The Parliament of the Commonwealth of Australia

Report 382

- **Tactical Fighter Operations**
- **Magnetic Resonance Imaging Services**
- **High Wealth Individuals Taskforce**

Review of Auditor-General's Reports
1999-2000
Fourth Quarter

Joint Committee of Public Accounts and Audit

June 2001
Canberra

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DISSENTING REPORT

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Foreword

Report 382 is the outcome of the review by the Joint Committee of Public Accounts and Audit (JCPAA) of the Auditor-General's audit reports tabled in the fourth quarter of 1999-2000. Of the sixteen audit reports reviewed, the Committee selected three for further examination.

Audit Report No. 40, Tactical Fighter Operations; Audit Report No. 42, *Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations;* and *Audit Report No.* 46, *High Wealth Individuals Taskforce,* were examined at public hearings in Canberra on Friday, 3 November 2000.

Audit Report No 40 reviewed the administration of Tactical Fighter Operations (TFOs) by the Royal Australian Air Force (Air Force). The JCPAA focused its examination on air superiority and regional capabilities, and management of the fast-jet pilot workforce. Air superiority, which encompasses tactical fighter operations, airborne early warning and control (AEW&C), and air-to-air refuelling (AAR) is critical to the defence of Australia.

The JCPAA supports initiatives outlined in the *2000 Defence White Paper* to acquire AEW&C and enhance Air Force's AAR capability.

The management of the fast-jet pilot workforce comprising recruitment, training and retention is a major issue for the Royal Australian Air Force, and ultimately Australia's defence. It is unacceptable that there are insufficient numbers of fast–jet pilots. In a crisis situation, Australia's ability to sustain extended air combat could be under serious pressure. The ANAO should conduct a follow-up audit to assess how Air Force is addressing this issue.

Audit Report No. 42 examined the effectiveness and probity of the policy development processes and implementation involved in improving access to

the Magnetic Resonance Imaging (MRI) Services. The audit concluded that there were areas for improvement by the Department of Health and Aged Care in its policy development, risk management and in its management of negotiations with representatives of the Royal Australasian College. The number of machines for which eligibility for MBS rebates was sought greatly exceeded expectations. The desired distribution of machines was still not fully realised. Expenditure for MRI services also exceeded expectations.

Chief among the ANAO findings was a lack of adequate documentation by departmental officials. The Committee found it unsatisfactory that DHAC was so lacking in rigour in its probity arrangements, given the professional interests involved. The department's open-ended approach to risk management was deficient, especially in its handling of conflicts of interest and its acceptance of statutory declarations at face value as proof of date of order and installation. Until the cut-off date of 10 February 1998 came into effect on 1 November 1999, almost $46 million had been paid in medical rebates, some to machines subsequently deemed ineligible.

The Committee recommended that the department improve its practices in contract management and urged departmental officers to base its guidelines on the ANAO *Better Practice Guide on Contract Management* (2001). In addition, the Committee has noted that the department has made an effort to improve its record keeping, its risk analysis and risk management. **T**he Committee, however, would have more confidence in improved future performance by DHAC if DHAC frankly recognised and addressed these major flaws.

In *Audit Report No. 46*, the aim of the audit was to examine and report on the management and operations of the High Wealth Individuals (HWI) taskforce established by the Commissioner of Taxation in 1996. The HWI taskforce had been set up to act on tax planning techniques already identified by the Australian Taxation Office (ATO); gain an expanded and comprehensive understanding of the techniques employed by high wealth individuals; and to continue to identify, monitor and address emerging techniques.

The audit report concluded that the management and operations of the taskforce were effective; that the taskforce was achieving the revenue targets set by the government; and that it had contributed to the development of administrative and legislative proposals to address undesirable tax minimisation practices. The audit also found that the taskforce could improve its reporting of taskforce outcomes.

The Committee examined the issues of taskforce resourcing, litigation and settlement. The Committee endorsed the ATO's allocation of resources based on a properly planned risk management approach and noted that the ATO had a fairly rigorous process in place to guide settlements.

Taskforce outcomes and reporting were also examined by the Committee. The Committee agreed with the ANAO that publishing the results of and issues involved in the taskforce's operations are important for community education and compliance. The Committee noted steps taken by the ATO to improve its reporting but made a recommendation aimed at further improving public awareness of the HWI taskforce's activities and achievements.

Bob Charles MP
Chairman

Membership of the Committee

Chair Mr Bob Charles MP

Deputy Chair Mr David Cox MP

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Senator Helen Coonan

Senator the Hon Rosemary Crowley (until 28/06/01)

Senator the Hon John Faulkner (until 12/10/00)

Senator the Hon Brian Gibson AM

Senator John Hogg

Senator Andrew Murray

Senator the Hon Nick Sherry (from 28/06/01)

Senator John Watson

Mr Kevin Andrews MP

Mr Malcolm Brough MP (until 7/3/00)

Mr Petro Georgiou MP

Ms Julia Gillard MP

Mr Alan Griffin MP (until 9/8/99)

Mr Peter Lindsay MP (from 7/3/00)

Ms Tanya Plibersek MP (until 10/4/00)

The Hon Alex Somlyay MP

Mr Stuart St Clair MP

Mr Lindsay Tanner MP (from 9/8/99)

Mr Kelvin Thomson MP (from 10/4/00)

Membership of the Sectional Committee

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Deputy Chair	Mr David Cox MP	
Members	Mr Petro Georgiou MP	Senator the Hon Brian Gibson AM
	Ms Julia Gillard MP	Senator Andrew Murray
	Mr Peter Lindsay MP	
	Mr Alex Somlyay MP	
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	Ms Nina Franklin

Duties of the Committee

The Joint Committee of Public Accounts and Audit is a statutory committee of the Australian Parliament, established by the *Public Accounts and Audit Committee Act 1951*.

Section 8(1) of the Act describes the Committee's duties as being:

(a) to examine the accounts of the receipts and expenditure of the Commonwealth, including the financial statements given to the Auditor-General under subsections 49(1) and 55(2) of the *Financial Management and Accountability Act 1997*;

(b) to examine the financial affairs of authorities of the Commonwealth to which this Act applies and of inter-governmental bodies to which this Act applies;

(c) to examine all reports of the Auditor-General (including reports of the results of performance audits) that are tabled in each House of the Parliament;

(d) to report to both Houses of the Parliament, with any comment it thinks fit, on any items or matters in those accounts, statements and reports, or any circumstances connected with them, that the Committee thinks should be drawn to the attention of the Parliament;

(e) to report to both Houses of the Parliament any alteration that the Committee thinks desirable in:
   (i) the form of the public accounts or in the method of keeping them;or
   (ii) the mode of receipt, control, issue or payment of public moneys;

(f) to inquire into any question connected with the public accounts which is referred to the Committee by either House of the Parliament, and to report to that House on that question;

(g) to consider:
  (i) the operations of the Audit Office;
  (ii) the resources of the Audit Office, including funding, staff and information technology;
  (iii) reports of the Independent Auditor on operations of the Audit Office;

(h) to report to both Houses of the Parliament on any matter arising out of the Committee's consideration of the matters listed in paragraph (g), or on any other matter relating to the Auditor-General's functions and powers, that the Committee considers should be drawn to the attention of the Parliament;

(i) to report to both Houses of the Parliament on the performance of the Audit Office at any time;

(j) to consider draft estimates for the Audit Office submitted under section 53 of the *Auditor-General Act 1997*;

(k) to consider the level of fees determined by the Auditor-General under subsection 14(1) of the *Auditor-General Act 1997*;

(l) to make recommendations to both Houses of Parliament, and to the Minister who administers the *Auditor-General Act 1997*, on draft estimates referred to in paragraph (j);

(m) to determine the audit priorities of the Parliament and to advise the Auditor-General of those priorities;

(n) to determine the audit priorities of the Parliament for audits of the Audit Office and to advise the Independent Auditor of those priorities; and

(o) any other duties given to the Committee by this Act, by any other law or by Joint Standing Orders approved by both Houses of the Parliament.

List of abbreviations

AAR	Air-to-air refuelling
ADF	Australian Defence Force
AEW&C	Airborne early warning and control
AHTAC	Australian Health Technology Advisory Committee
ANAO	Australian National Audit Office
ATO	Australian Taxation Office
CT	Computerised Tomography
DHAC	Department of Health and Aged Care
DI	Diagnostic imaging
DoFA	Department of Finance and Administration
DPP	Director of Public Prosecutions
HIC	Health Insurance Commission
HPG	Health Program Grants
HRM	Human resource management
HTAC	[Australian] Health Technology Advisory Committee
HUG	Hornet Upgrade program

HWI	High Wealth Individuals
JCPAA	Joint Committee of Public Accounts and Audit
MBS	Medical Benefits Schedule
MoU	Memorandum of Understanding
MRI	Magnetic Resonance Imaging
PRB	Pilot Retention Bonus
RACR	Royal Australian College of Radiologists [The College]
RAAF	Royal Australian Air Force
TFG	Tactical Fighter Group
TFOs	Tactical Fighter Operations

List of recommendations

Audit Report No. 40, Tactical Fighter Operations

Recommendation 1 [paragraph 2.55]

The Committee recommends that the ANAO should conduct a follow-up audit in two to three years focusing on Air Force management of the fast–jet pilot workforce.

Audit Report No. 42, Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations

Recommendation 2 [paragraph 3.76]

The Committee recommends that the Department of Health and Aged Care develop clear guidelines—informed by appropriate legal advice—to assist its staff (a) in the negotiation and management of valid contracts; and (b) in their assessment of existing statutory declarations and contracts.

Recommendation 3 [paragraph 3.77]

The Committee recommends that in its development of clear contract guidelines, the Department of Health and Aged Care base its guidelines on the *Better Practice Guide on Contract Management* issued by the Australian National Audit Office in 2001.

Audit Report No. 46, High Wealth Individuals Taskforce,

Recommendation 4 [paragraph 4.77]

The Committee recommends that the Australian Taxation Office make further efforts to promote greater public awareness of the High Wealth Individuals Taskforce's activities and achievements by disseminating more widely the information contained in the Commissioner's annual report.

1

Introduction

1.1 One of the statutory duties of the Joint Committee on Public Accounts and Audit (JCPAA) is to examine all reports of the Auditor-General in terms of the significance of the program or issues raised; the significance of the findings; the arguments advanced by the audited agencies; and the nature of public interest in the report. The Committee is then required to report the results of its deliberations to both Houses of Parliament as it sees fit.

1.2 Upon consideration of the sixteen audit reports presented to the Parliament by the Auditor-General during the fourth quarter of 1999–2000, the JCPAA selected three reports for further scrutiny at a public hearing. The public hearings were conducted in Canberra on Friday, 3 November 2000.

1.3 The reports selected were:

- ***Audit Report No. 40, Tactical Fighter Operations***, Department of Defence;
- **Audit Report No. 42, *Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations***, Department of Health and Aged Care, and the Health Insurance Commission; and
- **Audit Report No. 46, *High Wealth Individuals Taskforce***, Australian Taxation Office.

Structure of the Report

1.4 This report draws attention to the main issues raised at the public hearing. Where appropriate, the Committee has commented on unresolved or contentious issues.

1.5 Chapter 2 of the report discusses the evidence taken relating to Audit Report No. 40, 1999-2000, *Tactical Fighter Operations*, on the management of the F/A–18 tactical fighter force operational capacity as part of Australia's defence strategy.

1.6 Chapter 3 of the report addresses issues raised in relation to Audit Report No. 42, 1999-2000, *Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations*, on the inclusion and registration of magnetic resonance imaging services for medical benefits schedule rebates.

1.7 Chapter 4 of the report discusses the evidence taken relating to Audit Report No. 46, 1999-2000, *High Wealth Individuals Taskforce*, on the effectiveness with which the High Wealth Individuals Taskforce in the Australian Taxation Office manages tax collection from this group.

1.8 In addition, the report provides an outline of the conduct of the Committee's review (Appendix A). The report should be read in conjunction with the transcript of evidence collected at the public hearing (Appendix D).

Report

1.9 A copy of this report is available on the JCPAA website at *http://www.aph.gov.au/house/committee/ jpaa/reports.htm*

2

Audit Report No. 40, 1999-2000

Tactical Fighter Operations

Department of Defence

Background

2.1 Tactical fighter operations (TFOs) form the basis of Australia's current military capability to ensure air superiority. The Government's *Defence 2000* White Paper commented that air combat 'is the most important single capability for the defence of Australia, because control of the air over our territory and maritime approaches is critical to all other types of operation in the defence of Australia.'[1]

2.2 Australia seeks to achieve air superiority through its fleet of 71 F/A-18A tactical fighter aircraft. The *Defence 2000* White Paper stated that 'Australia must have the ability to protect itself from air attack, and control our air approaches to ensure that we can operate effectively against any hostile forces approaching Australia.'[2]

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1 Department of Defence, *Defence 2000, Our Future Defence Force*, Commonwealth of Australia, pp. 84-85.

2 Defence, *Defence 2000,* p. 85.

2.3 Tactical Fighter Group (TFG), which comprises 1395 personnel, is responsible for providing TFOs. TFG's main weapons systems include:

- 71 F/A-18A *Hornet* tactical fighter aircraft;
- 26 Macchi MB326 lead-in fighter aircraft which were planned to be withdrawn by December 2000, as advised in the Audit Report;
- Hawk lead-in fighter aircraft of which eight are already in service and 33 will be in service by 1 July 2001; and
- three PC–9 forward air control aircraft.[3]

2.4 The functional organisation of TFG comprises:

- headquarters at Williamtown, NSW which comprises No. 81 Wing Headquarters, and Nos. 3 and 77 Squadrons;
- No. 75 Squadron, Tindal, NT;
- No. 76 lead-in fighter training squadron, Williamtown, NSW; and
- No. 79 conversion training squadron, Pearce, WA.[4]

2.5 As at June 1999 TFG's assets were valued at $2.7 billion. In 1999-2000 the cost of TFOs was $785 million with a capital use charge of $505 million.[5]

Audit objectives and findings

2.6 In *Audit Report No. 40, Tactical Fighter Operations*, the audit objectives were to:

- assess whether the resources used to provide the F/A-18A tactical fighter force operational capability are managed cost-effectively; and
- identify areas for improvement in the coordination, planning and practices employed in administration of tactical fighter operations.[6]

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3 ANAO, Report No. 40, 1999–2000, *Tactical Fighter Operations*, Commonwealth of Australia, p. 23.

4 ANAO, Report No. 40, 1999–2000, p. 24.

5 ANAO, Report No. 40, 1999–2000, p. 24.

6 ANAO, Report No. 40, 1999–2000, p. 25.

2.7 The ANAO's findings focused on military preparedness, the *Hornet* pilot workforce, logistics support, and the management of *Hornet* related projects.

2.8 With respect to military preparedness, the 'audit found that TFG met the specific military preparedness requirements in the Chief of the Defence Force Preparedness Directive, subject to certain qualifications.'[7] The ANAO noted the need for 'some deficiencies in the aircraft maintenance management system to be remedied, and secondly to allow the *Hornet* aircraft to deploy into the full range of operational theatres envisaged in strategic policy.'[8] In particular, the ANAO stated:

> …Air Force should monitor the military vulnerability of the aircraft and remedy any identified shortcomings, particularly those relating to levels of technology employed.[9]

2.9 The Royal Australian Air Force (Air Force) does not have enough fast-jet pilots. At June 1999 Air Force had about 40 operational pilots in the three *Hornet* squadrons. The human resource management of the fast-jet pilot workforce is a critical responsibility for Air Force. The challenge of recruiting, training and retaining fast-jet pilots is significant. The ANAO has correctly brought attention to this issue.

2.10 The cost of training a fast-jet pilot is about $9 million. The ANAO commented that in order to maximise this investment, Air Force 'should give priority to the retention of existing pilots and apply greater rigour in investigating the capability of the training system to produce the required number of pilots.'[10] At the same time, the ANAO reported that Air Force 'has no comprehensive workforce plan or planning model relating to the fast-jet pilots and no formal coordinated strategy to address the fast-jet pilot shortage.'[11]

2.11 With respect to logistics expenditure, the ANAO reported that for 1999-2000 expenditure 'is expected to be 87.1 per cent more in real terms than in 1994–95, but flying hours are expected to be only seven per cent more.'[12] The ANAO concluded that bringing

7 ANAO, Report No. 40, 1999–2000, p. 14.
8 ANAO, Report No. 40, 1999–2000, p. 14.
9 ANAO, Report No. 40, 1999–2000, p. 14.
10 ANAO, Report No. 40, 1999–2000, p. 14.
11 ANAO, Report No. 40, 1999–2000, p. 15.
12 ANAO, Report No. 40, 1999–2000, p. 69

together 'all logistic costs into an integrated management framework would facilitate comprehensive monitoring and holistic decision making for the totality of logistic support of TFO's.'[13]

2.12 The ANAO's audit also reviewed project management relating to the *Hornet* Upgrade (HUG) program. The ANAO found some persistent project management deficiencies. In particular:

- some projects had experienced delays in early stages of project approval and development, when timing apparently did not seem critical to decision-makers, making it difficult to accelerate progress later when timeliness was needed; and
- there appeared to be a tendency by the proponents of projects to underestimate the risks in projects, which was partially corrected by the capability development process. A greater emphasis on realistic risk assessment, including contract risk, in original proposals would aid the overall decision making process.[14]

2.13 In response to these findings, the ANAO made eleven recommendations, of which Defence agreed to all, two with qualifications.[15]

Committee objectives

2.14 The Committee focused its examination on the following three areas:

- air superiority and regional capabilities;
- management of the fast-jet pilot workforce; and
- project management related to the *Hornet* Upgrade program.

Air superiority and regional capabilities

2.15 The *Defence 2000* White Paper states that 'control of the air over our territory and maritime approaches is critical to all other types of operation in the defence of Australia.'[16] The ANAO noted that

13 ANAO, Report No. 40, 1999–2000, p. 15.
14 ANAO, Report No. 40, 1999–2000, p. 16.
15 ANAO, Report No. 40, 1999–2000, p. 17.
16 Defence, *Defence 2000*, pp.84- 85.

air superiority plays a critical role in this concept. The Air Power Manual defines air superiority as:

> Control of the air is the campaign in which operations are conducted for the purpose of gaining freedom of action in the air. Once control has been established, other air, land and sea campaigns may be conducted when and where desired, without prejudice from enemy air power. Achieving control of the air means defeating or nullifying the effects of enemy air power, both in the air and on the ground.[17]

2.16 Dr Kopp, a defence analyst, stated that the necessary ingredients for achieving air superiority are 'superior fighters, superior radar, missiles, pilots, tactics, doctrine, superior airborne early warning and control, superior surveillance, ample aerial refuelling, superior electronic combat capabilities and the ability to destroy as many of the opponent's aircraft on the ground as possible.'[18]

2.17 The ANAO, in discussing military preparedness, alluded to issues of air superiority and competitiveness when it stated:

> …to allow the *Hornet* to deploy into the full range of operational theatres envisaged in strategic policy, Air Force should monitor military vulnerabilities of the aircraft and remedy any identified shortcomings, particularly those relating to levels of technology employed.[19]

2.18 The major features of the air superiority triangle include fighter aircraft, air-to-air refuelling (AAR), and airborne early warning and control (AEW&C) aircraft. The Committee, was advised that for the F/A-18A fleet to have 'genuine combat credibility over the last decade of its operational life, it will require supporting Wedgetail airborne early warning aircraft and adequate aerial refuelling.'[20]

2.19 Project Wedgetail refers to the Defence program to acquire AEW&C aircraft. Air Force, in commenting on the importance of Project Wedgetail, stated that it is 'a critical aspect of our air defence, of our general management capability and protection of

17 C. Kopp, Submission no. 1, p. 4.

18 Kopp, *Transcript*, p. 111.

19 ANAO, Report No. 40, 1999–2000, p. 14.

20 Kopp, *Transcript*, p. 114.

our fleet units at sea and of our land based operations, wherever they may occur, if we are going to control the air.'[21]

2.20 Air-to-air refuelling (AAR) was considered to be no less important than AEW&C. The Committee was advised that to 'provide the required fighter patrol endurance in defence of the Pilbara, Timor Sea and Northern Territory, should the need arise, the RAAF [Royal Australian Air Force] will need a robust fleet of operational aerial refuelling tankers.'[22] Air Force stated that to maintain a presence in areas at reasonable range, 'air-to-air refuelling is critical, whether we are in a defensive posture or whether we are in an offensive posture, to carry a task to an area for a strike or for protection of a land based or sea based operation at some distance from our airfields.'[23]

2.21 On 6 December 2000 the Government released the Defence White Paper. The paper addressed the issues of AEW&C and AAR. The Government committed itself to acquiring four AEW&C aircraft with the possibility of acquiring a further three aircraft later in the decade.[24] The Committee was advised that between six and nine aircraft would be required for proper coverage of the Pilbara, Timor Sea and Darwin.[25]

2.22 In relation to AAR, the Government has scheduled a major project to replace and upgrade our AAR capability which will result in up to five new generation AAR aircraft.[26] It was suggested that in meeting combat scenarios in the Pilbara, Timor Sea and Darwin areas for example, Air Force would need to field 12–16 heavy tankers in the Boeing 747 class or 25-30 medium tankers in the Boeing KC-135R class.[27] Heavy tankers such as the 747 and KC-10A are considered to be more effective than medium tankers such as the KC-135R and Boeing KC-767. Dr Kopp suggests that 'typically half as many heavy tankers are required to deliver the same load of fuel, thus reducing support costs and aircrew numbers.'[28]

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21 P Devine, Royal Australian Air Force, *Transcript*, p. 123.

22 Kopp, *Transcript*, pp. 114-15.

23 Devine, *Transcript*, p. 123.

24 Defence, *Defence 2000*, p. 86.

25 Kopp, Submission no. 1, p. 77.

26 Defence, *Defence 2000*, p. 87.

27 Kopp, Submission no. *8*, p. 6.

28 Kopp, Submission no. 8, p. 10.

2.23 The other feature in assessing air superiority is the need to examine regional capabilities. The Committee heard that there has been and will continue to be a proliferation of high tech weapons in the region. This development is mainly attributed to the break-up of the Soviet Union, and Russia's existing financial condition which is forcing it to offload weapons.[29]

2.24 In assessing regional capabilities, attention was drawn to the proliferation of Russian made fighters such at the Su-27 and Su-30. At the same time, there has been a proliferation of Russian supersonic and subsonic air, sub and ship launched cruise missiles, and launch platforms such as the Tu-142M Bear and Tu-22M-3 Backfire bombers which translate into significant power projection weapons.[30] In relation to the uptake and use of Su-30 aircraft within the region, Dr Kopp stated:

> The Sukhoi Su-27 and Su-30 fighters are the Russian equivalent to the Boeing F-15, which is the finest Western air superiority fighter in operational service. With advanced aerodynamics, large internal fuel load and range, powerful engines, a large radar and potent missiles, the Sukhoi fighters are a direct challenge to the F-15 supremacy and more than a match for many lightweight fighters such as the F16 and F/A–18A.[31]

2.25 While the F/A–18s were the most capable fighter in the region when they became operational during the 1980s, 'the arrival of the F-15 class Su 27 swung the capability balance against the F/A-18.'[32] In addition, the ability of Air Force to commit its assets is influenced by the management of its fast-jet pilot workforce. This issue is discussed in the next section.

2.26 The ANAO made four recommendations which addressed military preparedness and aircraft battle damage repair capability. All four recommendations were agreed to, one with qualification. Defence in responding to the recommendations, however, suggested that the subject of some of the recommendations were already part of its initiatives.

2.27 For example, in recommendation one, the ANAO proposed that 'in order to maintain a cogent link between Defence's strategic

29 Kopp, *Transcript*, p. 111.
30 Kopp, *Transcript*, pp. 111-112.
31 Kopp, *Transcript*, p. 111.
32 Kopp, *Transcript*, p. 115.

planning and its military preparedness assessments of the tactical fighter force, Defence include in these latter assessments periodic and comprehensive intelligence assessments relevant to preparedness requirements.'[33] Defence responded that 'these assessments are considered during the periodic review of Military Response Options.' The ANAO subsequently responded arguing that 'Defence's assessments of TFG's military preparedness did not show evidence of a systematic and regular incorporation of intelligence assessments'.[34]

2.28 In recommendation 2, the ANAO proposed that Defence determine a longer term military preparedness capability for the Tactical Fighter Group (TFG) including the requirements for maintaining core skills. Defence responded that the TFG 'has already identified the longer term core skill requirements which are the basis of the pilot categorisation scheme.'[35]

Conclusions

2.29 *Audit Report No. 40* has provided the Committee with the opportunity to review aspects of tactical fighter operations including trends in regional capabilities and air superiority. Air superiority is critical to the defence of Australia. All defensive and offensive operations rely on air superiority for success. It is essential that the efficiency and effectiveness by which Tactical Fighter Group (TFG) delivers tactical fighter operations be examined, and where possible improvements made.

2.30 The Committee notes the critical importance of Airborne Early Warning and Control (AEW&C) Aircraft and air-to-air refuelling (AAR) to air superiority. Similarly, the importance of these air superiority elements was identified in the *Defence 2000* White Paper released on 6 December 2000. The Committee fully supports the initiatives outlined to acquire AEW&C and enhance Air Force's AAR capability.

2.31 The Committee notes that in response to some of the recommendations, Defence suggested that it was already undertaking the initiatives expressed in some ANAO recommendations. While this is positive because both the ANAO

33 ANAO, Report No. 40, 1999–2000, p. 33.
34 ANAO, Report No. 40, 1999–2000, p. 34.
35 ANAO, Report No. 40, 1999–2000, p. 36.

and the audited agency are in agreement, the implication is that the recommendation has less relevance. The Committee suggests, that in future, the ANAO and the audited agency should seek to resolve matters, prior to tabling, where it is argued that an audit recommendation reflects an existing agency practice. In those cases where similarities are found, the audited agency could be asked to provide more information on implementation.

Management of the fast–jet pilot workforce

2.32 In November 1998 the Government stated that a key objective for 1998 and 1999 would be to 'increase pilot numbers in operational fast–jet squadrons.'[36] The ANAO reported that as at 'June 1999 Air Force had about 40 operational pilots in the three *Hornet* squadrons.'[37] While the required number of fast–jet pilots is not disclosed publicly the current workforce is well below operational requirements. A similar problem exists for fast–jet pilots for the F111 squadrons.[38] Air Force acknowledged that it has ‘a problem with the number of fast jet aircrew in totality', and similar problems exist with the F111s.[39]

2.33 Air Force indicated that '*Hornet* pilot numbers in operational squadrons will recover gradually and that numbers will be fully restored in 5–7 years. However, the ANAO commented that 'previous Air Force projections on expected times of recovery in pilot numbers have been incorrect.'[40]

2.34 In examining these matters, the following discussion will examine some of the reasons explaining the inadequate fast–jet pilot numbers and the proposed strategies for improving the situation.

Recruitment, training and retention

2.35 The ANAO notes that problems of achieving fast-jet pilot numbers first began to appear in the 1980s, and was 'caused mainly by high wastage rates as Air Force pilots took up employment with

36 ANAO, Report No. 40, 1999–2000, p. 42.
37 ANAO, Report No. 40, 1999–2000, p. 44.
38 J Blackburn, Royal Australian Air Force, *Transcript*, p. 119.
39 Blackburn, *Transcript*, p. 119.
40 ANAO, Report No. 40, 1999–2000, p. 44.

civilian airlines, and stagnation in recruitment rates.' The ANAO also noted that these problems are not unique to Australia as 'United States (US), Canadian, United Kingdom (UK) and many European air forces face similar, though generally less severe shortages for similar reasons.'[41]

2.36 In relation to recruitment, Air Force indicated that it aims to 'graduate in the order of 57 pilots a year'. However, Air Force commented that 'the percentage of those pilots who have the skill sets and abilities to fly fast jets has not met the number we actually need to send to the F/A-18 and the F111.'[42] Air Force concluded that as a result, 'with recent high resignation rates, we have not been able to maintain the number of people in the squadrons that we need'.[43]

2.37 In addition, more pilots will need to be trained in the coming years to service Air Force's intention of having AAR and AEW&C aircraft. While this is not specifically related to the fast-jet pilot issue under consideration it is another matter that must be dealt with. The Committee was advised that fulfilling the crewing needs for AEW&C and, in particular, AAR will not be easily solved.[44]

2.38 The *Defence 2000* White Paper addressed the issue of human resource management in the Defence force in general. The White Paper indicated that research undertaken in 1998 found that only four per cent of those aged between 18 and 35 would 'definitely consider' a career in the Defence Force. The White Paper concluded that if the Australian Defence Force (ADF) 'is to become the employer of choice for more people, its culture and approach will need to change–and be seen to change.'[45]

2.39 In relation to fast-jet pilots, Defence identified the following reasons for the difficulty in meeting pilot recruitment quotas:

- the lack of specific, targeted pilot recruitment campaigns;
- increased competition with other industries as the economy grows;

41 ANAO, Report No. 40, 1999–2000, p. 42.
42 Blackburn, *Transcript*, p. 119.
43 Blackburn, *Transcript*, p. 119.
44 Kopp, Submission no. 8, p. 7.
45 Defence, *Defence 2000*, p. 67.

- the reluctance by applicants to commit to Defence employment for 10 years or more as required by the pilot 'return of service' obligation; and
- strict physical criteria for pilots.[46]

2.40 The ANAO concluded:

> It has proved difficult for Defence to attract a sufficient pool of suitable applicants and then identify potential fast-jet pilots within that pool. A variety of tests are applied to applicants; Air Force is conducting research to identify particular characteristics that suggest ultimate success as a fast-jet pilot.[47]

2.41 Training for fast-jet pilots can take between two and half and three years. The cost of training a fast-jet pilot is estimated at about $9 million.[48] The ANAO reported that the challenge for Defence is to accurately estimate the training outcomes for a given set of pilot trainees. If, for example, pass rates fluctuate significantly from year to year then pilot projections will be under pressure. The ANAO 'considers that the fast–jet pilot training system could be made more predictable and stable with improvements to data management and overall organisation.'[49]

2.42 Air Force and Defence documents attribute the major cause of the shortage of fast–jet pilots to high wastage rates. The ANAO reports that the key drivers of wastage are:

- the posting cycle;
- career paths;
- attractiveness of other careers and pay;
- perceptions of poor career management;
- return of service obligations; and
- limited flying hours.[50]

2.43 In relation to retention rates, the Air Force commented:

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46 ANAO, Report No. 40, 1999–2000, p. 49
47 ANAO, Report No. 40, 1999–2000, p. 49.
48 ANAO, Report No. 40, 1999–2000, p. 42 and 57.
49 ANAO, Report No. 40, 1999–2000, p. 60.
50 ANAO, Report No. 40, 1999–2000, p. 62.

> If you look at the problems across Defence, there are significant difficulties in our retention rates across the three services. In the past, resignation rates have been in the order of eight or nine per cent on average. We have in the order of 13 to 14 per cent loss rates right now. On the recruiting side, Army and Navy are in the region of mid-80 per cent of achieving recruiting goals—and I understand Navy is down to 55 or 60 per cent. This is not a problem that just exists in the fighter force or in a single area.[51]

2.44 A range of initiatives has been used to help improve retention. The Pilot Retention Bonus (PRB), for example, was introduced in 1996 with a cost of $32 million since inception. The PRB is available to pilots who have completed, or are within two years of completing, their return of service obligations. The ANAO noted that the PRB 'can be repaid and has been characterised as a free loan that pilots can take up, invest and refund at little net cost to the pilot.'[52] Air Force stated that 'preliminary findings by my staff indicated that the PRB in its current form is not an effective retention tool.'[53] The ANAO concluded:

> High wastage rates are the major cause of the fast-jet pilot shortage. Defence has introduced some initiatives to try to control wastage but they have not been effective. Until recently, Defence's rigid personnel system has provided little scope to respond flexibly to market pressures. To try to retain fast–jet pilots who would otherwise leave, Defence could seek pilots' views on the PRB as part of a broader review of the Bonus. Consideration should also be given to using individual agreements or particular arrangements for jet–pilots as a specialist employment stream.[54]

Human resource management solutions

2.45 In proposing solutions to the management of the fast–jet pilot workforce, the ANAO suggested the need for a comprehensive human resource management approach to the problem. In order

51 Blackburn, *Transcript*, p. 121.
52 ANAO, Report No. 40, 1999–2000, p. 63.
53 ANAO, Report No. 40, 1999–2000, p. 63.
54 ANAO, Report No. 40, 1999–2000, p. 64.

to achieve adequate fast–jet pilot numbers, the ANAO suggested that achieving this goal should proceed on the basis of:

- robust and firm planning targets for the desired number of pilots;
- appropriate recruitment targets and selection processes;
- research on workforce planning and modelling; and
- agreement on key result areas and measures for recruitment, selection, training and retention.[55]

2.46 The ANAO made five recommendations seeking to achieve better administration and outcomes associated with fast–jet pilots. Air Force agreed to all recommendations. In particular, recommendation nine proposed that 'Defence coordinate its efforts to acquire and retain sufficient numbers of pilots for the Tactical Fighter Group (TFG) by formulating and implementing a TFG pilot workforce plan'.[56]

2.47 Air Force, in evidence to the Committee, suggested that it was moving to a more strategic approach to its human resource management. Air Force acknowledged that in the past, it has 'actually looked at the elements rather than at the totality of the system.'[57] Air Force suggested that it is seeking to integrate the various stages of recruitment, training and retention strategies. In relation to retention issues, Air Force stated:

> Accepting there are market forces that change, depending upon the economy, we are now trying to address the retention far more holistically: not just looking at throwing a bonus at somebody to stay in the service, but really looking at what it is that encourages them to leave: the lifestyle, the remuneration, their career opportunities, vocational stability, spousal issues. We have a strategic aircrew management cell now that looks at it from one end to the other of the system. It is going to take a few years to see if those changes we have made in these elements are effective. What we do not want to do is continually react as we did in the past when we see a blip or a problem without having seen if one change we have

55 ANAO, Report No. 40, 1999–2000, p. 65.
56 ANAO, Report No. 40, 1999–2000, p. 65.
57 Blackburn, *Transcript*, p. 119.

made is going to be effective overall. This is going to take five to eight years to try and recover, if we can get all of those pieces of the puzzle together.[58]

Conclusions

2.48 The management of the fast-jet pilot workforce comprising recruitment, training and retention is a major issue for the Royal Australian Air Force, and ultimately Australia's defence. It is unacceptable that there are insufficient numbers of fast–jet pilots. In a crisis situation, Australia's ability to sustain extended air combat could be under serious pressure.

2.49 The ANAO has correctly focused on this matter and examined the historical situation and the efficiency and effectiveness of administration of this problem. The ANAO's chief message is that Air Force should bring a more rigorous and integrated human resource management approach to this issue. Air Force to its credit has accepted that in the past it has not applied a holistic approach focusing on the elements rather than the totality of the system. Air Force indicated that it now has 'a strategic aircrew management cell' that looks at all parts of the system. At the same time, Air Force suggested that constructing an effective human resource management system and achieving improvements will take five to eight years.

2.50 The Committee accepts that Defence understands some of the key issues causing the high wastage rates and ultimately low numbers of fast-jet pilots. Some of these issues were listed in paragraph 2.40. The ANAO also cited the posting cycle, career paths, attractiveness of other careers and pay, perceptions of poor career management, return of service obligations and limited flying hours as key drivers of wastage. The Committee is less convinced, however, about Defence's capacity to address these problems and reverse the current wastage rates.

2.51 It is reassuring that Air Force has indicated that it will bring a holistic approach to its human resource management. But as the *Defence 2000* White Paper states, 'if the ADF is to become the employer of choice for more people, its culture and approach will need to change—and be seen to change.'[59] In respect to fast-jet

58 Blackburn, *Transcript*, p. 114.

59 Defence, *Defence 2000*, p. 67.

pilot recruitment, training and retention, Defence has a serious human resource management (HRM) challenge. In addressing this problem it must be prepared to confront its cultural constraints. At the same time, the best HRM experts, from both the public and private sectors, should be brought to bear in developing an effective HRM strategy.

2.52 For example, in relation to the issues of career paths and limited flying hours, Air Force may need to be more flexible. Pilots should not be required to undertake 'desk duties' during their core flying years. At the same time, pilots who reject desk duties should not have their careers disadvantaged through promotional setbacks.

2.53 The Committee considers the management of the fast-jet pilot workforce as the key issue identified in Audit Report No. 40. For example, the recruitment and training of a fast-jet pilot costs about $9 million and wastage rates are unacceptably high. At the same time, air superiority is the most critical aspect of Australia's defence. The ANAO's audit has helped target these matters and ensured that Defence gives greater focus to its human resource management in the coming years.

2.54 The Committee, however, would like further reassurance that Air Force is achieving its targets and is on course to meets its objectives in five to eight years. Therefore, the ANAO should conduct a follow-up audit in two to three years focusing on Air Force management of the fast–jet pilot workforce strategy.

Recommendation 1

2.55 **The Committee recommends that the ANAO should conduct a follow-up audit in two to three years focusing on Air Force management of the fast–jet pilot workforce.**

Project management related to the *Hornet* Upgrade program

2.56 As discussed in part one of this chapter, the maintenance of air superiority is a vital part of Australia's defence strategy. When the F/A–18As entered service in 1985 they were highly competitive and gave Australia clear air superiority in the region. However, as discussed in part one, the competitiveness of the F/A–18As is

being challenged. In order to maintain competitiveness, a range of upgrades is planned for the *Hornets* during the next decade. The projects are complex and will cost over $1.5 billion.[60]

2.57 The ANAO, as part of the audit, examined aspects of the project management of the *Integrated Avionics Systems Support Facility* and the *Hornet Upgrade Program* (HUG).[61] Both projects are managed by the Defence Acquisition Office with Air Force input.

2.58 The ANAO sought to identify particular features of the upgrade program that place additional pressures on Defence. For example, Air Force operates the A/B model *Hornet*. The US Navy operates a large fleet of *Hornets* comprising the A/B and C/D models and it will be upgrading to the E/F Super *Hornet*. The US is currently retiring its A/B fleet. The decision by the US Navy not to upgrade its A/B fleet means that Australia will have to fund a significant amount of the engineering and design work for the upgrade.[62]

2.59 The HUG is divided into two phases. Phase 1 is considered low technical risk because most of the equipment has been installed on US Navy *Hornets*. This phase is expected to be completed by the end of 2001. Phase 2 is considered to have more technical risk because the equipment has not been installed into A/B model *Hornets* overseas. The electronic warfare component of this upgrade is expected to be completed by the end of 2002. Other elements of this phase will begin in 2003 and proceed past 2005.[63] The ANAO stated:

> Defence assumed that Air Force would be able to incorporate US experience in its upgrades. However, due to delays in the US Navy programs, Phase 2 of the HUG will be the lead aircraft integration program and will be incorporating some systems in advance of the US Navy. This increases the technical and cost risk of the upgrades. The original documentation portrayed the project as low to moderate risk, but over time this changed. Phase 2 is now described as having '…medium to high schedule and cost risks that are based on technical and management uncertainties with the acquisition strategy.'[64]

60 ANAO, Report No. 40, 1999–2000, p. 79.
61 ANAO, Report No. 40, 1999–2000, Chapter Five.
62 ANAO, Report No. 40, 1999–2000, p. 81 & 88.
63 ANAO, Report No. 40, 1999–2000, pp. 86–87.
64 ANAO, Report No. 40, 1999–2000, p. 87.

2.60 The ANAO reported that HUG Phase 1 was delayed for over a year based on two developments. First, the US Navy decided not to upgrade its *Hornet* A/B models. Second, McDonnell Douglas Aerospace, 'the original manufacturer of the *Hornet* notified Defence that it would not participate in a competitive tender for the work or act as subcontractor in the project.'[65]

2.61 In its conclusion, the ANAO noted some persistent deficiencies, namely:

- some projects had experienced delays in early stages of project approval and development, when timing did not seem critical, making it difficult to accelerate progress later when this was needed;
- there appeared to be a tendency by the proponents of projects to underestimate the risks in projects, which was partially corrected by the capability development process; and
- there was limited consideration of life-cycle costs at the acquisition stage of HUG.[66]

Conclusions

2.62 The *Hornet* Upgrade is a vital part of keeping the F/A–18As competitive and maintaining air superiority through to about 2010–2012 when Australia will acquire a new state of the art fighter. Efficient and effective project management is essential to ensuring that the HUG is achieved on time and within budget. The Committee's examination of Defence's project management of HUG follows a chequered history relating to other projects. In the past, most concerns related to poor contract management, and cost and delivery blowouts. Hence, whenever the ANAO draws attention to issues of Defence project management, the Committee takes this extremely seriously.

2.63 The Committee notes the ANAO's concern that there have been delays with some projects. For example, HUG Phase 1 was 'delayed for over a year'. This was due to the US Navy deciding not to upgrade its *Hornet* A/B models, and the original manufacturer deciding not to tender for the upgrade. It is debatable whether Defence could have included these outcomes

65 ANAO, Report No. 40, 1999–2000, p. 88.

66 ANAO, Report No. 40, 1999–2000, pp. 92–93.

as possible contingencies in its risk assessment strategy. Based on these reasons, which are outside the influence of Defence, the Committee does not hold Defence to account for the delay in Phase 1.

2.64 In relation to risks, the ANAO found that there was a tendency to underestimate risks in the project. For example, in relation to HUG Phase 2, Defence will have to accept increased technical and cost risks because of delays in US Navy programs. Consequently, Defence will have to incorporate some systems in advance of the US Navy. While Defence initially portrayed this project as 'low to moderate risk', it has correctly revised this assessment and rated Phase 2 as 'medium to high schedule and cost risks'. The Committee finds that Defence has acted correctly in revising its risk assessment. It is standard procedure in developing risk strategies to revise assessments where either internal or external factors change.

2.65 Not withstanding these issues, there is now increased pressure on Defence to deliver the HUG on budget and within projected times. The Committee places a high priority on this program.

3

Audit Report No. 42, 1999-2000

Magnetic Resonance Imaging Services

—effectiveness and probity of the policy development processes and implementations

Introduction

Background

3.1 Radiology departments in Australia began to use Magnetic Resonance Imaging (MRI)[1] scans as a diagnostic tool in the 1980s. Until the 1998 Budget measure, however, Commonwealth funding for MRI services was restricted to 18 publicly owned MRI units through a Health Program Grants (HPG) arrangement under the *Health Insurance Act 1973,* although 54 MRI units existed in the public and private sectors.[2] This funding program, which

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1 A **MRI** machine is basically a superconducting magnet, cooled down with liquid helium, which exerts a powerful magnetic pull. A patient having an image taken of some part of his or her body is placed inside the magnet and subjected to radio waves. The patient's body takes in the energy of the waves, the machine is turned off, the body gives out the energy, and the machine captures this as an image. This results in extremely clear images of soft tissue and bone, which allow doctors to diagnose illnesses more accurately. MRI is not invasive and has the potential to replace surgical testing procedures. ANAO, Report no. 42, 1999–2000**,** *Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations,* Commonwealth of Australia, May 2000, p. 14.

2 AHTAC, *Review of magnetic resonance imaging,* October 1997, p. 10.

commenced in the 1991–92 financial year, provided grants to the States for the purchase of MRI units and accounted for about 80 per cent of recurrent costs. The total cost to the Commonwealth of the HPG arrangements was about $20 million per annum.[3]

3.2 States were also able to purchase services from privately owned units. MRI scans were provided, on the basis of a specialist referral, free of charge to private (non-refund) patients, hospital outpatients and Medicare hospital in-patients. People living in rural areas, however, often had to travel some distance to a funded MRI centre, if they did not wish to pay the full fees, even though an unfunded MRI unit was closer.[4]

3.3 On 12 May 1998, the Government announced, in the 1998–99 Budget context, a measure to constrain growth in diagnostic imaging expenditure under the Medicare benefits arrangements and fund increased access to MRI services. This followed the 1997 review by the Australian Health Technology Advisory Committee (AHTAC) which had recommended extending publicly funded MRI services.[5]

3.4 The Government anticipated that improved MRI access would provide MRI services:

- in rural and remote regions;
- for paediatric use; and
- as another means of diagnosis.[6]

3.5 The announcement was underpinned by an Agreement between the Government and the diagnostic imaging profession, following a period of intense discussion and negotiation with representatives of the Royal Australasian College of Radiologists (the College).

3.6 The Government concluded its Agreement with the College on 6 May 1998, when it was agreed that Medical Benefits Schedule (MBS) rebates would be provided for MRI services from 1 September 1998, provided those services met certain clinical and eligibility requirements.

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3 ANAO, Report no. 42, 1999–2000, pp. 15–16.

4 AHTAC, *Review*, p. 12.

5 AHTAC, *Review*, pp. 12, 69.

6 ANAO, Report no. 42, 1999–2000, p. 16.

3.7 A key eligibility requirement was that benefits would only be paid in relation to 'equipment [MRI machines] which is in use in hospitals or practices...[and]...which has been either ordered or leased under an unconditional and enforceable contract at 7.30pm EST on Tuesday, 12 May 1998 but are still to be delivered at that time'.[7]

3.8 Contracts lodged with the Health Insurance Commission (HIC) for MBS rebates indicated the following pattern of orders for MRI machines, with the surge of orders occurring in the space of five days in May:

7–13 January 1998	3 machines ordered
February 1998	none ordered
5–31 March 1998	8 machines ordered
2–29 April 1998	6 machines ordered
7–12 May 1998	33 machines ordered[8]

3.9 In early June 1998, the Department of Health and Aged Care (DHAC) received the first allegation of significant orders being made for MRI units prior to the Budget announcement. As a measure of control over orders of MRI units, DHAC advised the Minister for Health and Aged Care, on 7 August 1998, that statutory declarations be used as part of the assessment of MRI services for Medicare benefits.

3.10 In November 1998, following its receipt of an anonymous allegation about backdating of MRI orders, the HIC began investigating allegations of irregularities in MRI orders, completing its preliminary review in February 1999.

3.11 Questions were raised about the Budget MRI measures on 8 February 1999 at a Senate Estimates Hearing in Parliament. The issues covered included the negotiation process and the number of eligible machines. There were accusations that some radiologists ordering machines prior to 12 May had access to information that MRI machines installed, ordered or leased by Budget night would be eligible for MBS rebates.

3.12 The sudden increase in the number of applications for eligibility for MBS rebates exceeded the expected numbers of registered public and private machines —namely those machines actually installed and operating at the time. The HIC acknowledged in its

7 ANAO, Report no. 42, 1999–2000, p. 92.

8 ANAO, Report no. 42, 1999–2000, p. 88.

December 1999 report that ‘there are some unresolved questions arising from the fact that so many contracts were said to have been entered into prior to 12 May 1998’.[9]

Scope of audit

3.13 On 18 October 1999, the Minister for Health and Aged Care requested the Auditor-General to inquire into and report on 'the probity of the processes surrounding the negotiation of the Agreement between the Government and the diagnostic imaging profession'.[10] In initiating the audit, the Minister 'agreed that the Audit Office could extend its normal powers to get right to the heart of the matter'.[11]

3.14 The audit by the Australian National Audit Office (ANAO) became Audit Report No. 42, 1999–2000**,** *Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations.* It reviewed the effectiveness and probity of the processes involved in the development and announcement of the proposal to improve access to MRI services as announced in the 1998 Budget.

3.15 The audit also:

- Examined government negotiations with the diagnostic imaging profession;
- Assessed the administrative and monitoring arrangements related to the registration of ‘eligible providers’ and ‘eligible equipment’ for claims under MBS; and
- Examined the adequacy and timeliness of action taken by the DHAC in response to unanticipated or inappropriate MRI submissions.[12]

Audit findings

3.16 ANAO stated that ‘one of the key concerns arising in relation to this audit was whether there was a leak of Budget information which led to this pre-Budget rush of orders’.[13] Evidence seemed to

9 ANAO, Report no. 42, 1999–2000, p. 89.
10 ANAO, Report no. 42, 1999–2000, p. 12.
11 D. Borthwick, *Transcript*, 3 November 2000, p. 83.
12 ANAO, Report no. 42, 1999–2000, pp. 12–13.
13 ANAO, Report no. 42, 1999–2000, p. 21.

indicate that the meeting of 6 May 1998 had some influence either directly or indirectly, on the sudden surge in orders for MRI machines in the space of four days.[14] In respect of this key question, ANAO reported:

> Statements have also been made by College representatives who attended the meeting on 6 May 1998 with the Minister that, although the Minister did not reveal what measures would be in the Budget, there was discussion of the option to include machines on order as at Budget night. All but one have stated that this was initiated by the Minister (the other has indicated this was initiated by the Minister or the departmental official present) within the general context of College concerns about restrictions on sites. They have also indicated that the College expressed concerns regarding the enforceability of such a measure. On the other hand, the Minister, the Minister's adviser and the departmental officer present, dispute the radiologists' recollection of the meeting. They do not recall the specific matter of machines on order being discussed.[15]

3.17 In ANAO's view, 'no substantive conclusion about inappropriate disclosure of budget sensitive information could be expected on the basis of such contradictory evidence…much under oath or affirmation'.[16] ANAO considered, however, that:

> …on the balance of probabilities, the evidence does at least suggest that negotiation and consultation with the College representatives and open debate on supply control issues created an environment where some participants may have deduced, or actually become aware, that the Commonwealth was giving consideration to the inclusion of machines on order in the Budget measure. Nevertheless, the audit was not able to conclude whether, or to what extent, the actual surge in orders was based on reliable information, or informed or partly informed speculation.[17]

14 ANAO, Report no. 42, 1999–2000, pp. 104–106.
15 ANAO, Report no. 42, 1999–2000, p. 22.
16 ANAO, Report no. 42, 1999–2000, p. 22.
17 ANAO, Report no. 42, 1999–2000, p. 22.

3.18 ANAO found that overall patient access to MRI services improved as a result of the Agreement.[18] Of the 65 MRI units which ultimately became eligible for MBS rebates, only 17 units (25.7%) were located in non-metropolitan areas.[19] While this was an improvement from the previous zero funded MRI units in non-metropolitan areas[20], the desired distribution of machines, as recommended by the AHTAC in its 1997 review, was not fully realised.[21]

3.19 Expenditure for MRI services had also exceeded expectations. ANAO highlighted that, at the time of its audit, the anticipated cost containment in MBS rebates had not been achieved. MRI rebate expenditure for 1998-99 'was some $4 million over the anticipated level. Projections for 1999–2000 suggest expenditure of $6 million over target.'[22] Furthermore:

> …prior to the reduction in eligible machines to 66, there was considerable potential for expenditure to exceed targets by larger amounts if all 111 machines registered had remained eligible. This is particularly important given that, under the Agreement, the Commonwealth assumed the financial risk for MRI volumes above the designated ceiling for scans.[23]

3.20 At the public hearing, ANAO made the following comments about the MRI Agreement negotiations, DHAC's identification and management of the following aspects:

> [In Audit Report No. 42]…we make the point that we believe the department's approach to risk management was uneven. We readily acknowledge that high level risks were addressed but we felt that insufficient consideration was given to risk identification and management for some aspects of the policy development process.…the graph on page 88,…shows the machines on order, and ask the question: does that suggest tight risk management processes? It seems to me the answer is: we think they could have done better. So while we are not

18 ANAO, Report no. 42, 1999–2000, p. 37.

19 ANAO, Report no. 42, 1999–2000, p. 22; J Blandford (Chair), *Report of the Review of Magnetic Resonance Imaging*, 8 March 2000, p. 20.

20 DHAC & HIC, Submission no. 3, p. 15.

21 ANAO, Report no. 42, 1999–2000, p. 22; Blandford, *Report of the Review*, p. 21.

22 ANAO, Report no. 42, 1999–2000, p. 112. For further details, see paragraphs 3.90–3.91.

23 ANAO, Report no. 42, 1999–2000, p. 112.

> universally saying the department has not applied risk management, we are saying there is certainly scope for improvement.[24]

3.21 Prior to attending the negotiations, members of the Task Force were not asked to declare any potential conflict of interest, pecuniary interest, or intention to buy MRI machines. There were no agreed procedures or arrangements in place to address potential conflicts of interest. In addition, there had been an appalling lack of adequate documentation by DHAC of its negotiations with the College and of its oral advice to its Minister.[25]

3.22 ANAO emphasised that its findings and conclusions—which since the audit was tabled have remained unchanged[26]—showed:

> The MRI measure has also resulted in the unexpected outcome of exposure of the Commonwealth to risks of fraud through backdating of contracts or otherwise misrepresenting the nature of the contracts. These matters have been the subject of the HIC investigation…[27]

3.23 The Committee examined the following issues at its public hearing on 3 November 2000:

- Policy development—MRI options
  - ⇒ Adequate documentation of ministerial advice and negotiation processes
  - ⇒ Probity arrangements for the negotiations
- Accountability and monitoring of MRI measures
  - ⇒ MRI Agreement
  - ⇒ Conditional contracts
  - ⇒ Statutory declarations
- Risk management
  - ⇒ Constraining growth in diagnostic imaging expenditure and achieving net savings
  - ⇒ MBS payments for diagnostic imaging services
- The quality of the administrative processes supporting the implementation of the MRI Budget measure

24 I McPhee, *Transcript*, 3 November 2000, p. 63;

25 ANAO, Report no. 42, 1999–2000, pp. 20, 68–71.

26 McPhee, *Transcript*, 3 November 2000, p. 62; A. Greenslade, *Transcript*, 3 November 2000, p. 84.

27 ANAO, Report no. 42, 1999–2000, p. 112.

⇒ Administrative outcomes achieved

- The HIC investigation.

Policy development

3.24 The responsibility for providing policy advice to the Minister for Health and Aged Care rests with DHAC. In developing its advice, DHAC engages in discussions and consultations, taking into consideration its responsibilities for implementing the health policy once the Government has made a decision. Policy development operates within a variety of contexts, ranging from open public debates to the development of policy proposals for Cabinet consideration or inclusion in the Commonwealth Budget.

> However, there can be tensions between maintaining a strict 'need to know' approach in a new policy area and at the same time ensuring that the final outcome is both practical and acceptable to those parties with an interest in its implementation, which often depends on consultation, even if necessarily restricted.[28]

3.25 As noted in the ANAO report:

> While openness in policy development provides real benefits in allowing better targeting and acceptance of the policy measure…, it also carries risks, particularly where parties consulted may gain an unfair advantage over others in the community due to the knowledge gained through the consultation process.[29]

3.26 Agencies responsible for policy development require a sound risk management strategy to safeguard the integrity of sensitive information in any discussions or negotiations with interested parties. It should develop and implement a risk management strategy to preserve the integrity of sensitive information—in this way protecting the interests of all concerned. Documentation is essential and careful risk management 'underpins achievement of planned policy outcomes'.[30]

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28 ANAO, Report no. 42, 1999–2000, p. 58.
29 ANAO, Report no. 42, 1999–2000, p. 58.
30 ANAO, Report no. 42, 1999–2000, p. 59.

Adequate documentation

3.27 ANAO found that DHAC had not always made or maintained official records on significant briefings of, and decisions made by, the Minister in relation to the development of some elements of the policy on MRI, specifically about the merits, risks and alternative options in relation to the inclusion of machines on order.[31]

> Such documentation is generally accepted as a key element of sound administration and accountability. Official records were not taken or maintained of some significant briefings of, and decisions by, the Minister. As a consequence, there is limited departmental documentation on the development of the key elements of the MRI supply measure.[32]

3.28 In addition, no record was kept of meetings between the Commonwealth and the College and there is no record of what was agreed (other than drafts of the Agreement in the latter stages of negotiation).[33] ANAO commented that such practices were 'not consistent with good administrative practices'.[34]

> In this situation, the pressure on the Department to progress sensitive consultations over a short time period actually demanded greater discipline in record keeping and accountability as part of a sound control environment which is integral to robust and successful corporate governance. The latter also provides management with some assurance that required actions will be undertaken particularly in periods of stress accentuated by, for example, time pressures and multiple demands being placed on the same people.[35]

3.29 It was therefore difficult to establish a clear audit trail throughout this period, resulting in ANAO being unable to draw any substantive conclusions about some aspects. It stated:

> The audit methodology has been significantly influenced by one of the findings in this audit report—that Commonwealth documentation and maintenance of

31 ANAO, Report no. 42, 1999–2000, pp. 20–21, 25–27, 67–68, 71.
32 ANAO, Report no. 42, 1999–2000, p. 20.
33 ANAO, Report no. 42, 1999–2000, p. 25.
34 ANAO, Report no. 42, 1999–2000, p. 27.
35 ANAO, Report no. 42, 1999–2000, p. 72.

> documents in this instance have not been of a standard that adequately supports accountability for policy development and implementation.[36]

3.30 Instead ANAO tried to reconstruct documentary evidence, through its powers under section 32 of the *Auditor-General Act 1997*. Critical aspects of evidence were obtained by reviewing archived emails; consulting documents held in the private sector and through extensive oral evidence from key parties under oath or affirmation.[37]

3.31 During the public hearing, the Committee explored why there was a lack of departmental documentary evidence on the MRI negotiations. DHAC agreed with the Committee that its standard of record keeping was of an unsatisfactory standard.[38] Inevitably there is speculation about these matters as shown in the following exchange:

> **Ms GILLARD** [*Member for Lalor*]—This is a question I asked the auditor before but, as I understand it, when the Audit Office comes in and there is an unsatisfactory documentary record, are you able to say whether or not any documents were removed or destroyed?
>
> **Mr Borthwick** [*Deputy Secretary, DHAC*]—To the best of my knowledge, there were no documents that were deliberately removed or destroyed. However, I think the Audit Office might be able to comment on it. I think some officers' personal records, such as notes, went missing, but they were personal notebooks, time had moved on and the issues were no longer relevant. I might leave it to the Audit Office to respond to that question.
>
> **Mr Greenslade** [*Executive Director, ANAO*]—We found no evidence that documents were deliberately destroyed to hide evidence.
>
> **Ms GILLARD**—So you found no direct evidence that documents were deliberately destroyed, but it is a possibility, isn't it, when there is such an unsatisfactory record? Either they were not kept or they were subsequently removed—there are two possibilities.

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36 ANAO, Report no. 42, 1999–2000, p. 13.

37 ANAO, Report no. 42, 1999–2000, pp. 13–14.

38 Borthwick, *Transcript*, 3 November 2000, p. 82.

> **Mr Greenslade**—Yes.
>
> **CHAIRMAN** [*Mr Bob Charles, Member for La Trobe*]—Wouldn't it be highly unlikely in a department for documents to be purposely destroyed?
>
> **Mr Borthwick**—The point is that it is highly unlikely and the nature of this audit commission, where they had unfettered access to all of our staff and interviewed them under oath, if need be, would have revealed whether there had been some action to destroy documents. There was no such action.
>
> **Ms GILLARD**—I accept there is no direct finding of that by the Audit Office.[39]

3.32 In their joint submission to the Committee, DHAC and HIC declared that:

> there were some aspects of the policy process leading to the introduction of MRI onto the MBS that should have been better documented. In particular, it is noted that [it] is desirable to have formal minutes of meetings where negotiations were taking place and a record of outcomes of key meetings with the Minister.[40]

3.33 When asked by the Chairman why the radiologists kept much better records of meetings and agreements, DHAC responded: 'Our processes were not up to mark. Everything the Audit Office says about that reflects deficiencies in that process by the department.'[41] Since then, DHAC said, the processes have been extensively improved:

> …in terms of not just this particular area of the department but at a departmental wide level in terms of making it very clear what responsibilities are of officers for record keeping, filing and all those basic bureaucratic skills.[42]

3.34 Although DHAC believes its record keeping has since improved, this improvement does not detract from the Committee's conclusion that DHAC had been remiss and its documentation of

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39 Various, *Transcript*, 3 November 2000, pp. 82–83.

40 DHAC & HIC, Submission no. 3, p. 9.

41 Borthwick, *Transcript*, 3 November 2000, p. 82.

42 Borthwick, *Transcript*, 3 November 2000, p. 82.

all that had occurred during the negotiation of the MRI Agreement had been appalling.

Probity arrangements

3.35 Linked to the issue of inadequate documentation was another of ANAO's major findings—the lack of 'formal record or minute of the Department's intentions' in its probity arrangements with the College MRI Taskforce, with whom DHAC was negotiating MRI arrangements. DHAC informed the Committee that it fully expected the Taskforce members to discuss the MRI measures with its constituents and therefore excluded Budget sensitive information from the discussions.[43] 'Taskforce members were not required to sign any confidentiality agreement prior to the commencement of the negotiations process.'[44]

3.36 Confidentiality arrangements once established would have bound both parties. Instead, there was ambiguity about what was to be treated in confidence and what could reasonably be discussed more openly.

3.37 ANAO stated that one of its key concerns was whether a leak of Budget information led to a pre-Budget rush of orders. The most significant interactions between the Commonwealth and the profession in connection with this matter occurred in the final stages of negotiations. 'Statements have been provided that the Commonwealth's consideration of the option of including machines on order as at Budget night was discussed with the College Task Force on MRI prior to the Budget.'[45] The recollections of most participants do not support this view. ANAO found DHAC had kept no record of these discussions.[46]

3.38 In addition, DHAC did not document the voluntary declarations made by the Taskforce members of their potential conflicts of interest, pecuniary interest and / or intention to purchase MRI machines.[47] Yet, as ANAO found, 'five of the eleven radiologists involved in the negotiations were associated with practices that allegedly ordered nine machines prior to the Budget'.[48]

43 DHAC, Submission no. 4, p. 2.
44 ANAO, Report no. 42, 1999–2000, p.68.
45 ANAO, Report no. 42, 1999–2000, p. 21.
46 ANAO, Report no. 42, 1999–2000, p. 21.
47 ANAO, Report no. 42, 1999–2000, p. 69.
48 ANAO, Report no. 42, 1999–2000, pp. 21, 87.

3.39 DHAC acknowledged that 'there should have been better measures put in place for handling conflicts of interest and confidentiality requirements'[49] in its discussions with the College. DHAC subsequently accepted that it should have requested formal statements of interest and identified process for handling conflicts of interest from the Taskforce members.[50] DHAC said at the public hearing:

> The ground rules should have been a lot clearer in terms of dealing with the profession....we were expecting the College to go back and talk to all their members about the aspects of the Agreement because we were expecting them to sign on the bottom line. It is quite clear there was some confusion on that point and we were not clear enough in terms of setting out those requirements.[51]

3.40 Since then, in the light of ANAO's comments and recommendations, DHAC has tightened its procedures and adopted a number of measures including the development of a Deed of Confidentiality and a Conflict of Interest Declaration.[52]

3.41 ANAO found that record keeping practices of departmental Taskforce members did not compare well with those of College Taskforce members who were not subject to the same accountability disciplines as DHAC. The ANAO used the notes kept by College Taskforce members to provide some record about decision making and the sharing of information.[53] ANAO was also able to verify that by late March / early April 1998, College members knew the Government was considering controlling the supply of MRI services through a site freeze[54], which was understood to mean:

> ...a freeze on eligibility of machines beyond a certain point in time which was generally, but not exclusively, understood to be installed machines. In essence, the type of control which was implemented.[55]

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49 Borthwick, *Transcript*, 3 November 2000, p. 63.

50 DHAC, Submission no. 4, p. 2; Borthwick, *Transcript*, 3 November 2000, p. 63; ANAO, Report no. 42, 1999–2000, p. 70.

51 Borthwick, *Transcript*, 3 November 2000, p. 63.

52 DHAC, Submission no. 4, p. 3.

53 ANAO, Report no. 42, 1999–2000, p. 71.

54 ANAO, Report no. 42, 1999–2000, p. 79.

55 ANAO, Report no. 42, 1999–2000, p. 79.

3.42 ANAO concluded in its report:

> Whatever the basis for this purchase activity, it would be reasonable to conclude that, if this fact were known in the profession, it would also have had some influence on other radiologists considering purchasing MRI machines.[56]

Committee comments

3.43 The Committee found it disturbing that DHAC was so lacking in rigour in its probity arrangements, given the professional and financial interests involved. As a result of this neglect of probity arrangements, it was possible for persons privy to confidential information to subsequently make commercial decisions based on that information in a short space of time. ANAO described the negotiations as 'information which gave them [radiologists] a privileged position'.[57]

3.44 The Committee believes there are several possible explanations for the increase in MRI orders prior to the Budget announcement:

- In the normal course of professional development, there were legitimate business reasons for ordering MRI units;[58]
- The AHTAC Report of October 1997 had recommended that MBS funded scans be increased to the equivalent of '10–12 units working at full capacity';[59]
- There was a leak—therefore ordering a MRI unit presented minimal risks;
- There was sufficient firm belief formed during the negotiations—therefore some were willing to take a calculated risk;
- There were unsubstantiated speculations—upon which some were willing to gamble; or
- Contracts were apparently backdated.[60]

3.45 DHAC denied there had been a leak and chose to believe that the radiologists:

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56 ANAO, Report no. 42, 1999–2000, pp. 21, 91.
57 McPhee, *Transcript*, 3 November 2000, p. 78.
58 ANAO, Report No.42, 1999–2000, p. 90.
59 AHTAC, *Review*, p. 69
60 ANAO, Report No.42, 1999–2000, p. 89.

> …were taking a commercial gamble that these machines would be put on the MBS. I think, with the benefit of hindsight, that we did not fully appreciate that that is what they were doing.[61]

3.46 In light of subsequent events, DHAC acknowledged:

> That is why the Minister initiated this wide audit inquiry and agreed that the Audit Office could extend its normal powers to get right to the heart of the matter, because we, too, were concerned by that rush of orders.[62]

3.47 In its analysis of why a large number of MRI scanners were purchased between 7–12 May 1998, ANAO examined several scenarios. Its conclusion was 'some participants may have deduced, or become aware, that the Commonwealth was giving consideration to inclusion of machines on order'[63] in the Medicare Benefits Schedule. Other possible explanations, however:

> …do not rule out prior knowledge or strong suspicion of the likely inclusion of contracts signed before Budget day as part of the MRI Budget measure.…The HIC report acknowledges that there are some unresolved questions arising from the fact that so many contracts were said to have been entered into prior to 12 May 1998.[64]

3.48 The Committee concluded that as ANAO was unable to determine from its audit whether some radiologists 'may have deduced, or actually become aware that the Commonwealth was giving consideration to the inclusion of machines on order in the Budget measure',[65]its own view would be equally speculative. The Committee notes that DHAC did not face up to the magnitude of the deficiencies in its negotiation processes. The Committee believes that DHAC's probity arrangements need to be improved, taking into account all the possibilities. Reforms need to be made to ensure that in the future there is full accountability and a definite audit trail for all programs.

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61 Borthwick, *Transcript*, 3 November 2000, p. 64.

62 Borthwick, *Transcript*, 3 November 2000, p. 83.

63 ANAO, Report no. 42, 1999–2000, p. 85; McPhee, *Transcript*, 3 November 2000, p. 81.

64 ANAO, Report no. 42, 1999–2000, p. 89.

65 ANAO, Report no. 42, 1999–2000, p. 90.

3.49 Given the allegations sent to DHAC from 1 June 1998[66], the HIC investigation started in November 1998, the growing public concerns and the Senate Estimates interrogations on 8 February 1999, the Committee is puzzled that DHAC did not become alarmed until August 1999, when the Minister sought immediate advice about imposing an application cut-off date for MRI eligibility, in order to limit the units being ordered.[67] The Committee also noted that DHAC did not share the allegations made to it with HIC at the time they were made[68], thereby raising questions about the effectiveness of communication between the two agencies and their monitoring of risk management and accountability.

Accountability and monitoring of MRI measures

MRI Agreement

3.50 The negotiated Agreement, as finalised after the 6 May 1998 meeting, was endorsed by the Government and the arrangements announced as part of the Budget. On Budget night the Minister wrote to the President of the College, advising that:

> In order to attract Medicare benefits, [MRI] services must be provided with equipment which is in use in hospitals or practices at 7.30pm EST on Tuesday, 12 May 1998. This requirement will be relaxed to allow Medicare benefits to be paid for services provided with equipment which has been either ordered or leased under an unconditional and enforceable contract at 7.30pm EST on Tuesday, 12 May 1998 but are still to be delivered at that time. As well, providers may need to satisfy other eligibility criteria such as siting and accreditation / quality assurance system requirements as recommended by AHTAC.[69]

3.51 ANAO drew attention to several aspects of the endorsement of the MRI Agreement:

66 ANAO, Report no. 42, 1999–2000, p. 104.
67 ANAO, Report no. 42, 1999–2000, p. 106.
68 ANAO, Report no. 42, 1999–2000, p. 35.
69 ANAO, Report no. 42, 1999–2000, p. 92.

- The Minister had not attached a copy of the Agreement with his letter dated 12 May 1998.
- The College President did attach a copy with his response.
- The DHAC file copy contained annotations such as 'we never agreed to this'.
- No copy of the Agreement, signed by both parties, exists.

⇒ There is therefore no agreed version of the Agreement.[70]

3.52 The Committee believes that proper adherence to well founded risk management strategies would have been prudent and would have resulted in a signed certified Agreement. The Committee notes that DHAC failed to do this. As ANAO noted: 'Such uncertainty makes it difficult to monitor / review such agreements adequately'.[71]

Conditional contracts

3.53 The Committee questioned DHAC about conditional contracts which had been entered into around Budget night 1998. As noted above, the Budget announcement allowed MRI machines which were 'either ordered or leased under an unconditional and enforceable contract at 7.30pm EST on Tuesday, 12 May 1998 but are still to be delivered at that time' to be eligible for MBS rebates. Given that 33 machines were ordered between 7–12 May 1998, this wording is significant. The Minister's letter went on to outline the expected increase:

> They expand significantly the range of services funded from the existing 18 public hospital MRI units to some 60 Australia wide, give greater choice, and assure quality while continuing a managed approach to the funding and delivery of this specialised medical service.[72]

3.54 DHAC had sought advice on appropriate phrasing 'of the concept of machines on order upon which the MRI Regulations could be premised' from the Australian Government Solicitor on 8 May 1998. Specific advice on the actual phrasing, however, was not provided.

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70 ANAO, Report no. 42, 1999–2000, p. 93.
71 ANAO, Report no. 42, 1999–2000, p. 93.
72 ANAO, Report no. 42, 1999–2000, p. 92.

3.55 To give effect to this Budget announcement, the Government approved in late August 1998, amendments to the *Health Insurance (1997-1998 Diagnostic Imaging Services Table) Regulations* and consequent amendments to the General Medical Services Table and the *Health Insurance Regulations*. The amended regulations specified that eligible MRI machines included equipment which 'although uninstalled, [had] been purchased or leased before that time on that day under a contract, in writing, that did not contain an option to cancel the contract' as at 7.30 pm EST on 12 May 1998.[73]

3.56 In contrast to the Government's expectation, by September 1998, when the new arrangements were to commence, 71 applications had been submitted. By October 1999, this had increased to 111 applications.[74] This was nearly double the number of MRI units Australia-wide anticipated in the Minister's letter.

3.57 Ultimately the DPP was asked to advise on the possibility of prosecuting in relation to a number of matters involving MRI purchases. Some of the matters related to allegations of backdating of contracts and some related to contracts that were expressed to be conditional.[75]

3.58 In relation to the contracts expressed to be conditional, the DPP concluded that the term '*option to cancel the contract'* is not a usual term used in the law of contract and there was uncertainty as to how it would be interpreted by a court. Legal Counsel formed the opinion that contracts which were expressed to be '*subject to finance*' or even '*conditional order on Government rebate for MR procedure*' could not be said to constitute an option to cancel the contract.[76]

3.59 The DPP determined that it would be unlikely that the prosecution could 'prove that an offence had been committed beyond reasonable doubt.'[77] The Director advised that further investigation would not change his view and his decision.

3.60 Having examined the evidence fully and questioned DHAC about the way in which it had admitted the phrase 'option to cancel', it still remains unclear to the Committee why this phrase was

73 Health Insurance (1997–1998 Diagnostic Imaging Services Table) Amendment Regulations 1998 (no.1) 1998 No 267–Reg 4 http://scaleplus.law.gov.au/ 18 June 2001

74 ANAO, Report no. 42, 1999–2000, p. 104

75 Borthwick, *Transcript*, 3 November 2001, pp. 71–73; ANAO, Report no. 42, p. 89.

76 HIC, Media Release—Magnetic Resonance Imaging Investigation (27.9.2000), p. 1.

77 HIC, Media Release—Magnetic Resonance Imaging Investigation (27.9.2000), p. 1.

selected. This lack of clarity is inexplicable to the Committee. Furthermore, the Committee questions the wisdom of allowing the phrase 'option to cancel' to be included when clearly this was contrary to the Government's intent as specified in the Minister's letter of 12 May 1998.

3.61 The Committee is concerned that where orders were subsequently cancelled in terms of the contract, this could be seen as a decision to withdraw from the contract because the buyers could no longer profit, as they had earlier assumed they could. DHAC believed 'it would be a logical thing for them to cancel the contract if they had an opportunity in terms of the contractual arrangements to do so'.[78]

3.62 Questioned about this aspect, ANAO responded that the situation was a difficult one to comment on as 'we are not privy to sufficient information to help you draw a conclusion'. ANAO added that it would 'prefer to put the emphasis on the preventative approach to avoid the situation occurring, rather than trying to recover downstream.'[79]

3.63 The Committee endorses this view. It firmly believes that DHAC should not have admitted the use of the option phrase since its acceptance, together with the original absence of a cut-off date meant that many more MRI units were seeking registration. Given that the Agreement stated that the Government would assume the financial risk for MRI volumes above the designated ceiling, it appears that some radiologists may have assumed minimal risks—and some might have made sizeable gains—in entering into these conditional contracts.

3.64 Central to this discussion are the 26 units which were ordered but not installed by the time the cut-off date was imposed in October 1999 as a means of addressing the surge in the number of MRI units. The cancellation of these 26 contracts could be seen as the reaction by those radiologists on being excluded from MBS rebates since their machines were ordered after 10 February 1998.

3.65 The Committee inquired whether the additional machines which became ineligible for registration at 18 October 1999 as a result of the ministerial freeze, were eventually installed and operating. DHAC told the Committee it was unable to provide any further information on the machines caught in the freeze, as these were no

78 Borthwick, *Transcript*, 3 November 2000, p. 81.

79 McPhee, *Transcript*, 3 November 2000, p. 79.

longer lodging claims, although 'there are some examples of machines moving from one location to another'.[80]

3.66 Given the public concern about probity issues in relation to the surge in the number of MRI machines, it seems basic for DHAC to monitor matters associated with these probity issues and track the cancellation of contracts caught in the Ministerial freeze. The Committee is concerned that DHAC could not tell if these MRI units are in private operation, not delivered or completely cancelled. This inability could hamper plans for future distribution of MRI units on an equitable basis.

Statutory declarations

3.67 Faced with an increasing volume of claims, DHAC tried to control supply by requiring that claim applications for MBS eligibility be accompanied by statutory declarations regarding contractual arrangements for the purchase of MRI machines. Advice was sought from the Australian Government Solicitor on 6 August 1998 to assist in developing the supply control arrangements.[81] DHAC was focused on addressing fraudulent claims rather than on limiting the number of eligible MRI machines.[82] By 30 September 1998, 71 applications had been submitted, one month after registration commenced.[83]

3.68 ANAO found that there was considerable variation in specific aspects of the contracts and in the statutory declarations, thus making it difficult 'to establish whether the machine had already been approved and to match statutory declarations with contracts'.[84] In effect, the statutory declarations were not effective control mechanisms.

3.69 DHAC did not focus on this aspect until the DPP tried to proceed to prosecution using the statutory declarations.[85] The department admitted: 'The fact that it would not stand up in the prosecutions was only known to us when the DPP advised us of that'.[86]

80 Watzlaff, *Transcript*, 3 November 2000, p. 67.

81 Borthwick, *Transcript*, 3 November 2000, p. 70; ANAO, Report no. 42, p. 97.

82 ANAO, Report no. 42, 1999–2000, p. 99.

83 ANAO, Report no. 42, 1999–2000, p. 104.

84 ANAO, Report no. 42, 1999–2000, p. 103.

85 Morauta, *Transcript*, 3 November 2000, p. 71, HIC, 'Media release: Magnetic Resonance Imaging Investigation', 27/09/2000, p. 1.

86 Morauta, *Transcript*, 3 November 2000, p. 71.

3.70 DHAC made it clear during the public hearing, however, that it still does not believe that the use of statutory declarations was a flawed process which did not legally assist with the control of supply and probity matters.[87] DHAC took the view that statutory declarations supported the purchases since:

> …prima facie these were contracts. Even though there was backdating on some of the contracts, the prior negotiations and prior exchange or whatever it was amounted to contracts that were entered into prior to Budget night.[88]

3.71 The failure of DHAC to understand the weakness of these specific statutory declarations as a control mechanism leads to Committee's concerns that DHAC may have not adequately learned from this experience.

3.72 Another of the Committee's concerns centred on the HIC claim processing whereby officers tended to accept the statutory declarations at face value. HIC indicated to ANAO that it had gained the impression from its discussions with DHAC that the statutory declaration arrangements were sufficient to address the problems of excessive orders and backdating.[89] Consequently, 'the registration procedures for eligibility of equipment generally resulted in applications being accepted, since the application was made by way of statutory declaration'.[90]

3.73 Total applications received numbered 111 by October 1999 when a cut-off date was being set.[91] Despite the continuing growth in the number of machines submitted for registration, DHAC did not address the risks involved in HIC's processing of machines on order because it continued to believe the statutory declarations dealt with possible fraudulent claims in an effective manner.

3.74 The Committee endorses ANAO's conclusion on this matter:

> Earlier and clearer guidance as to what constituted a valid statutory declaration or contract, what was invalid and a mechanism to address those cases that were unclear or

87 Borthwick, *Transcript*, 3 November 2000, p. 77.
88 Borthwick, *Transcript*, 3 November 2000, p. 72.
89 ANAO, Report no. 42, 1999–2000, pp. 101, 103.
90 ANAO, Report no. 42, 1999–2000, p. 104.
91 ANAO, Report no. 42, 1999–2000, p. 104.

ambiguous would have assisted timely processing of applications.[92]

3.75 The Committee accepts that during this period, DHAC was mainly focused on policy development and its advice to the Minister on extending access to MRI scans. Nevertheless, in the Committee's view, once the policy had been determined, DHAC should have focused on the sound processes needed to achieve outcomes and sought legal advice to facilitate these processes. DHAC should also have developed clear guidelines and provided staff training on managing legal risks. Post-events, DHAC needs to review its processes for developing Budget initiatives so that probity, confidentiality and legal arrangements for future Budget initiatives are of a satisfactory standard.

Recommendation 2

3.76 **The Committee recommends that the Department of Health and Aged Care develop clear guidelines—informed by appropriate legal advice—to assist its staff (a) in the negotiation and management of valid contracts; and (b) in their assessment of existing statutory declarations and contracts.**

Recommendation 3

3.77 **The Committee recommends that in its development of clear contract guidelines, the Department of Health and Aged Care base its guidelines on the *Better Practice Guide on Contract Management* issued by the Australian National Audit Office in 2001.**

Risk management

3.78 The Committee focused on how DHAC had managed emerging risks. ANAO maintained that DHAC should have developed a suitable strategy with safeguards covering all possible risks, such as a large number of orders placed before Budget night. Because MRI numbers exceeded DHAC expected numbers, one of its key supply controls was undermined, 'thereby placing at risk the

92 ANAO, Report no. 42, 1999–2000, p. 103.

Agreement target for MRI scans; and exposing the Commonwealth to potentially fraudulent claims'.[93]

> As well, more consideration could have been given to attendant benefits and risks for delivering the key supply measure and to the provision of information relevant to the Minister's assessment of departmental advice. This conclusion applies both to advice at Budget time and to subsequent advice concerning emerging problems with respect to machines on order.[94]

3.79 The Committee accepts that this advice is retrospective. ANAO did acknowledge, however, that 'the Department was under considerable pressure with tight timetables at this time, as well as the need to ensure the full cooperation and agreement of the profession.'[95]

3.80 DHAC maintained at the public hearing and in its submission that 'proper consideration was given to assessing and managing risks associated with the development and implementation of the new MRI arrangements'.[96] It highlighted the fact that 'specific steps were taken to address the possibility of non bona fide orders of MRI units'.[97] To differentiate genuine orders, DHAC advised the use of the term 'firm orders' to refer to equipment which had been either ordered or leased unconditionally in an enforceable contract.[98] Again the Committee expressed disquiet at DHAC's apparent lack of appreciation of the dimension and nature of the flaws in its approach to the MRI Budget announcement and its handling of its implementation.

Constraining growth in diagnostic imaging expenditure and achieving net savings

3.81 During the public hearing, it was established that 65 MRI machines were operating and receiving Medicare benefits. Of these machines, 59 were installed and operating prior to the

93 ANAO, Report no. 42, 1999–2000, p. 21.

94 ANAO, Report no. 42, 1999–2000, pp. 20–21.

95 ANAO, Report no. 42, 1999–2000, p. 21.

96 DHAC & HIC, Submission no. 3, pp. 7–8; Borthwick, *Transcript*, 3 November 2000, pp. 62–63.

97 Borthwick, *Transcript*, 3 November 2000, p. 59.

98 DHAC & HIC, Submission no. 3, p. 7.

12 May 1998, the day of the Budget announcement.[99] Three of these machines were ordered prior to 10 February 1998, that is prior to the date the Ministerial freeze came into operation.[100] Another three machines were ordered in the Ministerial freeze period but were exempted from the Ministerial freeze because of their non-metropolitan location.[101] As a result, there was a net addition of six machines operating in Australia.

3.82 Between 10 February 1998 and Budget night, a further 46 machines were on contract but had not yet been installed.[102] It was these machines that were ultimately caught in the Ministerial freeze.[103]

3.83 DHAC, however, did not see a need to introduce a cut-off date for registration, although it feared a blow-out by August 1998 of 'between 100-110 MRI machines on stream in the next 18 months'[104], instead of the anticipated 60 scanners.

3.84 ANAO found that the initial monitoring/auditing Agreement between DHAC and HIC did not cover the risks of more machines on order and claiming eligibility. The Agreement was not formally amended at any subsequent stage even though DHAC became increasingly aware, after the 1998 Budget, of emerging problems with respect to MRI orders, and briefed the Minister on this, but not the HIC.[105] Yet, in its advice to the Minister, DHAC did not discuss the risks associated with the department's preferred option of including, in the Budget measure, machines on order.[106]

3.85 The HIC understood its role was to monitor the number of services and detect inappropriate ordering and over-servicing.

> It was not aware of the need to audit risks related to contracts; the importance of detailed checking of the contracts beyond what it would see as normal administrative requirements; nor that numbers of

99 R. Watzlaff, *Transcript*, 3 November 2000, p. 65.

100 Watzlaff, *Transcript*, 3 November 2000, p. 66.

101 Watzlaff, *Transcript*, 3 November 2000, p. 65.

102 In total, 52 units were contracted for and caught in the ministerial freeze. Of these 6 'escaped' because one was ordered pre-10 February 1998 and the other 5 were in non-metropolitan areas. Watzlaff, *Transcript*, 3 November 2000, pp. 65–66.

103 Borthwick, *Transcript*, 3 November 2000, pp. 72–73. ANAO, Report no. 42, p. 89.

104 ANAO, Report no. 42, 1999–2000, p. 98.

105 ANAO, Report no. 42, 1999–2000, p. 101.

106 ANAO, Report no. 42, 1999–2000, p. 76.

> machines claiming eligibility beyond a certain level may indicate that some of the Department's risk treatments had not been effective.[107]

3.86 The Committee believes that this open-ended approach to risk management was inadequate and resulted in expenditure on diagnostic imaging exceeding by five per cent, the seven per cent growth anticipated.[108] As ANAO stated: 'At the time of this audit, the anticipated level of control over growth in diagnostic imaging outlays had not been achieved'.[109]

MBS payments for diagnostic imaging services

3.87 During the public hearing, the Committee was told that all eligible scanners including those subsequently excluded, had been able to register for and were paid MBS rebates.[110] Each eligible MRI service attracted a MBS fee of $475 in the first two years, rising to $529 in year 3 [2000–2001].[111] The expansion program was limited to 403 000 MRI scans over the full three year period, at a cost of $164 million. In addition, the MRI Agreement acknowledged that 'An excess demand above [403 000 MRI scans over three years] cannot be funded within global arrangements… Accordingly, the Government will assume the financial risk for MRI volumes above the designated ceiling'.[112]

3.88 In response to the Committee's query, DHAC replied:

> In 1998-99, 107 768 scans were performed. This was 7 768 scans in excess of the anticipated volume. In accordance with the DI Agreement, the Government financed these scans at a total cost of $3 272 192. However, expenditure on MRI was $4 343 506 more than anticipated, because the average benefit turned out to be $421.24 instead of the anticipated $410.53. The anticipated benefit was calculated on the assumption that 80% of scans would be out-of-hospital, however the actual proportion of benefits

107 ANAO, Report no. 42, 1999–2000, p. 101.

108 ANAO, Report no. 42, 1999–2000, p. 111.

109 ANAO, Report no. 42, 1999–2000, p. 111.

110 Borthwick, *Transcript*, 3 November 2000, p. 64; Watzlaff, *Transcript*, 3 November 2000, pp. 65–68.

111 ANAO, Report no. 42, 1999–2000, p. 94.

112 ANAO, Report no. 42, 1999–2000, p. 94.

> paid at the out-of-hospital rate turned out to be greater than 95%.[113]

3.89 Furthermore, the number of MRI scans continued to exceed the anticipated volume. In 1999–2000, 163 537 scans were performed—15 537 above the Agreement level. As a result, the cumulative overspend at 30 June 2000 was $56m and cumulative expenditure was $1.95 billion.[114] DHAC told the Committee that:

> The Government financed these scans at a total cost of $6 535 982. With an average benefit of $420.67, instead of the expected $410.53, expenditure on MRI was $8 037 012 more than originally anticipated.[115]

3.90 DHAC defined '*cumulative overspend*' as 'the total overspend in the Diagnostic Imaging (DI) Agreement, from the beginning of the DI Agreement until the period specified'.[116] This amount included most services attracting Medicare rebates through the DI Services Table—not just MRI scans. Expenditure on MRI services 'formed only 6.3% of expenditure under the DI Agreement in 1999–2000'.[117] This MRI portion in 1999–2000 was the $6 million overspend detailed by ANAO in its report.[118] DHAC provided the following table to the Committee as a means of explaining the cumulative overspend more clearly:

Table 3.1 Expenditure and overspend arising from the DI Agreement: 1998–2001

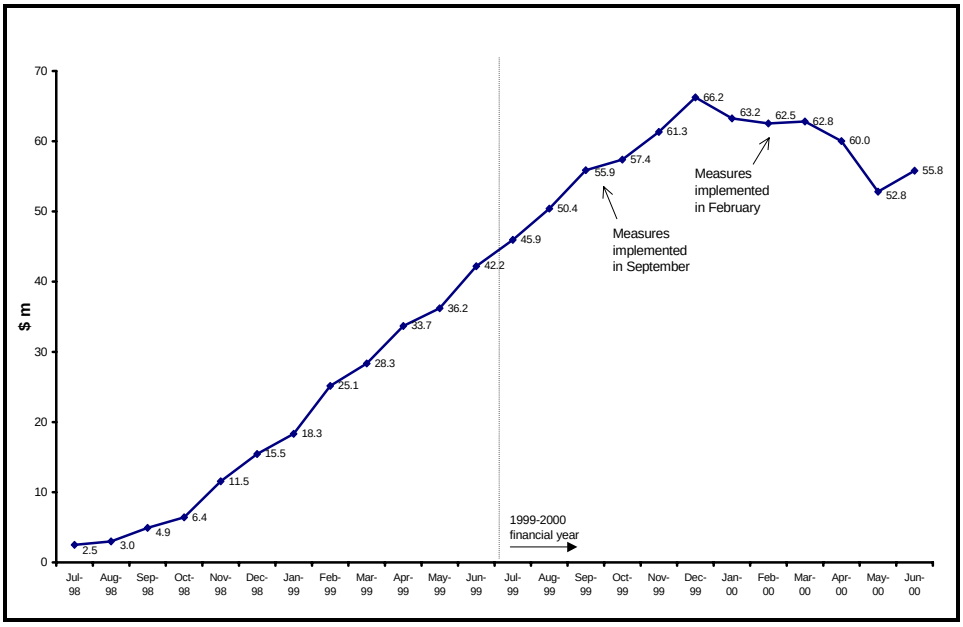
	Anticipated expenditure ($m)	Actual expenditure ($m)	Overspend ($m)	Cumulative overspend ($m)
1998-99	915.3	957.5	42.2	42.2
1999-2000	975.0	988.6	13.6	55.8
2000-01	1,032.2	1,029.6	-2.6	53.2

These figures are for the DI Agreement only—they exclude Nuclear Medicine Agreement expenditure.

Source: DHAC, Submission no. 13, p. 2.

113 DHAC, Submission no. 10, p. 1.
114 DHAC, Submission no. 10, p. 2.
115 DHAC, Submission no. 10, p. 2.
116 DHAC, Submission no. 13, p. 1.
117 DHAC, Submission no. 13, p. 1.
118 ANAO, Report no. 42, 1999–2000, pp. 19, 112.

Figure 3.1 Cumulative overspend in Diagnostic Imaging Agreement 1998–1999 and 1999–2000



Source DHAC, *Annual Report 1999–2000*, October 2000, p. 112

3.91 As shown in Figure 3.1, expenditure on total diagnostic imaging in the first year of the Agreement was almost $42.5 million over the target specified in the 1998 Agreement—namely, about five per cent higher than anticipated. ANAO had reported this amount as almost $46 million,[119] since at the time of the report, the final actual figures had not been calculated. DHAC explained:

> …the anticipated expenditure on MRI was offset by savings in the rest of the diagnostic imaging table.…There was a small wedge above that, which was unanticipated, that amounted to $9.81 million over the first two years. That is the amount that was unanticipated at the time the measure was put in place and which was drawn directly from the public purse, as opposed to what was paid for by the radiologists by taking reductions in rebates in the imaging table.[120]

3.92 DHAC informed the Committee that the savings made by 30 June 1999 was '$76.9m on the 1996 forward estimates' and $171.9m by 30 June 2000, were the MRI Agreement not negotiated.

119 ANAO, Report no. 42, 1999–2000, pp. 111.

120 L. Morauta, *Transcript*, 3 November 2000, pp. 67–68.

This made a cumulative savings of $248.8m.[121] In comparison, total expenditure on MRI rebates was $114.2m for the period September 1998—when MRI benefits were introduced—to 30 June 2000.[122]

3.93 The Committee expressed concerns about conferring a financial benefit on machines which may have been obtained as a result of backdated contracts or through other irregular means. In response, DHAC explained:

> As for the exclusion of individuals, unless these are some of the established cases of overservicing or criminal conduct or something of that kind, there is no gateway by which we could reject an application from a radiologist.[123]

3.94 Responding to a question taken on notice, DHAC submitted to the Committee that 19 MRI machines which had been installed and were attracting Medicare rebates during the period 1 September 1998 to 31 October 1999, lost their eligibility status as a result of the revised cut-off date. The revised cut-off date of 10 February 1998 came into effect on 1 November 1999.[124] Approximately $8.2m was paid in Medicare benefits to these 19 machines during the period when they were considered eligible for payments.[125] Individual levels of rebates ranged from $56 791 to $1 291 972.[126] Total expenditure on MRI benefits totalled $114 191 958 for the period September 1998 (when MRI benefits were introduced) to June 2000.[127] DHAC, however, is not able to determine whether rebates for individual units were able to cover capital costs.[128]

3.95 The Committee was informed by HIC that MBS rebates are 'a flat fee' encompassing 'within it a notional component for capital as well as recurrent costs'.[129] Because of the way rebates are paid, HIC is not in a position to recover moneys paid out for those services which had already attracted MBS payments.

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121 DHAC, Submission no. 10, p. 2.
122 DHAC, Submission no. 10, p. 2.
123 Watzlaff, *Transcript*, 3 November 2000, p. 76.
124 DHAC, Submission no. 2, p. 2.
125 DHAC, Submission no. 2, p. 3.
126 DHAC, Submission no. 2, p. 4.
127 DHAC, Submission no. 10, p. 2.
128 DHAC, Submission no. 2, p. 4.
129 Morauta, *Transcript*, 3 November 2000, p. 80.

3.96 DHAC said a number of measures had been implemented subsequently to restrict the growth rate of MBS claims for MRI services. These are:

- The cut-off date by which the unit was ordered or installed;
- The siting of a MRI unit within a medical practice or radiology department of a hospital;
- MRI services are to be delivered by an eligible specialist in diagnostic radiology who has been accredited;
- The requirement for a specialist referral for MRI services;
- The establishment of the MRI Monitoring and Evaluation Group.[130]

3.97 The change in the regulatory environment retrospectively on 1 November 1999, however, means that some MRI scanners are no longer able to offer MBS subsidised services after that date. Those radiologists no longer eligible for MBS rebates:

> …are either billing for services that are not covered by the MBS but [are] private services, and there is quite a range of those, or they might be billing just a small amount—in other words, not what they would otherwise wish to bill because there might be a free MRI service.[131]

3.98 DHAC pointed out that it is possible for some private MRI market to exist 'because of the narrow indications that are on the MBS and because of public hospital in-patients services'.[132] The Committee accepts that there is a private market for MRI services.

3.99 In response to further questioning by the Committee, DHAC stated: 'The profession bore the cost of the higher-than-anticipated average benefit level.'[133] Because the average benefit was $421.24 instead of $410.53—and over 95 per cent of benefits paid at the out-of-hospital rate, the cost of scans totalled $104 383 761 instead of $101 811 440. 'This, in effect, meant that there was $2 572 321 less funding available from the DI Agreement's agreed funds for the other modalities.' DHAC explained that an important principle of the DI Agreement was that savings in some areas of diagnostic imaging should be used to pay for increased expenditure in other areas.[134]

130 DHAC, Submission no. 4, pp. 3–4.

131 Borthwick, *Transcript*, 3 November 2000, p. 80.

132 Morauta, *Transcript*, 3 November 2000, p. 81.

133 DHAC, Submission no. 10, pp. 1–2.

134 DHAC, Submission no. 11, p. 1.

Committee comments

3.100 The Committee is firmly of the opinion that agencies involved in sensitive negotiations should develop systematic procedures to circumvent any future occurrence of a similar nature.

3.101 First and foremost, all agencies responsible for policy development and policy advice, should develop and implement a risk management strategy which anticipates all possible eventualities within a sensible time frame. In doing this, consideration should be given to all relevant issues and to the assessment of risk as well as to what would be considered acceptable risks. Sensible plans of action have to be clearly thought through to deal with levels of risk and other unusual developments. Throughout the process, officers involved should focus on accountability as well as outcomes.

3.102 Where stakeholders and peak interest groups are consulted and involved in policy development, clear written requirements have to be drafted so that all are aware of the confidentiality level of the information being considered and their obligations and responsibilities to protect this information. Potential conflicts of interest have to be considered so that all are aware of their accountability responsibilities and the penalties for any breaches.

3.103 Thought also needs to be given to the implementation of the policy once a government has made a decision. For instance, it would have been sensible for DHAC to advise the Minister, from the beginning, that only MRI scanners negotiated or leased before or on 10 February 1998 and installed by Budget night would be eligible for MBS rebates, instead of giving this advice some 18 months later and seeking to impose the cut-off date retrospectively.

3.104 The Committee believes that all agencies which are involved in contract management or are considering it, should integrate the ANAO *Better Practice Guide to Contract Management* into their policy and practices.

The quality of the administrative processes supporting the implementation of the MRI Budget measure

3.105 The Committee acknowledges that without the Agreement and the subsequent development of the Regulations, MRI services would have remained limited and expensive. Problems arose because implementation did not focus on:

> …the number of MRI machines, and perhaps it should have been, with hindsight; it was directed to what the number of services was that could be clinically justified. It was not directed at the number of machines. The risk management was all in terms of the number of clinical services.[135]

Administrative outcomes achieved

3.106 Following the Agreement, the rate of growth in MRI services was rapid in the first six months (from just over 2000 services in September 1998 to 10 000 in February 1999 and 14 000 by March 1999), before settling to a slower growth.[136] 'The data indicates a statistical association between the increase in eligible machines and the number of services (up to October 1999, at which time the eligibility date was changed).'[137] ANAO concluded:

> …one of the key concerns arising in relation to this audit was whether there was a leak of Budget information which led to this pre-Budget rush of orders.[138]

Cut-off dates

3.107 On 13 September 1999, the Minister, faced with increased claims, set 11 October 1999 as the cut-off date for registration. At that time, there were 111 units registered. Of these, 65 were deemed eligible for MBS rebates—59 were actually installed and operating by 12 May; 3 units had been ordered prior to 10 February; and 3 more were in non-metropolitan areas.[139] The remaining 46 units

135 Borthwick, *Transcript*, 3 November 2000, p. 64.
136 ANAO, Report no. 42, 1999–2000, p. 108.
137 ANAO, Report no. 42, 1999–2000, p. 108.
138 ANAO, Report no. 42, 1999–2000, p. 21.
139 Watzlaff, *Transcript*, 3 November 2001, p. 65.

under contract were 'frozen out'[140], despite having been processed as lodging eligible statutory declarations with HIC, by 12 August 1999.[141] At the time of the public hearing—3 November 2000, a total of 83 machines were eligible for MBS benefits.[142]

3.108 The public announcement of a cut-off date was followed by the lodging of a further 13 applications.[143] When claims continued to grow—in excess of the predicted level and in excess of what was required to meet Australian needs—DHAC advised the Minister to alter the cut-off to 10 February 1998, effective from 1 November 1999. An exception was made, however, for those 17 scanners in non-metropolitan regions.[144]

Committee comments

3.109 DHAC's original risk management strategy failed. All MRI scanners assessed as eligible for benefits, received them. Once paid, these benefits could not be recovered, even though the machines were ineligible because of the cut-off date. The large number of machines on order exceeded that anticipated by DHAC. The Minister was not kept informed as he should have been. ANAO stated in its report that it was the Minister who insisted that something be done as soon as he found out that new machines were still being registered.[145]

The HIC investigation

3.110 As noted in paragraph 3.49, HIC which was processing the claims, backed by statutory declarations, was not informed about allegations of back-dating and other complaints.[146] It was not till HIC itself received an anonymous allegation in November 1998 that any investigation began.[147]

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140 Watzlaff, *Transcript*, 3 November 2001, p. 66.

141 ANAO, Report no. 42, 1999–2000, p. 106.

142 This total comprises the original 18 units operating prior to 1997 together with the 65 units eligible under the DI Agreement. Blandford, *Review*, p. 20.

143 ANAO, Report no. 42, 1999–2000, p. 106.

144 Watzlaff, *Transcript*, 3 November 2000, p. 66; ANAO, Report no. 42, pp. 106–107.

145 ANAO, Report no. 1999–2000, 42, p. 106.

146 ANAO, Report no. 42, 1999–2000, pp. 105, 115.

147 ANAO, Report no. 42, 1999–2000, p. 105.

3.111 ANAO found that it took three months before HIC's first interview was conducted in March 1999. Apparently, not all the relevant documents had been passed on to HIC which experienced difficulty internally, extracting the relevant data from its own records.

> This was because the statutory declarations provided by applicants did not have to include details of the contract and it was therefore necessary to examine the contracts accompanying the statutory declarations; and because the relevant documents were not filed by the HIC in a systematic way.[148]

3.112 HIC did not complete its investigation and present its report to the Minister till 23 December 1999, well after the Minister had requested an audit from ANAO and asked Professor Blandford to review MRI services.[149] The complexity and scope of the HIC investigation increased proportionally as the number of registrations grew until the cut-off date for registration was imposed. Each interviewee had to be given 14 days notice and the interviews themselves were complex. Some parties had to be interviewed more than once. For each of the 19 cases referred to the DPP, a detailed briefing had to be prepared.[150]

3.113 ANAO indicated in its report that HIC underestimated the scope and complexity of its investigation. This affected its project plan, project management procedures, its costing and resourcing:

> …the evidence indicates that the widening scope of the investigation was not responded to promptly enough in terms of adequately matching resourcing to the task.[151]

> **…**there were no formal reviews of progress of the investigation which provided justification for additional resources, an increase in the Budget and a change in the milestones.[152]

3.114 The delay in presenting the HIC investigation report to the Minister meant that it was not till 23 December 1999 that the

148 ANAO, Report no. 42, 1999–2000, p. 117.
149 ANAO, Report no. 42, 1999–2000, p. 120.
150 ANAO, Report no. 42, 1999–2000, p. 117–118.
151 ANAO, Report no. 42, 1999–2000, p. 119.
152 ANAO, Report no. 42, 1999–2000, p. 120.

Minister announced that 19 MRI contracts had been referred to the DPP for possible legal action.

3.115 After extensive investigation, on 27 September 2000, the DPP advised that:

> …there is insufficient evidence to meet the test in the Prosecution Policy of the Commonwealth that there be a prima facie case with reasonable prospect of conviction for a prosecution to proceed.[153]

Conclusion

3.116 Having considered the evidence presented, the Committee believes that lessons have been learnt from the whole MRI exercise.

3.117 The Government's stated aim in negotiating the 1998 MRI Budget measure was to improve public health by facilitating increased access to an important diagnostic tool, while constraining the growth in Government funding, and achieving a better distribution of MRI services across Australia. The MRI Budget measure, however, did not fully constrain cost growth or achieve the desired distribution, and was accompanied by serious concern about probity questions.

3.118 The importance of careful planning and of comprehensive consideration of all likely issues involved in such an exercise cannot be emphasised enough. DHAC states that it realises the importance of:

- full and accurate record keeping;
- comprehensive risk analysis;
- ensuring that stakeholders are fully briefed on the confidentiality of information being shared;
- documenting possible conflicts of interest and having procedural measures to address these;
- developing risk management strategies which anticipate all likely variations and at all levels of the organisation;

153 HIC, Media Release, 27 September 2000, p. 1.

- keeping the HIC fully informed; and
- having processing procedures which are fully accountable.

3.119 Despite the comments made in DHAC's *Annual Report 1999–2000*[154], the Committee remains concerned that DHAC still seems to deny the magnitude of the problems associated with the MRI Budget measure and its implementation. **The Committee would have more confidence in improved future performance by DHAC if DHAC frankly recognised and addressed these major flaws.**

154 DHAC, *Annual Report 1999–2000*, 1999–2000, pp. 5, 114.

4

Audit Report No. 46, 1999-2000

High Wealth Individuals Task Force

Australian Taxation Office

Introduction

4.1 During 1995-96, the Australian Taxation Office (ATO) raised concerns about the income tax compliance behaviour exhibited by some wealthy individuals. Many of these taxpayers and their related entities paid very little tax. The ATO's estimate of revenue potentially at risk was $800 million per year.[1]

4.2 In 1996, the Commissioner of Taxation set up a High Wealth Individuals (HWI)[2] Taskforce to:

- act on tax planning techniques already identified;
- gain an expanded and comprehensive understanding of the techniques employed; and
- continue to identify, monitor and address emerging techniques.[3]

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1 ANAO, Report No. 46, 1999-2000, p. 9.

2 The ATO defines an HWI as an individual who owns or controls net wealth of $30 million or more.

3 ANAO, Report No. 46, 1999-2000, p. 18.

4.3 To enhance the ATO's investigations into HWIs' compliance with tax laws, the Government allocated in the 1996-97 Budget additional funds to the ATO of $9.7 million in 1996–1997 and $9.5 million in 1997–1998. In the 1998-99 Budget, the Government extended funding for a further two years, allocating $9.5 million in both 1998–2000 and 1999–2000. [4]

4.4 The Government expected that improvements in compliance by HWIs as a result of the activities of the taskforce would generate revenue in the order of $100 million in 1997–1998. The Government required additional revenue from taskforce activities of $100 million in both 1998–1999 and 1999–2000.

4.5 The Government's decision to provide additional resources to the ATO required the HWI taskforce to accomplish the following two outcomes:

- undertake ongoing investigation and management of the payment of income tax by high wealth individuals (to yield an estimated $100 million in additional revenue in each of 1997–98, 1998–99 and 1999–2000); and
- develop administrative responses and, in association with Treasury, legislative proposals to address undesirable tax minimisation practices as they were identified.[5]

4.6 In Audit Report No. 46, *High Wealth Individuals Taskforce*, the aim of the audit was to examine and report on the management and operations of the HWI taskforce. In doing so, the ANAO reviewed the ATO's own evaluation of the taskforce and assessed the performance of the taskforce against the outcomes specified by the Government.[6]

4.7 The ANAO concluded that the management and operations of the taskforce was effective, and that the taskforce:

- managed the investigation of the tax affairs of HWIs in accordance with the ATO's risk management principles;
- was achieving the revenue targets set by government;

4 ANAO, Report No. 46, 1999-2000, p. 9.
5 ANAO, Report No. 46, 1999-2000, pp. 9-10.
6 ANAO, Report No. 46, 1999-2000, p. 23.

- had contributed to the development of administrative and legislative proposals to address undesirable tax minimisation practices; and
- could improve its reporting of taskforce outcomes.[7]

4.8 The ANAO made three recommendations aimed at improving the public reporting of the outcomes of the HWI taskforce's work and maintaining the focus and specialist resources in the ATO to manage the risk to revenue associated with the HWI population.[8]

4.9 The ATO agreed to all of the recommendations in the audit report and indicated at the public hearing that the recommendations were being implemented.[9]

4.10 At its hearing on 3 November 2000, the Committee took evidence from the ATO and the ANAO on the following issues:

- taskforce resourcing;
- litigation and settlement;
- revenue;
- taskforce involvement in addressing tax minimisation techniques; and
- taskforce reporting of outcomes.

Corporate governance framework

Taskforce resourcing

Memorandum of understanding

4.11 The HWI taskforce prepared a memorandum of understanding (MoU) with the Department of Finance (DoFA) covering the recording of revenue raised by the taskforce. The MoU was associated with the additional funding provided to resource the taskforce.[10]

7 ANAO, Report No. 46, 1999-2000, p. 10.
8 ANAO, Report No. 46, 1999-2000, pp. 12-13.
9 K Fitzpatrick, *Transcript*, 3 November 2000, p. 85.
10 ANAO, Report No. 46, 1999-2000, p. 55.

4.12 The Committee wished to know whether a substantial part of the funding for the taskforce had been determined by a resource agreement with DoFA.[11]

4.13 The ATO stated that the MoU did not determine the resources the ATO allocated to HWIs and that it was a reporting mechanism established because of the additional funding provided by government:

> I would regard the memorandum of understanding as a reporting by the Tax Office to the Department of Finance and Administration on the allocation of that additional funding and what was being achieved with that additional funding. [The MoU] did not determine how many resources were put into looking at high wealth individuals in the Tax Office.[12]

Taskforce funding

4.14 The specific purpose funding granted to the ATO for the establishment of the taskforce will cease at the end of 1999-2000.[13]

4.15 The Committee sought to ascertain the extent of ongoing resourcing to be provided to the taskforce by the ATO into the future.[14]

4.16 The ATO responded that it had made a decision to continue with the taskforce approach of looking at high wealth individuals:

> Each year we make assessments of risk…as to where we allocate our resources. Obviously, the Tax Office, as I am sure you appreciate, has a major job at the moment in implementing tax reform. A lot of our resources go toward that. We have other risk areas, the cash economy, for example. We allocate those resources, as has already been discussed, on a risk management approach each year, but clearly we have made a conscious decision to continue with this area of our work.[15]

4.17 The ATO indicated in the audit report that a continuing resource level of approximately 120 staff as well as additional

11 *Transcript*, 3 November 2000, p. 96.
12 Fitzpatrick, *Transcript*, 3 November 2000, p. 97.
13 ANAO, Report No. 46, 1999-2000, p. 26.
14 *Transcript*, 3 November 2000, p. 101.
15 Fitzpatrick, *Transcript*, 3 November 2000, p. 101.

administrative and legal costs would be provided for this area in 2000–2001. Furthermore, other areas of the ATO worked with the HWI taskforce:

> For example, we call in experts from our tax counsel network and our international tax division within the ATO. Other areas, particularly the large business area of the ATO, are working on some high wealth individual cases.[16]

4.18 In addition, the ATO commented that some ATO base funding was used to access external expertise.[17]

4.19 By way of explanation, the ANAO noted that in 1999–2000, overall funding for the HWI taskforce was approximately $15 million, of which $9.5 million was additional funding.[18]

4.20 The Committee sought a response from the ANAO as to whether additional ATO resources would lead to the collection of more revenue.[19]

4.21 In reply, the ANAO commented:

> … it is never easy for government to handle that particular issue. As Mr Fitzpatrick has mentioned, the Tax Office uses a risk profiling approach to determine the allocation of resources. I think it is pretty hard to argue conceptually with that, although there is always the view that, if you can continue to make $2 for every $1 you put into the Tax Office, why doesn't the Government pump in another $500 million to make more? ….These are very difficult decisions for Government and they get made in the budget context.[20]

Committee comments

4.22 The ANAO and the Committee agree that providing additional resources to the HWI taskforce would run into the marginal cost argument and the law of diminishing returns. The Committee notes the opportunity cost of increased resources for the HWI

16 Fitzpatrick, *Transcript*, 3 November 2000, p. 93, ANAO, Report No. 46, 1999-2000, p. 26.

17 Fitzpatrick, *Transcript*, 3 November 2000, p. 93.

18 P White, *Transcript*, 3 November 2000, p. 93.

19 *Transcript*, 3 November 2000, p. 100.

20 I McPhee, *Transcript*, 3 November 2000, p. 101.

taskforce and the possibility that those resources may be used more effectively elsewhere.

4.23 The Committee endorses the ATO's allocation of resources based on a properly planned risk management approach.

Litigation and settlement

4.24 The HWI taskforce established a Compliance Management Strategy to address its responsibilities. One of the elements of this strategy is litigation and prosecution.[21]

4.25 In the audit report, the ANAO commented:

> Disputed assessments are inevitable given the complexity of tax arrangements utilised by some HWIs and the differing interpretations that can be applied to the provisions of existing tax law. That is, there are circumstances in which the amount of tax payable is not clear. At February 2000, 13 HWI cases were on hand where tax outstanding [was] disputed. In some cases, the factual and legal complexities and difficulties in obtaining evidence mean that cases of disputed assessments would be unsuitable to proceed to court, and are best resolved if an appropriate result can be achieved by means of settlement.[22]

4.26 The ANAO noted the request of the Senate Economics and References Committee for it to consider the taskforce's approach to handling tax in dispute. The ANAO found that the taskforce conducted settlement processes in accordance with the ATO's *Code of Settlement Practice* and that settlement processes had been conducted with a view both to protection of the revenue outcomes possible and to the ongoing maintenance of fairness to the HWI taxpayer concerned.[23]

4.27 The Committee asked about the negotiating process with a HWI or entity.[24]

4.28 The ATO outlined the approach it applies to large business, including HWIs:

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21 ANAO, Report No. 46, 1999-2000, p. 29.
22 ANAO, Report No. 46, 1999-2000, p. 40.
23 ANAO, Report No. 46, 1999-2000, pp. 40, 41.
24 *Transcript*, 3 November 2000, p. 108.

> When we do an audit, we look at the issues…and come to a view based on the facts available as to how we see the law applying. We then issue what we call a position paper, which outlines the facts as we understand them and our view of how the law operates or applies to those facts; and we would generally propose to amend assessments in accordance with that view. We enable taxpayers and their advisers to respond to that and tell us where we have got it wrong, on either the facts or our view of the law. …that is generally done before any amended assessments are issued.
>
> Sometimes the taxpayers or their advisers come back to us and we accept that we got the facts or the law wrong and an assessment might be issued for what would be a lesser amount than otherwise would have been the case pursuant to our position paper. Sometimes there is a settlement discussion of what should be the right tax outcome. Sometimes there is no agreement and assessments are issued and there may well be litigation or subsequent discussions at a later stage which resolve a case.[25]

4.29 The Committee inquired whether the taskforce had evaluated in any quantitative way the success of the taskforce's litigation program:

> Did it, for example, evaluate how much tax was being deferred by the length of litigation proceedings? Did it examine in any quantitative way the decision that had been made to settle vis-à-vis taking cases to court?[26]

4.30 In reply, the ATO stated:

> In terms of the litigation, [the ATO] did not look at the monetary value that was being either held up or fought. ….We examined the procedures that led to settlement to ensure that they actually met with the general tax office guidelines.[27]

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25 Fitzpatrick, *Transcript*, 3 November 2000, p. 108.

26 *Transcript*, 3 November 2000, p. 91.

27 L Roe, *Transcript*, 3 November 2000, p. 91.

4.31 The ATO made the point that it did not have control over whether a taxpayer went to litigation on an issue.[28]

4.32 In response to the Committee's question asking whether many taxpayers litigated cases to defer paying tax, the ATO stated that tax was not always deferred in full because a case is before the courts. 'Some taxpayers agree to pay part of the tax in dispute whilst the matter is before the courts or the Administrative Appeals Tribunal.'[29]

4.33 The ATO pointed out that if the tax in dispute was not paid, a significant general interest charge accrued.[30]

Committee comments

4.34 In terms of litigation the ANAO identified that there was a risk management process in place, and that the ATO was systematic in identifying which cases went to court. The ANAO also followed up a recommendation of the Senate Economics References Committee and reviewed the actual settlement guidelines being applied.

4.35 The Committee notes that the ATO has a fairly rigorous process in place to guide settlements.

Taskforce outcomes

Revenue

4.36 Based on analysis of a sample of taxpayers and their related entities, a figure of $800 million per year was derived by the ATO as an order of magnitude estimate of revenue potentially at risk from aggressive tax planning and minimisation arrangements used by some HWIs.[31]

28 Fitzpatrick, *Transcript*, 3 November 2000, p. 93.
29 Fitzpatrick, *Transcript*, 3 November 2000, p. 94.
30 Fitzpatrick, *Transcript*, 3 November 2000, p. 94.
31 ANAO, Report No. 46, 1999-2000, pp. 9, 20.

4.37 The Committee asked the ANAO whether it had made an independent assessment of the revenue being lost or at risk from the activities of HWIs.[32]

4.38 The ANAO stated that while it had not made an independent assessment, it had looked at the advice provided to the previous government and found no reason to dispute the assessment of $800 million per year potentially at risk.[33]

4.39 In providing additional funding to the taskforce, the Government's required revenue targets for the taskforce were $100 million in each of 1997-98, 1998-99 and 1999-2000.[34]

4.40 The ANAO found that although the taskforce's reporting arrangements could be improved, the direct revenue outcomes reported by the taskforce were supportable. It also found that the indirect revenue figures represented a reasonable estimate resulting from the activities of the taskforce.[35]

4.41 The ANAO concluded that the taskforce had achieved its revenue targets for 1997–98 and 1998–99. The taskforce's direct and indirect revenue outcomes since it was created in 1996 are summarised in Table 4.1.[36]

4.42 The Committee inquired of the ATO whether the taskforce had met its revenue outcomes for 1999–2000.[37]

4.43 The ATO responded that the taskforce had met its revenue outcomes for 1999–2000 and, moreover, that it had attempted to report on revenue outcomes in a consistent way.[38]

32 *Transcript*, 3 November 2000, p. 90.
33 Roe, *Transcript*, 3 November 2000, p. 91.
34 ANAO, Report No. 46, 1999-2000, p. 48.
35 ANAO, Report No. 46, 1999-2000, pp. 48, 49, 51.
36 ANAO, Report No. 46, 1999-2000, pp. 52, 53.
37 *Transcript*, 3 November 2000, p. 105.
38 Fitzpatrick, *Transcript*, 3 November 2000, pp. 105-6.

Table 4.1 HWI Taskforce—Revenue Outcomes

Year of Collection	Direct Revenue ($m)	Indirect Revenue ($m)[1]	
		Companies	Individuals
1996–1997	37.804	28	3
1997–1998	23.014	48	5
1998–1999	63.890	104	5
1999–2000	(3) 38.867	(2)	(2)
TOTAL(4)	163.575	180	13

Source: ANAO analysis of ATO quantitative data, *Audit Report No. 46*, *1999-2000*, p. 52

Notes:

(1) Indirect revenue figures are derived, rather than representing actual cash collection figures, and hence are shown as rounded figures.
(2) Indirect revenue impacts of taskforce activities are not available yet for the 1999–2000 year as calculations can only be completed when processing of all income tax returns for the year has been completed.
(3) Direct revenue collections for 1999–2000 apply up to 14 April 2000.
(4) As a result of rounding, individual components may not add to totals.

Taskforce involvement in addressing tax minimisation techniques

4.44 One of the objectives of the HWI taskforce was to identify and provide advice on tax planning techniques being utilised by HWIs, and to recommend areas requiring reform through subsequent legislative action to address some of the undesirable elements of these activities. The audit report stated:

> The ANAO has sighted evidence that the taskforce has provided a number of substantial reports covering tax minimisation techniques in use by some HWIs and that it has suggested areas for systemic policy reform to Government. The ANAO is aware also that the taskforce has circulated a number of internal working papers within the ATO covering both identified questionable tax planning techniques and possible action that may be taken to address them.[39]

4.45 The audit report noted that as legislative amendments in the taxation area were commonly initiated and developed through joint input within the ATO and with Treasury involvement, it was

39 ANAO, Report No. 46, 1999-2000, p. 56.

not possible to attribute action taken by government to legislate in particular areas, including those affecting HWIs, as being solely the result of the activities of the taskforce. However, it was clear to the ANAO that taskforce examination of techniques used by HWIs and subsequent advice by the taskforce had contributed information that the Government had acted upon.[40]

4.46 In response to a Committee question, the ANAO confirmed that while it did not itemise taskforce submissions to government against legislative action taken, there had been a very substantial volume of advice from the taskforce (coordinated through the ATO to Treasury) to government.[41]

4.47 The Committee inquired whether the ATO would be willing to provide the Committee with copies of the advice put to government.[42]

4.48 The ATO, in reply, stated:

> Our advice to government is provided in the normal way. It is up to the government to decide what it wants to do with that advice in the sense of policy change. With respect to the approach we have taken in this area of our work in more recent times, we certainly provided advice to the Ralph review of business tax reform to assist that review to formulate its recommendations to government. Before that, we had provided advice to government on the findings of the task force and our recommendation on what some high wealth individuals were doing to minimise tax. But it is not normal for the ATO to provide advice that it gives to government to anybody else.[43]

4.49 However, the ATO noted, as outlined in the audit report and its own annual report, that it had advised the government on areas of the law where people were able to minimise tax:

> We have attempted to identify the systemic drivers of tax planning, looking for systemic approaches to addressing some of those practices through legislative change …. We have looked at the tax planning practices over the period on time and … at the systemic weaknesses in the law and

40 ANAO, Report No. 46, 1999-2000, p. 57.
41 Roe, *Transcript*, 3 November 2000, p. 91.
42 *Transcript*, 3 November 2000, pp. 91-2.
43 Fitzpatrick, *Transcript*, 3 November 2000, p. 92.

> provided advice accordingly. It is for government and the parliament to decide whether it wishes to change the law to remedy what we see as areas where taxpayers are able to minimise tax.[44]

4.50 The Committee put the view that if the ATO recommended to government that a tax loophole be closed and estimated the revenue effect, and the government did not accept the recommendation, then the loophole effectively became a tax concession.[45]

4.51 The ATO responded:

> … the tax profession does not always agree with the Tax Office on whether a particular area of the law is a loophole or not. There is a lot of debate on whether a particular piece of law is appropriate, whether it is tax avoidance or not tax avoidance, whether it is being exploited or otherwise.[46]

4.52 The Committee then asked whether the ATO thought it should release information on the tax benefit of such loopholes or concessions.[47]

4.53 In reply, the ATO stated:

> To the extent to which it is reasonably measurable….But it depends on what information is available. If the government of the day decides that a particular concession continues to be available, or there is no need in its view to change a particular area of the law which the tax office might believe enables people to minimise, as distinct from avoid or evade taxes, we do not necessarily then continue to look at that particular area so we can properly measure what is going on. The decision has been made. This is a legally available way of reducing one's tax. We are not going to devote significant resources to see what is then happening.[48]

4.54 The Committee questioned the ATO on the estimate of revenue likely to be achieved from the legislative changes it had

44 Fitzpatrick, *Transcript*, 3 November 2000, p. 95.
45 *Transcript*, 3 November 2000, pp. 101-2.
46 Fitzpatrick, *Transcript*, 3 November 2000, p. 103.
47 *Transcript*, 3 November 2000, p. 102.
48 Fitzpatrick, *Transcript*, 3 November 2000, p. 102.

recommended to the Treasurer to deal with the activities of HWIs but which have not been implemented.[49]

4.55 The ATO indicated that it was not possible for it to provide an estimate of likely additional revenue from HWIs in respect of legislative changes which had not been implemented.[50]

4.56 The Committee asked whether the ATO could estimate the revenue collected as a result of legislative measures which had been introduced by the Government in recent years, and which were outlined in the audit report.[51]

4.57 The ATO could not give an estimate of the revenue impact of these legislative measures.[52]

4.58 The ANAO sighted evidence that the taskforce had provided a number of substantial reports covering tax minimisation techniques in use by some HWIs and had suggested areas for systemic policy reform to Government.[53]

4.59 On the basis of evidence gathered by the taskforce to date, the taskforce considers that the most significant systemic generators of tax planning by HWIs are the use of trusts and related party or intra-group transactions. [54]

4.60 The Committee asked the ATO to confirm a view that the ATO expected the Government's proposed business tax reforms, including the taxation of trusts through the new entity tax system, would address major deficiencies in the current tax system.[55]

4.61 The ATO responded:

> The ATO expects that some of the tax planning arrangements of some high wealth individuals will be addressed by the proposed reforms to the taxation of trusts and also to the proposed reforms – or, in some cases, already enacted reforms – to intragroup arrangements involving losses. …. In our view, those so-called integrity measures will have an impact on some of

49 ATO, Submission No. 6, p. 2.
50 ATO, Submission No. 6, pp. 2-3.
51 *Transcript*, 3 November 2000, p. 98; ANAO, Report No. 46, 1999-2000, p. 57.
52 *Transcript*, 3 November 2000, p. 98.
53 *Audit Report No. 46, 1999-2000,* p. 57.
54 *Audit Report No. 46, 1999-2000,* p. 58.
55 *Audit Report No. 46, 1999-2000,* p. 58, *Transcript*, 3 November 2000, p. 92.

> the arrangements entered into by taxpayers, including some high wealth individuals.[56]

4.62 The Committee asked whether it was possible to know what revenue would be foregone in exempting trusts other than discretionary trusts from the Ralph integrity measures.[57]

4.63 In response, the ATO stated that:

> It is certainly our experience, not just with high wealth individuals, … that the minimisation of tax has occurred through the use of discretionary trusts, essentially. …. it is the area of discretionary trusts which has in the existing law enabled people to minimise tax more than fixed trusts have.[58]

4.64 In reply to the Committee's query as to whether the ATO would model the revenue effect of not applying company tax rates to unit trusts, the ATO stated that it '… would need to look at whether there would be a risk to the revenue through the use of fixed trusts', but that essentially, it was a policy issue.[59]

4.65 The Committee asked whether the ATO or Treasury had a model which could predict revenue effects of applying company tax to both discretionary and fixed trusts as opposed to just discretionary trusts.[60]

4.66 The ATO indicated that it did not have such a model and that it was not aware of the situation in Treasury.[61]

Taskforce reporting of outcomes

4.67 The audit report concluded that while there had been some public release of information on the taskforce's activities, the external reporting of the taskforce's performance that had taken place since its creation could have been more comprehensive. The ANAO acknowledged the augmented release of information on HWI taskforce activities provided in the Commissioner of Taxation's *Annual Report 1998-99*:

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56 Fitzpatrick, *Transcript*, 3 November 2000, p. 92.
57 *Transcript*, 3 November 2000, p. 106.
58 Fitzpatrick, *Transcript*, 3 November 2000, p. 106.
59 Fitzpatrick, *Transcript*, 3 November 2000, p. 109.
60 *Transcript*, 3 November 2000, p. 109.
61 Fitzpatrick, *Transcript*, 3 November 2000, p. 109.

> This release of more detailed material than previously allows for more informed public and parliamentary scrutiny of the activities of an important and relatively high profile ATO function.[62]

4.68 The ANAO considered that in the case of revenue collection outcomes, a move to more public reporting at the conclusion of the taskforce's additional funding would serve to demonstrate that ATO compliance activities were directed equitably throughout the taxpayer community, and assist in maintaining taxpayer confidence in the integrity of the tax system in Australia.[63]

4.69 The Committee asked the ATO what it had done to implement the ANAO's recommendation no. 2 that the ATO report publicly each year on the on-going achievements of the HWI taskforce.[64]

4.70 The ATO responded that its major reporting of HWI taskforce work was through the Commissioner's annual report. In the annual report for 1999-2000, the ATO outlined the results of the ATO's work in respect of HWI individuals compliance in revenue terms. The ATO also outlined the tax planning techniques or arrangements used to minimise tax.[65]

4.71 The Committee asked the ATO whether there was not more it could do to implement recommendation no. 2.[66]

4.72 The ATO stated that press releases had been issued over the period of the last four years, and that the ATO was willing to look for '…different ways in which it could communicate to the public what was happening and what had been achieved'.[67]

4.73 The Committee enquired about the possibility of the ATO reporting on the total amount of revenue collected from HWIs and the percentage of that amount due to taskforce activity.[68]

4.74 In reply, the ATO stated that it was attempting to report the increase of revenue in the HWI population, both directly through audit activities in the ATO, including some activities outside the

62 ANAO, Report No. 46, 1999-2000, p. 59.
63 ANAO, Report No. 46, 1999-2000, p. 59.
64 *Transcript*, 3 November 2000, p. 90.
65 Fitzpatrick, *Transcript*, 3 November 2000, p. 90.
66 *Transcript*, 3 November 2000, p. 90.
67 Fitzpatrick, *Transcript*, 3 November 2000, p. 90.
68 *Transcript*, 3 November 2000, p. 107.

taskforce. It was also attempting to report the improvements in voluntary compliance:

> That is the best estimate we can provide, which we call the indirect revenue impact. In our terms, that provides the measurement of the increase revenue from the high wealth individual area of the population…as a result…of the ATO's activities…[69]

Committee comments

4.75 The Committee agrees that publishing the results of and issues involved in the taskforce's operations are important for community education and compliance.[70]

4.76 The Committee notes the ATO's claim that it is attempting to enhance its reporting, and that it takes advantage of opportunities which arise to indicate its strategies and achievements to the community.[71] The Committee also notes that the ATO annual report contains a quantification of the direct and indirect revenue impact of the taskforce's activities. However, the Committee considers that more attention should be given by the ATO to this area.

Recommendation 4

4.77 **The Committee recommends that the Australian Taxation Office make further efforts to promote greater public awareness of the High Wealth Individuals Taskforce's activities and achievements by disseminating more widely the information contained in the Commissioner's annual report.**

Bob Charles

Chairman

28 June 2001

69 Fitzpatrick, *Transcript*, 3 November 2000, p. 108.

70 ANAO, Report No. 46, 1999-2000, p. 59.

71 M Tucker, *Transcript*, 3 November 2000, pp. 90, 108.

Dissenting Report

Audit Report No. 46, 1999–2000

High Wealth Individuals Taskforce

Australian Taxation Office

This dissenting report deals with the failure of the Government to legislate to deal with large scale tax avoidance and evasion techniques utilising trusts.

Introduction

The High Wealth Individuals Taskforce was established by the Commissioner of Taxation in May 1996 as an administrative response to a major problem the Australian Taxation Office (ATO) had identified late in the previous year.

Advice to the Previous Government

Trusts can provide a vehicle for a number of tax avoidance and evasion techniques. Throughout 1994 and 1995 the Treasurer's office pressed Treasury for advice on the extent of the problem and possible remedies. It was raised almost weekly but nothing was forthcoming until November 9, 1995 when the ATO advised that it had uncovered a significant problem using multiple trust structures.

The ATO had obtained software which was capable of finding patterns in large amounts of seemingly unrelated information. Using it, they had found that large numbers of seemingly unrelated trusts were related and a range of techniques were being used by high wealth individuals to reduce tax liabilities to low or negligible levels.

Treasury and the ATO worked on the issue over the next three months, eventually advising the Treasurer that it would be appropriate to make a

public announcement that the government would act to end these practices. The press release issued by then Treasurer Ralph Willis on 11 February 1996 was written directly from the Treasury and ATO advice. It was titled, *High Wealth Individuals - Taxation of Trusts,* and in full, it read:

On November 9, 1995 I was informed by the Australian Taxation Office that as part of the Compliance Enforcement Strategy, authorised by the Government, it had conducted analysis of the accumulation of wealth by certain individuals and the taxes paid by them. That analysis revealed that some high wealth individuals were employing strategies which allowed them to accumulate wealth, enjoy a lavish lifestyle, but pay little or no tax. The analysis was in its early stages but the ATO believed the revenue implications might amount to several hundred million dollars.

At my request, the ATO and Treasury provided more extensive advice and analysis on December 20, 1995. It revealed that in the 1993 financial year, 80 individuals each with a net worth of over $30 million had returned taxable incomes of $20,000 or less. This enabled some of them to qualify for low income rebates, Medicare exemptions, deferral of HECS payments and reduced child support payments. The tax minimisation techniques employed by these individuals mainly involved the use of trusts.

By January 19, 1996, the ATO and Treasury were able to advise that on the basis of the work undertaken to date in respect of 100 wealthy individuals alone, appropriate measures to deal with a range of specific tax minimisation techniques using trusts would produce additional revenue of at least $500 million. Later, at a meeting on January 23, 1996, Treasury gave me verbal advice raising that estimate to $800 million. Some amount could be forthcoming in 1996-97, but the first full year effect would be in 1997-98.

The January 19, 1996 advice also included separate revenue estimates in addition to the $800 million for techniques involving thin capitalisation and abuses of the provisions for payments by trusts to foreign charities.

The ATO has identified a number of complex tax planning arrangements used by some wealthy individuals to avoid tax, these include:

- *the characterisation of income as capital by the use of multiple trust structures to conceal a common controlling mind. If the activities of the various trusts and associated companies were viewed as a whole, the profits of the group could be treated as trading income. The ATO has found a number of cases of wealthy individuals operating over 100 trusts;*
- *the creation of artificial losses (revenue as well as capital) to neutralise otherwise taxable profits, particularly through the use of related party transactions;*

- *distributions to wealthy individuals and family members being disguised as loans and other benefits which are claimed to be non-taxable. In relation to companies this includes exploitation of alleged weaknesses in sections 47A and 108 of the Income Tax Assessment Act 1936, of the deemed dividend provisions;*
- *the continued use of offshore trusts to hold significant funds which seem to be applied for the benefit of wealthy individuals and their families; and*
- *the use of Australian charitable trusts and overseas organisations to disguise benefits provided by family trading trusts to family members.*

Obviously these are not techniques which are practised by the overwhelming majority of trusts operated by and for Australians. Trusts provide an appropriate structure to meet a range of legitimate needs such as for charities, educational and non-profit organisations, deceased estates, a variety of family purposes, and for solicitors and other professionals. The Government will not interfere with these arrangements. The Government undertakes that the measures it will adopt will ensure that activities not involving tax avoidance are not adversely affected.

No responsible government could stand back and let blatant abuse of the tax system by extremely wealthy individuals continue. The ATO is undertaking action to test the effectiveness of the existing law to deal with some of these practices. However, it is not expected that an outcome will be achieved by this means in the near future due to the long time frames involved in testing issues before the courts. The ATO has advised that it is particularly difficult to run test cases in these areas because the individuals concerned will settle at the end of the day rather than have their private affairs or practices exposed in public.

On January 29, 1996, I wrote to the Secretary to the Treasury and the Commissioner for Taxation, asking them as a matter of urgency to develop a legislative response to cover income from the 1996-97 financial year. The new tax measures which the Government will introduce to deal with these specific areas of tax avoidance will be prospective ***not*** *retrospective.*

One of the most important things this Labor Government has given Australia since it was elected in 1983 is a tax system based on the principles of integrity and fairness. Maintaining that basic integrity and fairness requires stamping out tax avoidance wherever and whenever it emerges.

The reason these measures are being announced today is because the Government is seeking a mandate to deal with this area of tax avoidance. We call on the other parties in this election to support these reforms. I am offering Mr Howard a briefing this afternoon from the Commissioner of Taxation.

The Government offered the briefing by the Commissioner of Taxation to the then Opposition Leader because it wanted to ensure that the

Opposition was aware of the serious risk to revenue through the abuse of trusts and to seek bipartisan support for measures to end that abuse. In announcing that it would proceed with legislation to deal with these aggressive tax planning techniques, the Government said that the revenue recovered would not be applied to any additional government spending.

Mr Cox made a formal request through the Committee Secretariat to the Treasury requesting that the JCPAA be given access to the advice provided to the previous Labor Government by Treasury and the ATO on trusts. The Executive Director of Treasury's Budget Group, Mr G J Smith, responded saying: *"…the Committee would be aware that advice provided to governments (both current and previous) by their departments is confidential in order to facilitate an effective advising relationship. Treasury considers that maintaining this confidentiality is in the public interest and is critical for the maintenance of good government."* After receiving a briefing from Mr Smith on the relevant conventions, the Committee did not proceed further with its request.

Response by the then Opposition

The then Shadow Treasurer, Peter Costello, received the briefing from the Tax Commissioner. On 15 February 1999, Mr Costello issued a press release titled *Meeting Our Commitments*, in which he said:

Naturally the Coalition regards Labor's minute to midnight detection of $800 million a year in tax avoidance through the use of trusts as somewhat convenient after more than 13 years of tax administration. Naturally there is considerable suspicion as to whether this sum will be fully recovered.

However, if a small number of wealthy individuals are avoiding proper liability through those schemes, it would be a dereliction of duty not to collect it. The Coalition will take the necessary steps to recover the sum being unfairly avoided.

Tax Commissioner established HWI Taskforce

In May 1996, the Commissioner of Taxation announced that the ATO was developing a comprehensive compliance program to act on the unacceptable tax planning and minimisation techniques already identified in the high wealth individuals (HWI) segment of the taxpayer population.

The ATO intended to get a comprehensive understanding of the tax minimisation techniques of HWIs and continually identify, monitor and address emerging minimisation techniques.

The Commissioner noted that the package of measures to be undertaken would include, as appropriate; information collection and analysis; release of rulings clarifying the ATO's view of how the law applied to particular arrangements; litigation to test the law; audit and prosecution activity; and recommendations to the Government on appropriate legislative responses.

In the 1996 Budget papers, the Treasurer, Peter Costello, said:

The revenue at risk from aggressive tax planning and minimisation arrangements used by some high wealth individuals, has been estimated at $800 million a year. Treasury and the ATO caution that this estimate is subject to uncertainties about wealth data, remedial measures, utilisation of losses and behavioural responses by affected taxpayers. This figure should be seen as an order of magnitude estimate of the 'revenue potentially at risk' rather than as the 'sum of gains from particular measures'.

Taskforce investigation will first identify the nature of the problem and mechanisms used, then design counter measures expected to generate revenue beyond 1997-98. [Treasurer, *Meeting our Commitments, Budget Statement,* 20 August 1996]

In the 1996 Budget, the Government allocated additional funds to the ATO ($9.7 million in 1996-97 and $9.5 million in 1997-98) for the operation of the HWI Taskforce. In announcing the additional funding, the Treasurer said:

Enhanced investigation activity and analysis will allow a greater understanding of the complex arrangements used by some high wealth individuals to minimise tax, and to progressively develop administrative and legislative proposals to deal with these arrangements and others that may be put in place in the future. [Treasurer, Budget Speech 1996-97, 20 August 1996]

In the 1998-99 Budget, the Government extended funding for the Taskforce for a further two years—allocating $9.5 million in each of 1998-99 and 1999-2000. The Government provided this additional revenue on the basis that additional revenue of $100 million was to be achieved each year for the additional outlay of approximately $10 million, a ten to one ratio.

A New Tax System

The Howard / Costello Government proposed legislation to provide for the consistent treatment of entities in the document *A New Tax System* (ANTS) released before the 1998 federal election.

These were measures to ensure that taxpayers in similar circumstances would pay the same tax, regardless of the type of entity through which they chose to operate.

The entity taxation proposals specifically in relation to trusts, were estimated in that document to provide additional revenue of $70 million in 1999-2000, $900 million in 2000-2001, $760 million in 2001-2002, and $430 million in 2002-2003.

When the ANTS package of legislation was presented to Parliament in 1999, there was no legislation relating to the common treatment of entities. The Treasurer said that the measures relating to trusts would be deferred and dealt with in the Review of Business Taxation (RBT) conducted by Mr John Ralph.

The ANTS legislation was passed on the votes of the Australian Democrats without an entity taxation measure.

New Business Tax System

The RBT recommended as an entity taxation measure, that trusts be taxed as companies. The RBT presented two sets of estimates for the additional revenue to be derived from this measure.

The first set of estimates were based on the existing company tax rate of 36%. On that basis the measure was expected to produce revenue of $70 million in 1999-2000, $830 million in 2000-2001, $930 million in 2001-2002, $520 million in 2002-2003, $600 million in 2003-2004, and $620 million in 2004-2005.

The second set of estimates were based on the anticipated phasing down of company tax rates to 34% in 2000-2001 and 30% in 2001-2002. On that basis the measure was expected to produce revenue of $70 million in 1999-2000, $730 million in 2000- 2001, $500 million in 2001-2002, $370 million in 2002-2003, $390 million in 2003-2004, and $410 million in 2004-2005.

As had been the case with the ANTS legislation, when the package of legislation for the RBT was presented to Parliament, there was no entity taxation measure to deal with trusts. This was a significant concern to the Opposition in terms of the cost to revenue of the package. There were discussions between the Shadow Treasurer and the Treasurer, and on the 24 November 1999, the Shadow Treasurer wrote to the Treasurer in the following terms:

Dear Treasurer

I am writing to set out some of Labor's concerns in relation to the business tax package and more specifically to inform you of an amendment I intend to move during the debate on the New Business Tax System (Integrity and Other Measures) Bill 1999.

Revenue neutrality

As I indicated in the course of our last two discussions, Labor is willing to pass the business tax package if it pays for itself. Labor will hold the Government to its promise on revenue neutrality. We cannot accept a reduction in business taxation at the expense of individuals and families who will be bearing the brunt of a GST, nor the use of the Budget surplus to fund business tax reforms.

This key criterion is now even more imperative given the announcements yesterday concerning the surcharge on some taxpayers to pay for the increased cost of the GST deal with the Australian Democrats.

Labor believes revenue neutrality can be achieved if the government fully implements the measures announced under Stage 2, as well as those measures in Stage 1 not yet before the Parliament, and if a stronger anti-avoidance measure is put in place to accompany the widening gap between income and capital taxation.

The first element is essentially the fulfilment of the government's commitment on the revenue measures that fund the tax cuts. As you know, many of these measures, particularly those politically sensitive to the government, are not yet before the Parliament.

'Work in progress'

In this context we welcome your announcement of 11 November in relation to the Stage 2 measures as an important step forward. However your release also acknowledges that further work and consultation is still under way on a number of measures. In essence, you are asking Labor to sign-off on what you acknowledge to be 'work-in-progress.'

For example, I note that your release states, in the context of dealing with the alienation of personal services income, that detailed criteria is still to be developed concerning what is a personal services business. Clearly this detail, and the detail of some other areas in this alienation context, will be critical to the revenue effect of the measures. An assessment of how much of a contribution this measure will make to revenue neutrality cannot be made without the fine detail being settled and the final impact known.

There is also considerable uncertainty surrounding the final detail of many of the other measures you announced on November 11. These include:

- *the proposed reduction in the 45 day rule concerning denial of franking credits—there is no firm proposal to replace this rule;*
- *the proposed new uniform capital allowance system—currently the subject of consultations; and*
- *the final design of the entity regime, especially the transitional arrangements.*

Similarly, Labor is favourably disposed to the claimed objective of strengthening the General Anti-Avoidance Rules (GAAR). However, it is not possible to evaluate the proposed new system on the basis of the announcements so far.

In this context I make special reference to the government's recent record on the GAAR in the GST legislation. Following representations from business groups the initially tough draft provisions were significantly weakened. This would not be an acceptable outcome for Labor in respect of the proposed tightening of the GAAR that you have announced for income tax purposes.

There also remains significant and understandable scepticism that the government will deliver on its 1998 promise on taxation of trusts as companies - a further reason we want the detail referred to above made available before we sign-off on the package.

Integrity measure

Addressing revenue leakage through appropriate anti-avoidance measures is obviously part of achieving revenue neutrality, particularly given the greater incentive to tax avoidance with the proposed widening of the gap between CGT and the top marginal tax rate.

The amendment I plan to move to the New Business Tax System legislation (copy attached) seeks to include a specific new clause in the existing GAAR, Part IVA of the Income Tax Assessment act 1936. Such a provision would also be necessary in any rewriting of the GAAR.

You will recall that I raised this matter in the course of our last discussions on business tax reform. While you stated a belief that the announced arrangements were sufficient, you asked me to put forward a proposal to address the matters highlighted.

Any drafting suggestions you might have would of course be welcome.

This new provision is designed specifically to address the increased incentive for tax planning which would arise were your proposed new nominal system of taxing capital gains to be adopted.

The need for these rules has been amply demonstrated in the evidence provided to the senate inquiry, which briefly examined some of your business tax proposals. I am sure you are aware of the testimony provided by some of Australia's leading

tax academics, confirming the risks of revenue leakage contained in your current proposals.

I disagree with the sentiments expressed at page 243 of the Ralph Committee Report which states, in the context of the proposed capital gains tax changes:

"The Review endorses the existing practice of not employing the GAAR where certain taxpayer or market behaviour is an acceptable outcome of the tax law's structure."

This seems to recommend not employing the GAAR to schemes that would exploit tax arbitrage possibilities. Labor does not support such a recommendation.

I was also very disturbed to hear of evidence before the Committee from senior Taxation Office officials that it is "unclear" if the proposed new GAAR would apply to such arrangements. Again, this is totally unacceptable to the Opposition.

Similarly, I am also concerned about the views of some witnesses before the Senate inquiry concerning the possible abuse of the scrip for scrip rollover proposals.

The anti-avoidance measure I have proposed, will not on its own fill the revenue hole that has been highlighted in the Senate's report on the current round of legislation. However, it is a necessary tool to ensure that the revenue is not put at serious risk due to your CGT proposals.

As you will understand from the preceding discussion, Labor is essentially seeking to ensure that the government sticks to all of its commitments on business tax reform.

To summarise, we are seeking:

- *Details on the measures not yet before the Parliament, particularly the revenue raising measures, as a level that allows us to reasonably conclude that their stated intentions will be achieved. This would ideally be in the form of draft legislation.*
- *An absolute and public guarantee that these measures, when the details are known, will be implemented in full.*
- *Support for Labor's proposed integrity measure or some mutually agreed version which achieves the same objective.*

I would be happy to discuss these matters with you in order to progress business tax reform in Australia.

Yours sincerely

SIMON CREAN

After further discussion between the Deputy Leader of the Opposition and the Treasurer, the Treasurer signed the following letter dated 24 November 1999, agreeing to the Deputy Leader's conditions for passage of the legislation:

Dear Mr Crean

Thank you for your letter of 24 November 1999 in which you state that if we can get agreement on three points, the Opposition will pass the Government's business tax reform package.

We agree to the three points.

1. *Details on the measures not yet before Parliament are set out in the attachments.*

   I expect legislation containing measures dealing with alienation of personal services income, and non-commercial losses, will be available early next year. The Government proposes to pass it prior to 30 June 2000. As I have indicated to you, I expect legislation on trusts to be prepared by 30 June next year and legislated in time to apply from 1 July 2001.

2. *The Government will introduce all the business tax changes announced in full.*

3. *I have received advice from the Australian Taxation Office that your proposed integrity measure would not add to the Government's proposed strengthening of Part IVA. Having said that, if it were re-drafted in a workable form, it would not detract from it either. If the Labor Party indicates its agreement to pass the Government legislation in the Senate, the Government would include this clause if you want it. It is your election.*

I am also enclosing copies of the two Bills which will be introduced into the Parliament tomorrow. These Bills provide incentives for investment in venture capital by non-resident tax-exempt super funds, streamline and extend small business CGT rollover relief provisions, provide scrip for scrip rollover relief and remove CGT averaging for individuals.

Since the Government has agreed to your three conditions, I look forward to your written confirmation that the Opposition will vote for the package in full.

Please confirm this as a matter of urgency.

Yours sincerely

PETER COSTELLO

The Deputy Opposition Leader provided the written confirmation the Treasurer had requested in another letter dated 24 November 1999:

Dear Treasurer

Thank you for your letter of 24 November 1999 in which you, on behalf of the government, accept all of the conditions set by Labor for passage of the business tax legislation.

As I spelled out in my letter to you and in the House today, acceptance of these conditions is essential to the achievement of revenue neutrality, the key condition set by Labor for passage of these business tax proposals.

I reiterate that Labor would not have designed the same package as the one before us, and restate our concerns about individual elements of the package outlined in the recent report of the Senate inquiry into the business tax legislation.

Nevertheless, I welcome your personal guarantee that the government will deliver, in full, all the business tax changes announced, recognising that any slippage on these measures in the future could expose the government in terms of its commitment to maintaining the integrity of the tax system.

I also note the detail you have provided on the measures not yet before the Parliament and the significance of your statement in the House that these should be understood to constitute legislative drafting instructions.

Finally, I welcome your offer to bring forward an anti-avoidance measure that fully reflects the intention of the amendment moved by Labor earlier today.

On the basis of these commitments from the government, Labor can support the business tax legislation in the House and the Senate.

When the measures not yet before the Parliament are introduced as legislation, it is important that they include a certification by the Treasury/ATO that the revenue generated by the measures is consistent with the estimates provided in your statement of 11 November.

I look forward to the introduction of a tax package that is both revenue neutral and preserves the integrity of the tax base.

Yours sincerely

SIMON CREAN

The Treasurer produced an exposure draft of entity taxation legislation in October 2000. The exposure draft contained a concept not mentioned in the Treasurer's letter, it provided for different tax treatment for fixed

trusts compared to discretionary trusts. This would undoubtedly have had revenue implications but the exposure draft was not accompanied by an estimate of its effect on revenue.

The exposure draft met with substantial opposition from the National Party and from a number of members of the Liberal Party. On 27 February 2001 the Treasurer issued the following press release announcing that the Government would not proceed with the exposure draft:

ENTITY TAXATION

In October 2000 the Government released exposure draft legislation providing for the taxation of trusts like companies.

Following the release of the exposure draft legislation, the Government received a great number of submissions which raised technical problems particularly in relation to distinguishing the source of different distributions, and valuation and compliance issues that meant that the draft legislation is not workable.

The Government has also taken advice from the Board of Taxation which recommended that the Bill not proceed and suggested looking at alternative approaches.

As a consequence the Government is withdrawing the draft legislation and will not be legislating it. It will begin a new round of consultations on principles which can protect legitimate small business and farming arrangements whilst addressing any tax abuse in the trust area. The Board will be part of consultation.

Claims that the cost to revenue of this decision amount to $1 billion are false. A New Tax System policy statement costed this measure in conjunction with revenue bring forward under PAYG which has already been introduced and on a 36 per cent tax rate. Stripping out PAYG which has been introduced and allowing for a reduced tax rate at 30 per cent (as will apply from 1 July 2001), the cost of this decision in the full financial year 2001-2002 is of the order of $110 million. [Peter Costello, Treasurer, *Entity Taxation, press release, 27 February 2000*]

However, in the Budget that was handed down on 22 May 2001, the Government revealed that:

…the withdrawal of the entity tax exposure draft legislation—in response to concerns raised in public consultations that the existing draft legislation did not strike an appropriate balance between protecting legitimate small business and farming arrangements while addressing tax abuse in the trust area (estimated to cost $1.1 billion over the four years from 2001-02).
[Budget Paper No.1; *Budget Strategy and Outlook, 2001-02; Statement 5—Revenue,* page 5-5]

In his speech responding to the budget at the National Press Club, on the 30th of May 2001, the Shadow Treasurer again offered bipartisan support on measures to address tax abuse using trusts, he said:

Why can't we agree to work together to ensure that everyone pays their fair share of tax? That's the view that drove my thinking on the business tax debate, where we offered and delivered bipartisan support. It would have been the easiest thing in the world to play politics on the issue, but I took the view that we could only achieve a genuine and lasting crackdown on tax avoidance and provide investment certainty for business, if both the government and the alternative government agreed on the measures that had to be taken.

In answer to a question after the speech, asking for elaboration on the Opposition's attitude to dealing with tax abuse using trusts, the Shadow Treasurer said:

We signed an agreement with the Government. And we will honour that agreement…we have honoured that agreement, because we delivered on it and voted for it in the Parliament. Forget all these scare campaigns that people go on with, we voted to lower tax rates, but it's part of the comprehensive package by which we got bipartisan support to crack down on tax avoidance. Why? Because the GST constraint said that whatever we did on business tax had to be revenue neutral. Not just us saying it, the Government adopted that and so did the business community. The most effective way in which you could give relief and pay for it in the revenue neutrality context, was to make people pay their fair share. And we said that we were prepared to sit with the Government and work out the most effective means by which we could crack down on the tax avoidance. We thought that the Treasurer would slither out of his commitments but he's on the record now as having written the letter to me saying that they would deliver them in full. He hasn't delivered them in full. But I note he still says he intends to introduce them. I think the question of trusts and the crackdown of them can only be done in bipartisan way. And that's why I was prepared to offer that support from Opposition to the Government to meet it. It may be in the circumstances that genuine people do get hurt. That's why we offered when we saw the Treasurer slithering away from this commitment, we offered to actually sit down and protect the genuine farms and small businesses that were going to be hurt. Did we get a response from the Treasurer? No. Was not even prepared to sit down with us and talk the issue through. So I still think bipartisanship is necessary and I don't think this can be done without bipartisan support. But we do know that this Government in Government has signed up to an agreement and we would like to test that in Government. And I note also that the Treasurer still has the intention to introduce this legislation down the track, only not just now. So we will deal with this issue in the way I've outlined in the speech. It can only be implemented in a bipartisan way and we will offer that bipartisanship to the

Opposition were we to become the Government. We would also sit down with the interested stakeholders to make sure that genuine cases were properly accounted for.

Official Estimates of the Revenue Available from Taxation of Trusts

Since the ATO identified that there was a major issue with HWIs using trusts to reduce their tax burden, the ATO and Treasury have made a number of estimates of the revenue involved.

In January 1996, the ATO's first estimate based on an analysis of 100 wealthy individuals alone was $500 million. This was subsequently increased verbally to $800 million by Treasury in the same month and confirmed by Treasury in writing in February 1996. That advice suggested that if prompt action had been taken it would have been possible to obtain a small amount of additional revenue in 1996-97 and the first full year effect in 1997-98.

After the 1996 change of government, no legislative changes were made but the HWI Taskforce was set up in May 1996 with an expectation that it would increase revenue by $100 million per year.

No proposals for legislative action were forthcoming until August 1998, when the Coalition Government needed additional revenue to fund tax cuts as part of its New Tax System package of proposals. At that time the ANTS document revealed that there was still a major revenue issue with the tax treatment of trusts that needed to be addressed by legislation, and it remained a similar dimension to the problem identified by the ATO almost three years before.

The Review of Business Taxation, released in July 1999, revealed that the revenue available from taxing trusts as companies was still of that order of magnitude.

Official Estimates of Revenue Available from Trusts with Entity Taxation Measures

	99/00	00/01	01/02	02/03	03/04	04/05
Original ANTS 1998	$70m	$900m	$760m	$430m		
Ralph Report 1999—36% company rate	$70m	$830m	$930m	$520m	$600m	$620m
Ralph Report 1999—reducing 36/34/30% company tax rate	$70m	$730m	$500m	$370m	$390m	$410m

[*Tax Reform: not a new tax, a new tax system,* August 1998; *Review of Business Taxation* July 1999]

When the Treasurer abandoned his entity tax exposure draft legislation measures on 27 February 2001, he said; *"…the cost of this decision in the full financial year 2001-2002 is of the order of $110 million."* [Peter Costello, Treasurer, *Entity Taxation*, Press Release, 27 February 2001]

However, in the Budget handed down on 22 May 2001, it was revealed that the cost of this measure was estimated at $1.1 billion over the four years from 2001-02.

Comment

When the Government needed funds to pay for tax cuts, it was prepared to accept the official estimates of the revenue that would be forthcoming from entity taxation measures. However, having obtained the political benefit from providing those tax cuts, and now having failed to legislate for the promised measures to pay for those tax cuts, the Treasurer tried to have the public believe that the cost of failing to pass that legislation was only $110 million. That was not a credible estimate of the cost to revenue. The 2001 Budget papers subsequently revealed another estimate of the cost to revenue of $1.1 billion over four years.

Trusts—the Most Significant Area of Tax Planning by HWIs

The Auditor-General set out what the HWI Taskforce had found to be the main area of tax planning activity:

On the basis of evidence gathered by the Taskforce to date, the Taskforce considers that the most significant systemic generators of tax planning by HWIs are the use of trusts and related party or intragroup transactions. The ATO expects that the Government's proposed business tax reforms, including the taxation of trusts through the new entity tax system will address the major deficiencies in the current tax system. [ANAO Report No.46, 1999-2000, page 58]

During the JCPAA public hearing on Audit Report no 46, *High Wealth Individuals Taskforce,* Mr Cox asked: *"Can you confirm that this is the ATO's view?"*

Mr Fitzpatrick (ATO)—*The ATO expects that some of the tax planning arrangements of some high wealth individuals will be addressed by the proposed reforms to the taxation of trusts and also by the proposed reforms - or, in some cases, already enacted reforms - to intragroup arrangements involving losses. The parliament has already enacted some measures concerning the creation and duplication of losses. In our view, those so-called integrity measures will have an impact on the arrangements entered into by taxpayers, including some high*

wealth individuals. The proposed consolidation regime is another foreshadowed reform which, in our view, will have some impact on the tax planning arrangements we have identified.

Mr Cox—*But the new entity tax system has not been legislated yet, has it?*

Mr Fitzpatrick—*No, that is correct. I think the draft legislation is presently out for consultation, and the government has announced the proposed reform of the taxation of trusts from 1 July next year.* [Transcript, 3 November 2000, page 92]

Size and complexity

The Auditor-General noted that the HWI Taskforce has 500 individuals on its list, including some individuals considered to be emerging or potential HWIs. To the end of March 2000, the Taskforce had examined 236 HWIs in depth and found that for 1997-98, the latest year for which a full set of tax assessments was available:

- These 236 HWIs were associated with a total of 7771 entities, including some 2171 trusts (comprising 1116 discretionary trusts, 667 fixed trusts, 31 charitable trusts and 357 where the trust type was unknown);
- 71 of these HWIs were associated with 10 or more trusts;
- on average, each of these 236 HWIs was associated with some 33 entities, including 22 companies, nine trusts and one partnership;
- average group total assets for these HWIs were over $270 million; average group net assets were over $110 million;
- on average, in the 1997-98 year the total tax paid by each HWI and the associated group of entities was $1.475 million;
- 60 per cent of these HWIs returned taxable income of less than $198 000 each in the 1997-98 financial year;
- 60 per cent of these HWIs each paid less than $40 800 tax in the 1997-98 year;
- average tax paid as a percentage of HWI taxable income was 20 per cent;
- average tax paid by these HWIs has increased by 36 per cent from 1995 to 1998;
- 60 per cent of the groups of entities associated with these HWIs paid less than $530 000 in tax for the group in the 1997-98 year;
- average tax paid as a percentage of group net income was 13 per cent;
- average tax paid by the groups of entities associated with these HWIs has increased by nearly 49 per cent from 1995 to 1998; and

- as at 30 June 1998, the total carried forward losses of these 236 HWI groups was $2.7 billion, comprising $1.7 billion in revenue losses and $1 billion in capital losses.

Revenue at Risk

On the issue of the amount of revenue at risk, the Auditor-General said:

"When the present Government came to office in 1996, it was advised by the Treasury and the ATO of the potential impact on revenue of continuation of the tax planning and minimisation practices utilised by some HWI taxpayers. A figure of $800 million per year, as had been disclosed by the previous Government, for revenue potentially at risk through HWI's application of tax planning practices, had been derived as an order of magnitude estimate arising from the ATO's initial investigation of the HWI taxpayer population mentioned at paragraph 1.2." (This appears to refer to the same advice given to the previous government.)

"Advice to the incoming Government was that $800 million did not represent additional revenue that could be gained from HWI taxpayers solely through application of compliance action by the ATO. The Treasury and the ATO advised the Government that the figure of $800 million should be seen as revenue potentially at risk of being lost if no legislative action was taken against the range of tax planning and minimisation practices employed by some HWIs." [ANAO paras. 1.8, 1.9; page 19]

At the public hearing, Mr Cox asked the ANAO: *"Did the Audit Office make an independent assessment of the revenue being lost or at risk from the activities of high wealth individuals?'*

Mr White (ANAO)—*No, we did not.*

Mr Cox—*Did you look at the advice to the previous government about the $800 million and did you find any reason to dispute that advice?*

Mr Roe (ATO)—*Yes, we looked at the advice that was provided, and no, there was not anything to suggest that it was different from the way we reported.* [Transcript, 3 November 2000, pages 90 and 91]

At the same public hearing, Mr Kelvin Thomson asked the ATO: *"It is a highly relevant question as to what has become of the $800 million and the $700 million gap between what was said at the start of 1996 and what was subsequently reported as to whether the measures that are outlined here and to which you have referred have been able to generate or save the $700 million. So my query is: do you have some feel for that?"*

Mr Fitzpatrick (ATO)—*Certainly the measures outlined here, and I have referred to previously, will have an impact on the revenue which we estimated to be at risk in respect of some high wealth individuals arrangements. From our experience it is clear that some of those taxpayers will look for other opportunities on an ongoing basis. We need to be alert to those as best we can to address whatever new opportunities arise, and that is certainly a clear focus of our intention at the moment.*

Mr Thomson—*It is not particularly satisfying to me for you to respond that it will have an impact and for me or others not to be able to get any feel for the quantum of the impact, the dimension of it, whether it goes to the $700 million gap or it does not. I might direct the same question to Mr White from the ANAO in terms of the Audit Office investigation of this area, whether you then get from this some suggestion as to whether these legislative measures have been effective in recovering the $800 million or whether they have not.*

Mr White (ANAO)—*Our report in discussing the $800 million makes it clear from the information we saw from the Tax Office that the $800 million is an order of magnitude estimate of revenue that could be gained from both audit activity but also from various legislative changes if they were to occur. What we did as part of—*

Mr Cox—*Whether it occurred in the last five years, yes.*

Mr White (ANAO)—*What we did as part of the audit was to specifically look at the direct and indirect revenue measures that the government required for the additional funding, the outcomes, and we reported back on that. We commented in the audit report that the Taskforce had contributed to various legislative changes. We were unable to quantify a financial amount in terms of the legislative changes, the impact thereof. I think it would be a fairly difficult thing to do.*

Mr Thomson—*Nevertheless, one of considerable public interest as to whether the $800 million has been addressed or whether it has disappeared and the high wealth individuals are still not paying their fair share of tax. In the legislative changes which are proposed here, there is the reference to entity taxation and, as David Cox mentioned, this legislation has not yet been passed. It stands to reason, doesn't it, that the delay in entity taxation must be costing the revenue money, given that it is identified as a way of addressing tax avoidance.*

Mr Fitzpatrick (ATO)—*To the extent to which high wealth individuals or other taxpayers use trusts to minimise tax, that would be correct.* [Transcript, 3 November 2000, pages 98–99]

Advice to Government by HWI Taskforce

On this issue, Mr Cox asked the ANAO at the public hearing: *"Did the Audit Office look at the specific advice that the Taskforce had given to the government in relation to the need for tax reform and legislative change?"*

Mr Roe (ANAO)—*We looked at a number of submissions that were made by the Taskforce which were then coordinated through the tax office to Treasury. We did not itemise those and check them against changes that were made. But, yes, we saw evidence of advice that was being provided on an ongoing basis.*

Mr Cox—*And it was a substantial volume of advice?*

Mr Roe (ANAO)—*It was.* [Transcript, 3 November 2000, page 91]

Mr Cox then asked the ATO whether it had given advice about the need for changes to legislation in areas where it had had to resort to use of the general anti-avoidance provisions.

Mr Fitzpatrick (ATO) responded: *"We have advised the government, as is noted in the report and in our annual report, on areas of the law where we believe that people are able to minimise tax—some quite legally, certainly. We have attempted to identify the systemic drivers of tax planning, looking for systemic approaches to addressing some of these practices through legislative change—not piecemeal, ad hoc changes to the law. That is not, in my view, the way to go in order to develop a more certain tax code which is more understandable for taxpayers generally. We have looked at the tax planning practices over the period of time and, as the Auditor-General's report notes, at the systemic areas of weaknesses in the law and provided advice accordingly. It is for government and the Parliament to decide whether it wishes to change the law to remedy what we see as areas where taxpayers are able to minimise tax - as I said, some quite legally.*

Mr Cox—*At the moment there are a number of outstanding areas where you have submitted advice to government and it has not been acted on yet?*

Mr Fitzpatrick (ATO)—*We have provided advice to government over a period of time. The Government has announced changes to law and the Parliament has passed changes to law in respect of some of that advice. It has foreshadowed reforms arising out of the Ralph Review of business tax. Some of those measures have been enacted. I mentioned before those loss integrity measures in particular. Others have been foreshadowed by government.*

Mr Cox—*Or deferred.*

CHAIRMAN—*Has it ever been any different from that?*

Mr Fitzpatrick (ATO)—*In general terms, no.*

Mr Cox—*the issue is whether there is a significant volume of advice going from the tax office to the government that the government is choosing not to pursue, and whether a substantial amount of revenue is being put at risk or remains in jeopardy because of that lack of action.*

CHAIRMAN—*May I suggest you ask the Treasurer that.* [Transcript, 3 November 2000, page 95]

Comment

The ANAO found that there was significant revenue at risk, of an order of magnitude of around $800 million, as a result of the tax planning arrangements of HWIs. Addressing that issue requires legislation as well as audit activity by the ATO. Legislation needs to address the systemic drivers of unacceptable tax planning arrangements, entity taxation measures for trusts have clearly been identified as a major area for urgent attention. The ATO has provided a large amount of advice on possible legislative action over a long period. Some major pieces of legislation identified as necessary to address these issue, have still not been put before the Parliament. After more than five years of inaction revenue previously considered potentially at risk is being lost.

Recommendation

We recommend that:

1. The Government recognise the necessity for bipartisan support for measures to deal with tax abuse in the trust area;
2. The Government open discussions with the Opposition on measures to address tax abuse in the trust area which protect legitimate small business and farming arrangements; and
3. The Government honour the Treasurer's agreement of 24 November 1999 to legislate to address any tax abuse in the trust area.

David Cox
Julia Gillard
Kelvin Thomson

7 August 2001

A

Appendix A — Conduct of the Committee's review

Selection of audit reports

The Auditor-General presented sixteen reports in the fourth quarter of 1999-2000. These were:

- Audit Report No. 37 Performance Audit
  Defence Estate Project Delivery
- Audit Report No. 38 Performance Audit
  Coastwatch
- Audit Report No. 39 Performance Audit
  Coordination of Export Development and Promotion Activities Across Commonwealth Agencies
- Audit Report No. 40 Performance Audit
  Tactical Fighter Operations
- Audit Report No. 41 Performance Audit
  Commonwealth Emergency Management Arrangements
- Audit Report No. 42 Performance Audit
  Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations
- Audit Report No. 43 Performance Audit
  Planning and Monitoring for Cost Effective Service Delivery—Staffing and Funding Arrangements

- Audit Report No. 44 Performance Audit
  Management of Job Network Contracts
- Audit Report No. 45 Performance Audit
  Commonwealth Foreign Exchange Risk Management Practices
- Audit Report No. 46 Performance Audit
  High Wealth Individuals Taskforce
- Audit Report No. 47 Performance Audit
  Survey of Fraud Control Arrangements in APS Agencies
- Audit Report No. 48 Performance Audit
  Follow-up audit of the Department of Education, Training and Youth Affairs (DETYA) International Services
- Audit Report No. 49 Performance Audit
  Indigenous Land Corporation—operations and performance
- Audit Report No. 50 Performance Audit
  Management Audit Branch—Follow-up
- Audit Report No. 51 Performance Audit
  Program Management in the Training and Youth Division of the Department of Education, Training and Youth Affairs
- Audit Report No. 52 Financial Statement Audit
  Control Structures as Part of the Audits of Financial Statements of Major Commonwealth Agencies for the Period Ended 30 June 2000

The Joint Committee of Public Accounts and Audit discussed the above audit reports and considered whether the issues and findings in the reports warranted further examination at a public hearing. In making this assessment the Committee considered, in relation to each audit report:

- the significance of the program or issues canvassed in the audit report;
- the significance of the audit findings;
- the response of the audited agencies, as detailed in each audit report, and
- the extent of any public interest in the audit report.

Following this consideration, the Committee decided to take evidence at public hearings on the following audit reports:

- Audit Report No. 40 Performance Audit
  Tactical Fighter Operations

- Audit Report No. 42 Performance Audit
  Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementations; and
- Audit Report No. 46 Performance Audit
  High Wealth Individuals Taskforce.

The evidence

The Committee held public hearings in Canberra on 3 November 2000. The transcript of evidence taken at the hearings is reproduced at Appendix D.

B

Appendix B — Submissions & Exhibits

Submissions

No.	Individual/Organisation
1	Dr Carlo Kopp, Defence Analyst
2	Department of Health and Aged Care and Health Insurance Commission
2a	Department of Health and Aged Care
3	Department of Defence
4	Department of Health and Aged Care
5	Health Insurance Commission
6	Australian Taxation Office
7	The Treasury
8	Dr Carlo Kopp, Defence Analyst
9	Health Insurance Commission
10	Department of Health and Aged Care
11	Department of Health and Aged Care
12	Department of Defence
13	Department of Health and Aged Care

Exhibits

No.	Individual/Organisation and Title
1.	Department of Health and Aged Care, Blandford, J (Chair), *Report of the Review of Magnetic Resonance Imaging*, March 2000
2.	Department of Defence, Brigadier G Yacoub, *'Minute -Army individual readiness notice (AIRN) - rewrite of DI (A) PERS 135-2'*, May 2000

C

Appendix C — Correspondence

Correspondence relevant to Audit Report No.46, 1999-2000, High Wealth Individuals Task Force

Telephone: (02) 6163 3774
Facsimile: (02) 6263 3360

THE TREASURY

Executive Director
The Treasury
Langton Crescent
PARKES ACT 2600

7 January, 2001
File:

Margot Kerley
Secretary
Joint Committee of Public Accounts and Audit
Parliament House
Canberra ACT 2600

Dear Ms Kerley

Thank you for your letter of 20 November 2000 to the Secretary concerning the Joint Committee of Public Accounts and Audit public hearing on 3 November dealing with, amongst other things, the Auditor-General's Report No 46 of 2000-2001, *High Wealth Individuals Taskforce.*

In your letter you note that the Vice-Chairman (Mr David Cox MP) made a request for information relating to Treasury advice to the previous government concerning high wealth individuals. My officers have examined the record of the hearing and the Vice-Chairman's request for advice given to a previous government as quoted in your letter is not immediately apparent.
However, the Committee would be aware that advice provided to governments (both current and previous) by their departments is confidential in order to facilitate an effective advising relationship. Treasury considers that maintaining this confidentiality is in the public interest and is critical for the maintenance of good government.

If you have any queries please contact Mr Rob Heferen on 6263 4489.

Yours sincerely

G.J. Smith
Executive Director
Budget Group
The Treasury

PARLIAMENT OF AUSTRALIA **HOUSE OF REPRESENTATIVES**

DAVID COX MHR

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28 February 2001

Mr Bob Charles MP
Chairman
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Bob

On January 17, 2001 the Treasury responded to a letter from the Secretary of the Committee requesting that it provide certain advice to the previous government in relation to the taxation of high wealth individuals.

Treasury declined on two grounds:

1. The request had not been made during the formal hearing; and
2. Treasury's belief that confidentiality is necessary for it to maintain an effective advising relationship.

Treasury's first argument defies the longstanding practice of the JCPAA to make requests outside of formal hearings for information in relation to inquiries.

In relation to Treasury's second point, I have spoken to the previous Treasurer who would be pleased to give Treasury permission to release the documents to the JCPAA. It is worth noting in this regard that the documents are not Cabinet documents.

I would like to request that the Committee advise Treasury accordingly and request that the documents now be provided.

Yours sincerely

David Cox
Deputy Chair

D

Appendix D — Transcript of evidence