹³

Reporting

Compliance with the *Charter of Budget Honesty Act 1998*

- 4.31 The Committee noted the discrepancy between the reporting requirements of the *Charter of Budget Honesty Act 1998* and Treasury's reporting practices. The Act requires detailed statements on tax expenditures to be included in the Mid-Year Economic and Fiscal Outlook (MYEFO).¹⁴ The Committee asked whether the discrepancies between the TES and the Budget Papers would be lessened if Treasury reported as required by the Act.
- 4.32 Treasury replied that it was difficult to report on tax expenditures in MYEFO as a lot of detail was required and Treasury prepared revenue estimates and costings at the same time MYEFO was

12 Mr Gallagher, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 9.

13 Treasury, Answers to Questions on Notice, p. 1.

14 Section 14, *Charter of Budget Honesty Act 1998*.

prepared. Treasury believed adding tax expenditure reporting to MYEFO would:

...severely complicate the MYEFO process. It would also severely complicate the delivery of the important information on the economy, on expenditure, on revenue and on measures taken since the budget that that document contains. There is an efficiency issue and there is a resource issue in terms of the Treasury.¹⁵

- 4.33 The Committee asked the ANAO for their opinion. ANAO noted they had not suggested that tax expenditure information be included within MYEFO, but that it was a requirement of the Act that was not currently occurring. The ANAO report noted:

The different methodologies adopted in the Budget papers and in the TES impedes analysis of the actual cost of new tax expenditures in terms of what was expected when they were introduced.¹⁶

- 4.34 The ANAO continued:

One of the things we did suggest was that Treasury should publish its own estimate of how reliable that tax expenditure is. Our perspective was that there is plenty of room in the existing tabulation in the TES for including one extra item of information which we think would be quite valuable to tell the reader that this tax expenditure of \$X million is, in Treasury's view, this reliable rather than that reliable.¹⁷

- 4.35 While the Committee understands the challenges facing Treasury in assembling MYEFO, it is the Committee's opinion that Treasury should not be operating at odds with the *Charter of Budget Honesty Act 1998*. The Committee will pursue this matter with Treasury and the ANAO.

The Canadian model of reporting

- 4.36 The Committee notes the tax expenditures reporting model currently used in Canada, which records measures that are undeniably tax expenditures (as is done in Australia), and then divides other forms of tax relief into three 'memorandum items':

15 Mr Gallagher, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 6.

16 ANAO Audit Report No. 32 2007-08 *Preparation of the Tax Expenditures Statement* p.18.

17 Mr Boyd, ANAO. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 7.

- relief that is part of the benchmark system;
 - relief where data is insufficient to separate the tax expenditure component from the tax concession component; and
 - relief that could be categorised either as a tax expenditure or a tax concession.¹⁸
- 4.37 This practice of reporting allows the quantum of tax concessions to be readily available for both public and Parliamentary scrutiny.
- 4.38 The Committee asked Treasury about the steps it had taken to emulate the Canadian model. Treasury replied they did not believe their method differed greatly, as the TES outlined the benchmarks and structural features of the tax system in a method similar to the Canadian use of 'memorandum items'.¹⁹
- 4.39 Treasury's method does differ greatly in one area, the Canadian model of dividing other forms of tax relief into 'memorandum items', rather than aggregating figures, provides a more complete picture. The system employed by Treasury prevents reporting of tax measures that can be viewed as preferential but are included as part of the benchmark. These measures, including many related to capital gains are unofficially calculated to cost several billion dollars annually.²⁰
- 4.40 The Committee believes the entire quantum of tax expenditures needs to be reported to improve public and Parliamentary scrutiny. While it is difficult to categorise all forms of tax relief with precision, the Canadian model errs on the side of disclosure, rather than precision, allowing the reader a broader view of a complex part of the tax system.

Recommendation 8

That Treasury further investigate the merits of the Canadian model of taxation expenditure reporting, publishing its findings in the paper proposed in Recommendation 7.

Data

- 4.41 In its opening statement, Treasury indicated that there was scope to improve the reporting of tax expenditures through use of data held by

18 ANAO Audit Report No. 32 2007-08 *Preparation of the Tax Expenditures Statement* p. 45.

19 Treasury, Answers to Questions on Notice, p. 2.

20 Department of the Parliamentary Library, Research Paper No. 8 2002-03, *Tax Expenditures: The \$30 Billion Twilight Zone of Government Spending*, p. 9.

other agencies. The Committee asked how Treasury had gone about improving and encouraging data collection. Treasury replied they would seek access to data from other agencies.²¹

- 4.42 The Committee noted there were 98 tax expenditures found to be unquantified, and asked Treasury as to their plans to quantify them.
- 4.43 Treasury noted data quality was an issue that affected the quality of the estimate, and that they were looking beyond tax data to improve the quality of their estimates.²²
- 4.44 The Committee is encouraged to hear Treasury's willingness to seek data from other agencies to improve its reporting of tax expenditures. The Committee wishes to see genuine progress being made in improving the reporting of tax expenditures, and recommends:

Recommendation 9

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.

Conclusion

- 4.45 The Committee understands the burdens placed on Treasury in its operations in the current fiscal climate, but believes improvements can still be made to the reporting of tax expenditures at little cost to Treasury. There still remains an abundance of data held by other agencies that Treasury is yet to access. Securing access to this data will improve the reporting of tax expenditures in the TES.
- 4.46 The Committee also remains concerned at the method used for calculating tax expenditures. The Committee is of the belief that there should be little difference between the figures prepared for the Budget Papers and those prepared for the TES. These discrepancies occur in large part due to the use of the revenue foregone method in the preparation of the TES.
- 4.47 Of even more concern is the lack of data available to illustrate the quantum of larger tax expenditures over time. Calculating these tax

21 Ms Mrakovcic, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports, Nos 27 (2007-08) to 2 (2008-09), p. 2.

22 Mr Gallagher, Treasury. Committee Hansard, Joint Committee of Public Accounts and Audit, Review of Auditor-General's reports Nos 27 (2007-08) to 2 (2008-09), p. 10.

expenditures using the revenue gained method will provide more clarity for both Parliament and the public.

- 4.48 It is important that the practices of Treasury and its obligations under the *Charter of Budget Honest Act 1998* should be compatible. Under the current situation, Treasury is not meeting its responsibilities under the Act. The Committee understands the reasons for this, and believes amendment of the Act to better reflect practice would be the appropriate course of action.
- 4.49 The Committee notes the review of the Australian taxation system currently being undertaken by Treasury, and anticipates extensive coverage of tax expenditures in the review.
- 4.50 The Committee is pleased with Treasury's enthusiasm in improving the quality of data available to it, and understands its reluctance to undertake practices that may result in an increased cost to Treasury. However, the Committee is of the opinion that full implementation of its recommendations would improve the operation of the *Charter of Budget Honesty Act 1998*, the quality of the TES and its value as a document for the reporting of tax expenditures.